

Record of Meeting
Federal Advisory Council and Board of Governors
Thursday, September 5, 2024

Item 1: Economic Activity

Are Council members seeing any signs that consumers' willingness or capacity to spend has been changing of late? In what ways? Are businesses reporting significant changes in their sales volumes, investments, or hiring? If so, are these changes in any particular sectors, product categories, or consumer segments? What is the Council's prognosis for the pace of spending by consumers and businesses through this year and next?

Consumer spending growth is slowing but remained solid. As the labor market cools, smaller job and wage gains are weighing on spending growth. High interest rates are also a drag on spending growth. Much of the slowing is taking place among lower- and middle-income consumers, who have been hit harder by inflation and are benefitting less than those with higher incomes from rising home values and equity prices. Consumers are cutting back on discretionary spending, particularly for services. Most Council members noted heightened price sensitivity among consumers. Higher-income households are generally holding up better but are turning away to some extent from more expensive brands. Consumer credit quality—which improved during the pandemic—has normalized, especially for lower- and middle-income households, but remains good. Consumer confidence survey results have not yet recovered to pre-pandemic levels, as uncertainty regarding inflation and the health of the economy remains elevated.

Conditions for commercial borrowers have softened after a few years of strong growth post-pandemic. The slowing is most pronounced in interest-rate-sensitive industries such as business investment goods, energy exploration and development, and housing-related industries. Manufacturing activity is generally flat. Capex growth remains muted across a number of industries, and surveys of capex plans remain low. In addition, the Institute for Supply Management (ISM) manufacturing index has been in contraction (below 50) since late 2022, while the non-manufacturing ISM index has consistently been in expansion. Consumer industries are holding up better, particularly for consumer staples. Business services—especially tech services—are also doing well. Hiring has slowed, but layoffs remain low.

Corporate earnings are showing the extent to which elevated inflation in 2021 and 2022 artificially propped up profit growth. As inflation has decelerated in recent quarters, earnings growth has been weak on a year-over-year basis. Earnings growth continued to disappoint in the second quarter. While many companies beat consensus expectations, the level of upside surprise was among the weakest since the pandemic. The S&P 500 posted headline growth of 11.5 percent, but growth was below 7 percent when the mega cap Magnificent 7 stocks are excluded. Revisions for the third quarter are also falling rapidly. Council members also noted the emergence of “winners and losers” in specific industries, something that was artificially suppressed during COVID-19.

Economic activity is expected to increase at a modest pace through the rest of 2024 and into 2025, and no Council members mentioned a near-term recession. High interest rates will remain a drag, although easing monetary policy is expected to provide support to the economy in 2025. The labor market is expected to remain solid, with moderate job growth and wages rising more quickly than inflation. The solid good labor market is expected to drive continued gains in consumer spending. In the near term, inflation is expected to further ease toward the Federal Reserve's 2 percent objective.

Item 2: Housing

What changes has the Council seen in the housing market, including changes in house prices, over the past year? How is the current level of interest rates influencing house prices? Are there signs of additional supply coming onboard? Are construction loan requests increasing or decreasing?

Although increases in housing prices have begun to show signs of slowing, affordability remains a significant challenge in all Districts due to a historic lack of supply of single-family homes. While demand-supply imbalances show some signs of abatement in markets in the Southeast and Southwest—both of which experienced comparatively high rates of construction over the past several years—more congested markets in the Northeast and the upper Midwest with less buildable land are experiencing acute housing inventory shortages, exacerbated by local regulatory constraint on, and community opposition to, new construction.

Council members reported that interest rates are having more of an impact on the supply of housing rather than on the demand. With 60 percent of existing U.S. real estate mortgages at rates less than 4 percent, and about 80 percent at rates less than 5 percent, a “lock in” effect is impeding normal resale, relocation, and refinance activity. As a result, home equity volumes are strong, as homeowners opt for renovations and additions to their existing homes, while preserving the existing rate on their mortgage. However, there does seem to be some demand elasticity when mortgage rates fall below 7 percent. Interest rates are most challenging for first-time buyers and low- to moderate-income households, but this is more of a function of rising home prices due to (1) record-low inventories and (2) competition from cash buyers for the relatively low number of houses available for sale. The substantial increase in property insurance premiums represents another headwind to housing supply and affordability.

