Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, September 7, 2023

Item 1: Economic Activity

What trends in business activity do Council members see among their clients and other contacts? Are Council members seeing particular strength or weakness in any sectors? Are there any lingering supply-side constraints? What is the Council's prognosis for the pace of economic activity during the remainder of 2023?

What trends in business activity do Council members see among their clients and other contacts?

Overall, the pace of economic activity slowed somewhat over recent months. Council members reported that firms that are engaged in the production, distribution, and sale of goods saw a more pronounced slowdown than those that provide services. In general, businesses are doing well, and Council members noted that their concerns about a recession in 2023 have lessened. Median deposit balances, payment rates, and line utilization remained favorable compared to pre-pandemic levels, while other metrics, such as delinquencies, have normalized but are not deteriorating. The pace of loan growth has begun to slow, although there seemed to be a level of adjustment to higher interest rates. The consumer and retail sectors continued to experience margin pressure due to their limited ability to pass through higher costs to consumers. Commercial real estate (CRE) activity remained low, with fewer transactions overall. Capital for CRE can still be raised in both the debt and equity markets, but traditional bank CRE financing was scarce. Deposit pricing pressure was high, and the outflow of deposits to investment firms continued.

Consumer spending was resilient, as consumers sustained by job security increased Q3 spending patterns to match growing incomes. Domestic hospitality and travel did well, and spending on restaurants, entertainment, and leisure remained strong—especially among upper-income segments. Merger-and-acquisition (M&A) activity has slowed. Ongoing concerns related to the resumption of student loan payments may affect spending over the near term. Throughout the country, funds from COVID-19 relief efforts and government infrastructure initiatives fueled increased municipality and state spending.

Are Council members, clients, or contacts seeing any new areas of strength or weakness?

Council members reported that the economy continued to moderate and that discretionary consumer spending on services remained strong. The lean inventory of existing homes for sale has funneled more buyers into the market for new homes, which has fueled home construction in some regions (although larger-scale projects, including land and subdivision development, have slowed). Residential investment activity decreased because of the elevated costs of capital, construction supplies, and labor. The agriculture and building materials sectors saw lower profits due to slightly lower volumes as well as rising costs that have outpaced prices. Consumer spending was focused on travel and tourism, recreation, entertainment, and restaurant services—with a particular concentration in high-end dining, tourism, and hotels. Oil, gas, and airlines saw increased profits driven by strong demand and expanding margins in energy markets. Overall, small businesses remained healthy, but higher interest rates have exposed weaker business models.

Although higher interest rates are expected to cause stress, that stress has not fully manifested yet. CRE is expected to further slow in the second half of the year. Many banks have slowed commercial lending. The insurance industry is increasingly wary of the risks presented by climate and natural disasters, prompting major firms to scale back their presence in more vulnerable states. The higher cost of insurance and loss of available commercial and residential property insurance options have become increasingly complex and challenging issues for owners.

Risks in the health care industry have increased, as the cost of supplies, labor, and pharmaceuticals has risen at a faster rate than insurance reimbursements.

Hospitals and other health care institutions continued to experience significant financial pressures due to staffing shortages and higher labor costs. Regulations and legislation are having a profound effect on the bottom line, energy transition efforts are elevating capital expenditures, and defense spending is seeing a sustained increase. Used auto dealers have experienced increased margin pressure and slower inventory turns because of declining values on used cars; meanwhile, new car prices and margins continued to be strong.

Are there industries or geographic areas in which significant supply-side constraints persist?

Council members reported that overall supply-side constraints have improved. Supply chain normalization was a consistent positive theme across the country, with a few lingering exceptions. This improvement was apparent in autos, capital goods, consumer products, and transportation infrastructure. Recently rising costs exerted pressure on margins instead.

By far, the greatest supply-side constraints across industries and regions of the country were labor shortages and labor costs. Although labor-intensive sectors—such as retail and health care—were among the hardest hit, rising personnel costs are expected to impact all industries in the coming months, as labor costs have increased faster than expected. Additionally, the scarcity of skilled labor continued to pose challenges. Throughout the country, community bankers reported that the skilled labor shortage has impacted theplans of employers—including schools and health care facilities.