Despite some increase in the supply of new homes, new housing permits have been on the decline because of higher interest rates, economic uncertainty, and elevated construction costs. There has also been a decline in construction requests in most areas, exacerbated by increased caution by lenders regarding speculative development. To help address housing affordability, builders continue to offer to pay closing costs and provide other buyer incentives such as price reductions and rate buy-downs. To keep costs down, builders are also constructing smaller floor plans and developing offering new communities farther from major metropolitan areas where lots are cheaper.

Due to the lack of inventory of single-family homes, the multi-family market remains strong, especially in the Northeast, as declining affordability pushes potential homebuyers to less expensive rental options. However, multi-family asset performance has slowed due to (1) inflationary pressures driving property expenses higher, (2) increased financing costs, and (3) an extended expansion in supply levels moderating rent increases. While conditions vary by market, most areas will likely see positive, but below-average, growth through 2024 and into 2025 as new supply is absorbed, with greater weakness anticipated in the Sunbelt’s more saturated markets. Overall, there has been little improvement in the supply of affordable housing due to higher operating expenses and continued non-paying tenancy, although the latter issue is diminishing as a result of expiring COVID-era eviction moratoria. Some Districts also reported funding gaps resulting from a decline in tax credit equity as higher interest rates decrease the ability of investors to pay for credits.

Item 3: Loan Markets

What is the Council's current assessment of supply and demand conditions in loan markets? Are Council members seeing any noteworthy developments in various lending categories, such as commercial real estate, residential real estate, consumer, small and medium-size business, or corporate?

Supply – Council members observed that the supply of credit is currently higher than the demand for it. Banks have been focused on building capital and are better positioned to provide credit; however, banks

remain cautious in their lending, focusing more on existing customers rather than aggressively pursuing market share. Nevertheless, the pace of additional bank credit tightening has moderated, with longer-term interest rates declining, continued growth in consumer and business spending, and financial markets anticipating imminent rate cuts from the Federal Reserve. Loan growth showed an upward trend in the second quarter of 2024, with both large and small banks experiencing modest increases in total loans. Even with intense competition for new loan opportunities, banks are largely maintaining their credit standards and pricing discipline, ensuring that appropriate returns are achieved despite the competitive environment. Banks are generally comfortable with their current credit risk exposures after increasing reserves in anticipation of higher credit losses, although banks with high concentrations in office commercial real estate (CRE) loans are facing challenges due to declining collateral values.

Demand – Total loan demand is not as robust as in prior years, as some customers continue to wait for lower rates, and others are cautious about economic activity and hesitant to invest unless the investment is very strategic. Businesses that cater to wealthier segments are still seeking growth, as their customer activity remains solid. Meanwhile, businesses whose customers are principally lower income are experiencing some softness. Still, aggregate loan demand appears steady for small and medium-sized businesses—just not as robust as in prior years. Over the past quarter, some Council members began to see increased demand, particularly in CRE, as there is a growing belief among borrowers that (1) interest rates will not increase any further and (2) rate cuts are increasingly likely. Agricultural lending is facing challenges due to weak commodity prices and higher operational costs. Agricultural borrowers are approaching their maximum credit lines a few months earlier in the year than normal.