Council members noted other industry-specific supply-side constraints. Construction material costs were high, and some specific components were difficult to source, though construction-grade wood repricing had slowed. Vehicles of all types (including personal, semi-trucks/trailers, and farm machinery) continued to have significant lead times, and producers worked to make up production losses from previous supply chain constraints that have now largely subsided. Volumes in all other manufacturing sectors had recovered to pre-pandemic levels and remained relatively stable quarter-over-quarter. Volumes in the commodities and airline sectors still trailed pre-pandemic levels, though the volumes continued to improve. Finally, supplies of semiconductors, particularly GPUs, were still significantly constrained. This is expected to persist because of the rapid growth of AI applications and the subsequent increase in demand. As global tech firms diversify supply chains away from China in response to geopolitical and concentration risks, costs are expected to rise.

What is the Council's prognosis for the pace of economic activity across sectors for the remainder of 2023?

Council members remained cautious about the economic outlook. Overall, contacts across sectors and geographical regions expected moderate conditions through the end of the year, as well as a continued slowdown in economic activity. Although production momentum is expected to continue through the rest of the year, loan demand is expected to moderate as the economy rebalances. State and local government spending on construction and infrastructure projects is expected to continue as funds flow from the federal government. Consumer spending may continue in the face of higher rates and prices, and there are some expectations that pent-up demand and lingering liquidity will persist through the end of the year. Residential construction is expected to eventually slow in the face of high mortgage interest rates. Job growth may also slow, but the tight labor supply is expected to blunt any increase in the unemployment rate. Contacts expected rates to remain elevated through the end of the year, and the majority of contacts expected the economy to slowly downshift. The fear of a severe recession in 2023 has largely abated since the previous FAC meeting.

Item 2: Labor Markets

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market? What are businesses' current strategies with respect to hiring, employee retention, and workforce reduction? Is the available labor pool growing? What kinds of compensation increases are Council members seeing now and foreseeing near term?

Summary

The labor market remained tight, and finding skilled workers continued to be challenging. However, it appeared that labor conditions were moderating. Turnover rates have declined, yet wage growth remained persistent. Employees continued to expect competitive pay, flexible working arrangements, and generous benefits.

Smaller and mid-sized companies still faced hiring challenges, and small business owners continued to identify labor cost and labor quality as the top problems facing their businesses. Application volumes increased, but many applicants lacked the appropriate skills to fill open positions. In addition, rising costs, contracting margins, and the overall slowing of the economy have lowered businesses' appetite for hiring. Layoffs were still limited, but many companies have paused hiring in anticipation of the economy continuing to slow.

What are businesses' current strategies with respect to hiring, employee retention, and workforce reduction?

Council members reported that companies are focused on retaining their current employees. Employers have responded to employees' heightened expectations with higher wages and enhanced benefits, including childcare and continuing education. Health care costs across the U.S. continued to increase, and employers have adopted mitigation plans to reduce the impact to employees. The "return to office" topic of conversation continued to be important across many industries, and employees have made their preference for a flexible work schedule clear.

Rising costs—including interest costs—declining contracting margins, and economic uncertainty have negatively impacted hiring. Some industries, such as technology, have resorted to reductions in force or layoffs. The majority of companies have slowed or paused hiring in response to slowing economic conditions. As a result, reported job openings may be impacted by companies that have decided not to fill—or to eliminate—open positions.

Is the available labor pool growing?

Although the labor pool appeared to be growing, a mismatch between open positions and the skills required for those positions remained. Given that the labor force participation has improved and is back to March 2020 levels, the decline in job openings in June was an encouraging sign that the labor market, while still tight, may well be on its way toward a more normal environment. Council members noted that the availability and cost of childcare continued to negatively impact the labor participation rate.

Average hourly earnings growth remained stubbornly high and even accelerated over the past three months. Further softening in economic activity is anticipated over the next two quarters. This slowdown is expected to trigger additional labor market cooling and eventually lead to moderating the average hourly earnings growth back to a pace more consistent with the Federal Reserve's 2-percent inflation target.

What kinds of compensation increases are Council members seeing now and foreseeing near term?

Council members saw wage increases ranging from 3 to 4 percent—down from elevated levels of the last two years and more consistent with historical norms. Incentive payments will likely decline. As a result, overall compensation will be down year over year. For small to mid-sized businesses, compensation is expected to moderate to similar levels. Recently negotiated labor agreements in industries such as airline and delivery services have significantly increased wages and will impact wage inflation.

Item 3: Loan Markets

What is the Council's assessment of current conditions in loan markets and financial markets generally? Are Council members seeing any developments of particular note in lending categories such as consumer, residential real estate, commercial real estate, construction, small and medium-size business, and corporate?

What is the Council's assessment of current conditions in loan markets and financial markets generally?

The credit markets continued to tighten as banks focused on the cost of funding, liquidity, and concerns about a likely increase in capital-levelrequirements. Banks were focused on their existing portfolios and were looking to preserve capital and liquidity for existing customers and full relationships with deposits. At the same time, business, corporate, wholesale, and CRE loan demand appeared to have slowed down; however, consumer loan demand is up. While borrowers were somewhat buoyed by a resilient economy, they were simultaneously weighed down by persistent price pressures, tightening credit conditions, and the prospects of a higher-for-longer interest rate environment. Depending on the category, loan spreads increased anywhere from 25bps to 100bps in recent quarters. With regard to credit quality, although Council members had seen some softening, a feared systemic deterioration had not occurred.

Consumer

Consumer lending in general remained steady, although growth continued to slow and normalize with the high-rate environment. Credit card balances reached an all-time high; however, consumers are still revolving less than before the pandemic due to elevated cash buffers. Auto loan demand may be showing some signs of recovery off the lows of the pandemic, but most Council members still reported attrition in auto portfolios. Credit quality continued to deteriorate and normalize; however, credit metrics still compared favorably to pre-pandemic levels. Council members reported some tightening in credit standards for consumer loans, and many Council members noted the anticipated impact the resumption of federal student loan payments will have on the sector.

Residential Real Estate

Despite a small improvement in the second quarter due to seasonality, home application demand remained at a two-decade low because of financing costs and the resurgence in home prices, which have been driven up by the lack of housing supply. Homeowners increasingly showed an unwillingness to sell their existing home due to their attractive existing mortgage rates, and refinancing levels were almost nonexistent. Homebuyers are being drawn to new construction, where homebuilders have made considerable progress bringing projects to completion as supply chain challenges subside.

Commercial Real Estate

Commercial real estate (CRE) lending continued to slow due to higher interest rates, the rising cost of capital, and market conditions. Although market conditions varied among property types and geographic region, as a whole, the sector is dealing with declining property valuations, moderating rents, and increased operating expenses. The high cost of insurance and loss of available options continued to hit the sector hard.

Council members anticipated foreclosure activity to continue and noted that certain large, well-capitalized investors have walked away from properties based on economic considerations and the market outlook. Limited debt capital was available for any type of CRE deal, and transactions have slowed. Issuance of commercial mortgage-backed securities was at record lows. Banks tightened underwriting standards and were focused more on existing portfolios and monitoring loan maturities.

The office market continued to face the most uncertainty. Despite businesses requiring more people to return to the workplace, office tenants have found ways to operate with less space. Consensus in the industry is that office stock far exceeds demand, especially in the central business districts. Meanwhile, the multifamily sector continued to perform well,but is moderating from recent highs. Softening rent growth and higher operating expenses have started to create headwinds for operators.

Retail properties, which have performed relatively well, experienced increased differentiation dependent on location, product class, age, and anchoring tenants. For example, well-located suburban centers with essential retail, such as a grocery store, will outperform older, central business district centers. The industrial sector is also expected to continue to perform relatively well in the current market, although any softening in consumer spending could impact both industrial and retail performance.

Construction

Construction and land development activities continued to grow and hold steady. This steady growth likely reflected the need for the products, the delays associated with supply chain issues, the labor shortage, and the long permitting and approval times. There is still a lot of supply to be delivered in the multifamily and industrial segment, as projects continued to fund up toward completion and lease-up. However, new demand was lower, and new construction starts have slowed. Heightened supply in some markets, recessionary concerns, slowing rent growth, the interest rate environment, and the cost of capital have all made construction projects difficult to pencil out. It is likely that most new construction projects will require a 45–55 percent down payment. Additionally, banks continued to tighten credit standards and reserve capital for existing customers and full relationships. Little appetite remains for certain asset classes, such as office. Lastly, lending to single-family housing developers tightened, but remained healthy.