Commercial real estate – Loan demand for CRE varied significantly across different regions. Urban markets have remained stable, and other areas—such as the Pacific Northwest—have experienced lenders pulling back due to concentration issues. The CRE sector faces challenges primarily due to elevated interest rates and inflationary pressures, which are affecting valuation, financing costs, and expenses, although these pressures are slowly easing. While some CRE segments such as retail, industrial, and data centers remain relatively active, others, such as office and multifamily, show signs of softness due to structural issues, higher interest rates, and muted investor activity. Demand for large CRE projects has been subdued as investors remain hesitant to meet the heightened cash equity requirements needed to make the projects economically feasible. There is an overall cautious outlook for the office market segment, which continued to experience significant stress. Valuations are down from pre-pandemic levels, and the lending appetite in this segment is limited.

Residential real estate – Loan demand remained slow, primarily due to a combination of low housing supply and elevated interest rates, although a slight increase in activity followed recent rate decreases. Residential mortgage activity continued to be light, but there is a growing trend of competitors pricing in anticipated rate cuts, leading to more mortgage rates in the mid-6 percent range being offered, down from the mid-7 percent range earlier in the year. Mortgage refinance activity is accelerating as rates decline, while mortgage loan purchase demand is falling at a slower pace, and mortgage delinquency rates remain low. To preserve liquidity and capital, banks are retracting from the buyer market for residential loans, as loan packages are being priced low, and banks are receiving even lower bids due to concerns about prepayment risk. Housing prices remain high while inventories are extremely low. Closed loan volumes remained flat, and future interest rate reductions may have only a limited impact on future volumes until inventory levels increase.

Consumer – Banks continued to tighten credit standards for credit cards and other consumer loans, although demand for these forms of credit has grown modestly. Credit card balances are at pre-pandemic levels, and delinquency rates have stabilized. Consumer loan requests, especially for home equity products, remain strong, driven by debt consolidation, bridge financing, and home improvements—despite the challenges posed by rising material and labor costs.

Small and medium business (SMB) – Lending remained stable, but competition was intense, particularly for high-quality borrowers, with pricing, structure, and terms being aggressively negotiated. Loan demand remained soft due to the continued elevated interest rate environment and broader economic concerns, leading to cautious borrowing behavior. Line utilization is significantly lower than pre-pandemic levels and has remained flat throughout 2024, with potential increases expected if rates decrease or the economy slows further. Medium-sized companies are strategically accessing the loan market to refinance existing debt, finance merger and acquisition (M&A) activities, and make capital expenditures, while showing overall discipline in their financial management. SMBs operating with variable rate loans and lines of credit are experiencing increased monthly payments, adding stress to their free cash flow and overall financial stability.

Corporate – Corporate lending remained modest, leading to heightened competition among banks, which has resulted in tighter spreads and extended maturities for corporate loans. Corporate clients are cautious with renewal activity, often opting to wait for better market conditions due to concerns about the depth and appetite within the bank market. Banks with limited relationship depth and ancillary business are not participating in renewals, reflecting a more selective approach in the current lending environment. M&A activity continued to be down, with most of the transactions occurring primarily among larger, high-grade borrowers, indicating a more conservative market posture. If benchmark rates decrease, corporate borrowers may rotate out of bank debt and back into capital markets, potentially leading to decreased loan funding for banks in the second half of 2024.

Item #4 Inflation

Have Council members observed any recent patterns or trends in businesses' pricing power or pricing behavior? How do Council members foresee businesses approaching pricing decisions through this year and next?

Since the Council's last meeting, pricing power continued to deteriorate, and businesses' margins continued to be under pressure. According to national surveys and feedback from Council members' customers, the number of business owners increasing prices has decreased in recent months and so has the number planning to increase prices. The past several years of inflation have taken their toll on consumers, who have become more price sensitive. While, overall, consumers remain healthy, their spending appears to be slowing down. Customers look to be more cautious with their purchases, buying only essentials, shopping around for the best deals, and, in some cases, trading down. Overall, consumers are still spending, but they are starting to prioritize their discretionary spend. Council members continue to see evidence that companies are responding to these trends by pursuing expense control strategies focused on lower investment and headcount, where possible.

Although the Federal Reserve has made considerable progress toward its 2 percent inflation goal, inflation remains a top concern for businesses and business owners. While it's true that supply chains have largely normalized and that wage growth has been moderating toward a more sustainable rate, margins are being squeezed because of the cumulative effect of wage pressure over the years and the inability to continue to increase prices. Pricing pressure appears to be affecting smaller and medium-sized businesses more on the margin, whereas larger corporate clients are experiencing a little more stability. Additionally, depending on industry and region, trends diverge when it comes to the ability to dictate pricing. Manufacturers of commodity products are generally seeing more downward pressure on pricing relative to service businesses. While slowing, there continues to be some strength in consumer discretionary and non-discretionary sectors overall, highlighting the resilience of the consumer. On the other hand, industries that have experienced weakness include airlines, chemicals, building materials, and autos. Prices in these industries continue to normalize lower. Council members noted that in areas where there is significant construction activity driven by government-funded projects, contractors have been able to achieve higher pricing.

Businesses have responded by focusing on expense management and operational efficiency, and by adopting strategies to protect their profit margins. On the expense side, Council members expect businesses to continue to delay large capital expenditures to the extent they can afford to do so while also rationalizing their labor force. On the income side, expectations are for businesses to continue to be more marginal-dollar—as opposed to revenue-dollar—focused. Looking forward, while progress in bringing down the rate of inflation is encouraging, there is still concern about the lasting impact of wage inflation on long-term margins. Additionally, Council members pointed out some obstacles that could slow the pace of cooling inflation, including an increase in government spending; global macroeconomic uncertainty, and the related impact on oil and gas production; an increase in freight and shipping costs; and the cost of insurance.

Item #5: Federal Reserve Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

Council members support a reduction in the policy rate in September. This is based on the improved outlook for inflation and the softening labor market. After a brief reacceleration in Q1, inflation appears to be continuing toward the Federal Reserve's 2 percent objective. Council members view the actions to date on monetary policy, portfolio activities, and consistent communication around these activities to be appropriate and supportive of guiding the economy to a soft landing.

Council members had mixed views regarding further rate reductions after September. GDP growth remains positive, the labor market is healthy, but slowing, and inflation is moving much closer to the desired goal. Balancing a continued healthy economy with a weakening labor market led to a variety of views on the magnitude and timing of future rate cuts. Additional data would be needed to gain a broader consensus. Ultimately, the depth and duration of any additional weakening in the labor market and broader economy would determine the trajectory and the endpoint of monetary policy easing.

Efforts by the FOMC to reduce the size of its balance sheet (i.e., quantitative tightening (QT)) have been necessary in a normalizing, post-pandemic economy. Reducing the size of the Fed's balance sheet has meaningful implications for banking system liquidity. Year-to-date, the reverse repurchase facility (RRP) usage has borne the brunt of the reduction in the balance sheet size, which has helped keep reserves stable at an ample level in the banking system. However, ongoing QT will impact reserves more proportionately the closer RRP utilization gets to zero. Council members believe (1) reserves in the banking system remain ample for now and (2) that it would be helpful for the Federal Reserve to communicate to markets the preconditions necessary for the Federal Reserve to end QT.

Item #6: Cloud Adoption

What issues are top of mind for Council members in connection with cloud adoption? Do Council members have a view on the functions within their banks that could most benefit from cloud capabilities? What are some of the challenges with implementing an effective risk management framework for cloud?

Council members agree that cloud-based solutions—both public cloud and software as a service (SaaS) providers—can offer greater operational efficiency, quicker time-to-market, lower costs, improved scalability, and robust business resiliency. Cloud enables the modernization of almost all work functions, enabling more efficient allocation of resources, better risk management, and greater resiliency. Moreover, cloud solutions bring equity to banking institutions, as availability of modern and modular technologies, at scale, allows for smaller organizations to adopt the latest technologies that historically only the largest banks could afford. However, there are risks associated with moving to the cloud, including the following:

- **Security** – Adoption of cloud capabilities shifts the security perimeter from legacy on-premises controls to identity and authorization cyber protections. Technology changes, especially cloud adoption, require an informed and engaged management discussion on how change may introduce incremental risk, including potential disruption due to outages and cyber-attacks. Reliance on cloud service providers can increase the risk of a single point of failure in the event of an outage or a cyber-attack. Also, it is critical for banks to understand their security responsibilities between the cloud provider and the bank. Providers rely heavily on the “shared responsibility” model, where the provider owns the security of the cloud platform itself, and banks own the security of their applications running on the cloud.
- **Cost** – With movement to the cloud, IT spend migrates from a capital expenditure to an operating expenditure leveraging consumption-based models. Public cloud utilization is akin to renting rather than owning, with a monthly bill that could fluctuate upward quickly without adequate controls in place, and with no benefit of depreciation.
- **Talent** – Cloud expertise within the financial sector and with regulatory knowledge is difficult to recruit and retain. Banks must address skill gaps as part of their change management process through training and hiring to ensure successful cloud adoption.
- **Complexity risk** – There are inherent challenges in migrating to the cloud, especially considering the complexity of legacy technology environments that will be replaced or integrated with. There is also an ongoing debate on whether to have a single provider as opposed to multiple providers for public cloud. Multiple providers diversify concentration risk, require banks to retain internal skills to build and run technology on their own, and protect the banks’ competitive core competencies with less dependency on third parties. However, providers fiercely compete to differentiate their services, which increases the complexity of making the services interoperable.

Collectively, Council members do not think of cloud adoption on a function-by-function basis, as they believe most services can benefit from leveraging some part of existing or emerging cloud capabilities. Instead of taking a function-by-function view, banks are prioritizing applications and data based on the business value to migrate to public cloud. Cloud adoption strategies that focus on modernizing applications to leverage cloud native serverless capabilities offer greater business value when compared to more traditional Infrastructure as a Service (IaaS) solutions. This provides greater flexibility, scaling, and less management overhead, resulting in much more efficient use of cloud resources and lower total cost to the organization. Examples include online and mobile banking channels to support volume growth and resiliency, a high-performance computing grid to improve the speed and coverage of market risk calculations, and a data science platform to train and deploy artificial intelligence/machine learning (AI/ML) models against large and varying data sets for use cases such as fraud detection, client recommendations, or security event monitoring. Public cloud enables business benefits for these applications with access to infrastructure on demand at a reasonable cost together with significant R&D investment by the cloud providers in new features that would be both cost and time prohibitive to build internally.

Implementing an effective risk management framework for cloud presents challenges for banks as it introduces new risks related to third parties, cyber, and data privacy. Notably, information about cloud providers (including SaaS) is limited. Specific details on cyber controls, edge controls, AI usage, and privacy practices are often lacking. It is the responsibility of the banks to ensure their third-party vendors adhere to industry regulations and standards such as those of the FFIEC, and cloud providers are still catching up with the transparency typically expected by banks. As noted earlier, cyber risk management is more complex as banks must define requirements by criticality of applications across geographic placement, recovery, testing, and governance, and banks must understand the allocation of security responsibilities between the cloud provider and the bank. Lastly, banks are navigating complex regulatory

requirements across multiple disciplines (e.g., the General Data Protection Regulation, Payment Card Industry Data Security Standard, and Sarbanes-Oxley Act), as well as ensuring that the cloud solutions comply with regional and international regulations.

Item #7: Cybersecurity

Reviews of banks' cybersecurity programs are part of prudential regulators' examinations, and banks face additional cyber-related reporting requirements from other agencies as well. At this point, does the Council see regulatory compliance as a significant strain on their cybersecurity teams' resources and as compromising their capacity to defend against current and emerging cybersecurity threats? If so, what practical steps can the Federal Reserve and other regulators take to streamline cybersecurity oversight processes and requirements so as to improve the effectiveness of banks' cybersecurity resources?

Although regulators are correct in prioritizing cybersecurity given the current threat environment and critical role of technology in financial institution operations, the increasing depth, breadth, and frequency of regulatory requirements and exams are disproportionately straining larger firms' cybersecurity resources. When regulations and oversight activities—including coordination of exam scope and scheduling—are not properly harmonized, firms often must prioritize compliance activities over other material risk-mitigating security programs. This strain is greatly exacerbated by independent, federal, and state regulators' failure to harmonize their activities with those of the prudential regulators. Overall, Council members recommend that one prudential regulator take the lead for exams at more complex financial institutions. To address this increasing strain on firms, regulators should also consider the following practical steps.

Harmonize security requirements

Regulators should improve their efforts to harmonize security requirements and joint guidance, supported by common standards and established frameworks that allow for consistent guidelines and exam execution. FFIEC members could continue to set an example to independent regulators on harmonization by requiring that all new security requirements are incorporated into the FFIEC IT Examination Handbook or guidance, as opposed to issuing bespoke security requirements or guidance. Furthermore, FFIEC members could invest more in their outreach programs to independent regulators to encourage adoption of the FFIEC guidance and use of established frameworks such as the National Institute of Standards and Technology's Cybersecurity Framework to inform and prioritize cyber risk management.

The extremely adverse proliferation of duplicative and conflicting regulations is best illustrated by the existence of cyber incident reporting requirements from 11 distinct regulatory bodies for the same event at applicable financial institutions. A decision tree for cybersecurity incident reporting would be helpful to ensure appropriate information flow from the impacted financial institution to the regulatory agencies. Additionally, a standard format for reporting could provide more efficient information flow and decrease the need for follow-up discussions.

Synchronize regulatory examinations

Regulators should establish a means to coordinate exam timing, scope, and joint participation, as needed. Firms appreciate that prudential regulators (i.e., the FRB, FDIC, and OCC) continue to increase harmonization of their exam schedules and scope, including joint participation. However, the lack of exam synchronization by independent federal and state regulators between themselves and with prudential regulators is a primary cause of the burden firms face. As a practical next step, prudential regulators could take the lead in synchronizing schedules with the remaining FFIEC members.

Responding to a single exam frequently consumes thousands of staff hours and requires hundreds of documents to be produced. Increased regulatory scrutiny for cyber has led to the common situation where several regulators conduct overlapping or consecutive exams on the same or similar topics. Overlapping exams exacerbate the problem, as critical first-line, subject-matter experts in cybersecurity are kept from their daily duties to work on evidence requests. This excessive burden is causing cybersecurity staff to work exceptionally long hours to complete their daily jobs during exam execution. This scenario leads directly to staff burnout, increased error rates, and staff turnover. Firms have hired additional staff or engaged consultants to address the increase in work demand; however, the firms and regulators are all trying to hire talent with the necessary experience and skill sets to effectively manage and supervise cybersecurity. The deep operational subject-matter expertise required for understanding prudential supervisory frameworks and supporting regulatory engagements is limited and cannot be easily supplemented by additional consulting or administrative staff.

Reciprocity

Regulators should establish a holistic reciprocity agreement with streamlined oversight requirements to accept the results of oversight activities performed by another regulator on the same or a similar topic. Prudential regulators could take the lead in establishing a reciprocity framework across the FFIEC members and independent regulators. By leveraging each other's documentation, evaluations, and findings, regulators will receive the information they need to conduct rigorous oversight while reducing strain on cybersecurity resources. Repackaging responses to similar questions on different exams consume significant staff resources, with up to 85 percent of the responses requiring rework, as evidence needs to be recreated based on discrete dates and scope.

Consistency in examiner finding identification and resolution

To reduce inappropriate findings, prudential and independent federal and state regulators should enhance their exam training and internal review process to focus on unidentified material and strategic risks and to view risk in the context of a firm's overall controls environment. Firms have found that improper corrective actions can cause firms to invest in cyber capabilities not aligned with their risk profile and compensating controls. An overemphasis on prescriptive compliance and administrative processes diverts examiner resources from the critical task of identifying and remediating strategic/material risks. Examiners also need to ensure that they view processes in the context of a firms' overall controls environment and risk appetite instead of an isolated view. Finally, regulators should be vigilant to limit instances of self-identified weaknesses with valid resolution plans from being written up as MRAs (Matters Requiring Attention), which adds administrative burden on both parties without added risk-reduction benefits.

Item #8: Use of Generative Artificial Intelligence (AI)

To what extent, and in what ways, are banks finding generative AI applications useful for delivering services, conducting analyses, increasing productivity, or improving decision-making? In what areas are banks seeing the greatest opportunities? The greatest challenges? Are there specific actions that regulators could take to better support the prudent exploration and application of growing AI capabilities?

To what extent, and in what ways, are banks finding generative AI applications useful for delivering services, conducting analyses, increasing productivity, or improving decision-making?

Council members agreed that GenAI has the potential to transform the banking sector, due to the ability of GenAI to understand and generate natural language and allow users to interact directly with AI models through intuitive interfaces. GenAI is an evolution of the AI/ML technologies that banks have long been using and that are managed through existing governance and risk control and risk management

frameworks, covering model, technology, data, and operational risks, among others. However, since GenAI requires additional consideration in the areas of explainability, accuracy, data, third parties, and resourcing, its deployment by banks is still in the nascent stages focusing on low-risk, internal-facing applications with a human in the loop.

Banks are currently using GenAI applications in various stages—from pilots and testing through production—and in various ways, such as to:

- **Deliver services**—Help banks offer more effective customer service and personalized financial products and services by analyzing customer interactions and preferences, providing instant support, processing transactions, and guiding customers through service offerings
- **Conduct analysis**—Process unstructured data (e.g., documents, regulations, and contracts) to query and analyze data and produce business analytics
- **Increase productivity**—Streamline operations, such as data entry, document verification, and compliance checks, and automate manual tasks, such as drafting documents or summarizing large texts, which allow employees to focus on more complex tasks

In addition, the increasing incorporation of AI/ML capabilities by SaaS platform providers (e.g., Microsoft and Salesforce) into their standard service offerings—customer relationship management, human resources, office productivity, contract management, and accounting products—is making advanced AI capabilities more accessible to banks of all sizes. As noted by one Council member, smaller banks are heavily reliant on vendors, particularly in areas such as fraud identification and call center automation.

In what areas are banks seeing the greatest opportunities?

Most Council members agreed that promising near-term opportunities for GenAI in banking include improving software engineering (e.g., code translation, development, and documentation, thus streamlining the development process); enhancing customer service and experience (e.g., use of AI-driven assistants to provide prompt responses to general user queries, condense large volumes of text quickly, and extract insights more efficiently); and optimizing operational processes (e.g., automation of repetitive and time-consuming tasks).

One Council member noted that in the longer term, the advent of “AI agents” capable of autonomously navigating and executing complex, multi-step workflows that have traditionally been hard-coded or done by humans presents an exciting opportunity. For example, an AI agent could carry out all the steps to execute a research request (determine a step-by-step plan, retrieve internal and external information, write a draft report, and evaluate output quality before human review). Although the range of possible actions that an AI agent could take would be pre-defined, the AI agent would determine the next action in a series of tasks to address multi-task objectives. This emergent capability could revolutionize many industries, including banking, and could impact various aspects of banking operations, from customer service to strategic decision-making.

In what areas are banks seeing the greatest challenges?

Some Council members emphasized that many types of risks posed by GenAI are not unique, which means that banks can leverage and adapt existing, comprehensive risk management frameworks for GenAI as they have done for other forms of AI. However, while there is a need for all AI to be safe, robust, and transparent, GenAI can amplify some risks compared to traditional AI, creating new challenges in managing those risks and constraining banks from realizing the full potential of GenAI in the near term.

- **Explainability**—GenAI models, due to increased complexity and the ability to dynamically update, cannot be explained using traditional explainability techniques, so banks need to rely on alternative measures to detect potential model issues and errors.

- **Accuracy** – Ensuring that GenAI models are accurate will be critical when they are customer-facing or informing decisions that can have significant consequences. Several Council members cited the unique challenge of GenAI “hallucinations,” where models generate incorrect or nonsensical outputs, although some Council members noted that this risk can be reduced by limiting the scope of GenAI’s use, extensive testing, expert review of outputs, prompt engineering, and techniques specifying the corpus from which answers must be derived (i.e., retrieval augmented generation).
- **Data** – Content and knowledge management—ensuring that you have authoritative and curated data—is an important consideration in mitigating hallucinations. Additionally, complex potential GenAI applications may take advantage of more real-time or unstructured data than traditional AI, which enhances the need for data to be high quality, well-organized, fit for purpose, and representative, and to have a clear provenance.
- **Third parties** – The increasing reliance on third parties for GenAI models, systems, and infrastructure will result in banks having to enhance their third-party due-diligence processes and controls, especially as banks may have limited visibility into proprietary models, and because third parties may resist disclosure of important information about systems if they are not required to do so. Relatedly, banks must prevent data leakage and ensure that proprietary or customer data is not used improperly (e.g., prompt data used to train future versions of models).
- **Resources** – GenAI increases the demand on a small pool of AI specialists that can engineer GenAI systems, and also necessitates a holistic workforce development program with relevant training.

Are there specific actions that regulators could take to better support the prudent exploration and application of growing AI capabilities?

The existing bank regulatory framework provides a sufficient basis for managing GenAI risks. Regulators should maintain a risk-based approach that focuses on regulating activities and outcomes rather than on the technology itself (tech neutral), and continue to promote innovation by banks of all sizes that can improve the customer experience. The following specific actions would be helpful:

- **Have clear and consistent expectations** – Regulators should confirm the applicability of existing requirements to GenAI and ensure consistency in supervisory expectations. Regulators should consider the need for additional guidance to allow for banks to adapt their model risk management practices for GenAI—for example, leveraging a greater reliance on alternative controls for explainability and validation, such as ensuring good data hygiene, robust outcomes-based testing, and auditing.
- **Support a unified federal framework** – Federal financial regulators should engage in broader cross-sectoral efforts to develop a federal regulatory framework for AI to avoid a fragmented patchwork of state and non-industry-tailored regulations and enforcement, and to ensure that banks do not become subject to duplicative or contradictory requirements.
- **Support industry efforts to advance safety and security** – As highlighted in the 2024 Treasury report on AI-specific cyber risks, an increase in the number and sophistication of cyber and fraud attacks is likely. As such, regulators need to empower banks and consumers to manage these risks, including supporting banks’ development of advanced cyber and fraud prevention measures and facilitation of fraud-data-sharing initiatives between banks that solve for issues around privacy and liability when sharing such data.
- **Align expectations for nonbanks** – Some Council members expressed concerns around the risk of nonbank companies adopting AI-enabled platforms and using consumer data in unexpected ways that could lead to poorly managed risks for both customers and the financial system. Federal

action is likely required to ensure consistent expectations between bank and nonbank firms providing financial products and services, including through the use of AI.

- **Engage in public-private partnership** – Regulators should participate in public-private partnerships to develop risk-based AI standards, for example, through standards-generation efforts supportive of best practice and policy development (via the National Institute of Standards and Technology and related ongoing efforts).
- **Leverage existing authorities to manage third-party risks** – Given the increasing role of third-party model developers and cloud service providers in the AI supply chain, financial regulators should use available authorities and coordinate with nonfinancial regulators to ensure that key third parties are aware of bank regulatory expectations and adhere to robust standards around model development and disclosure that are crucial for maintaining the integrity and security of AI applications in banking.