Small and Medium Business

Small and medium businesses remained healthy overall. Balances, payment rates, and line utilization remained favorable over pre-pandemic levels. Other metrics, such as delinquencies, have normalized but are not deteriorating. Some banks have started to see increased line utilization as the economy slows and elevated cash balances return to normal. Some banks have also seen increased permanent working capital term-outs.

Middle Markets and Corporates

Similar to the last FAC meeting, Council members agreed that there continued to be a slowdown in middle-market lending due to higher interest rates, a softening economy, and tighter credit markets. Higher rates continued to be a drag on cash flow, limiting the borrower's ability to pay down debt or fund capex. M&A activity remained muted, as buyer and seller expectations often were not aligned. Some banks, depending on their own capital allocation needs and risk profile, were unwilling to continue participating in deals without a broader relationship. In response, activities have focused on bank group consolidations, amendments, and restructuring as opposed to new money. In the corporate sector, loan markets remained healthy and available for investment-grade and higher-quality borrowers with modest leverage profiles. Despite the diminished loan appetite overall from banks and increasing cost of funding, market pricing improved only modestly.

Item #4: Inflation

Have Council members observed any recent shifts in the trajectory of the prices of consumer goods? Home or apartment rents? Consumer services other than rents? How do Council members foresee these trajectories evolving over the near term? How would Council members characterize current perceptions of, and expectations for, overall inflation among consumers and businesses?

Similar to the previous two quarters, Council members noted that inflationary pressures have eased and pricing pressures have slowed. Core CPI over the last three months has increased at a 3.1% annualized rate, which is the slowest pace since September 2021, and the most recent headline inflation was driven by shelter costs, which accounted for 90 percent of the price level increase in July. Finally, although June and July trends were very positive, the outlook for August remained more uncertain due to increasing energy prices.

Many Council members noted that goods-producing customers reported normalizing supply chains, faster delivery times, and cooling input price pressures. Service businesses reported similar trends, though less pronounced. Significant declines or stabilizations in June and July included transportation prices in general, with the most pronounced changes being an 8.1 percent month-over-month decline in airline pricing (down 18.6 percent for the year). Used autos also declined 1.3 percent, though new vehicle prices remained stable.

The sectors that have been the most impacted by inflation (especially wage inflation), are facing tough consequences in the near term. Industries such as health care/senior care, retail, and restaurants may need to review business models for the long term.

In terms of rents, Council members reported that the actual rates of increase have been mixed and in some situations are very geographically specific. Although the national average continued to increase, it is at a much lower rate than previous quarters. Council members in the Northeast noted continued increases, though others in the Western and Southern U.S. observed declines of up to 25 percent year over year in cities such as Oklahoma City, as well as an average 3.5 percent overall decline in the state of California. Council members noted that in general the areas that are seeing the greatest declines had also seen the greatest increases during the pandemic and that rent prices remained elevated compared to the beginning of the pandemic..

For the mortgage/home ownership sector, Council members continued to observe that prices have not cooled as much as expected, which some Council members attributed to a shortage of new homes and increased costs of ownership. Some Council members noted that homebuilders have adjusted to the new interest rate environment by building at lower pricing levels, and many existing homeowners have declined to reenter the market or upgrade their properties due to the elevated mortgage rates.

While the disinflation trends at both the consumer and producer levels remained largely on track, the path is not likely to be an easy one. Consumer perception of inflation has improved over June and July, though the rise in commodity prices is expected to impact August. Among small and medium-sizebusinesses, while inflation remained a top concern, it has softened slightly and is now only one of several concerns. Large businesses continued to report that margins are tightening due to rate hikes, and many of these businesses have implemented internal cost cutting initiatives as a result.

Overall, Council members agreed that the actions and messaging from the Federal Reserve has been clear and transparent. Going from 3 percent to 2 percent inflation will be a challenge, and Council members recommended maintaining the fact- and data-based approach to ensure that high inflation does not reemerge.

Item #5: Federal Reserve Policy

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

Economic growth hasn't responded to the tightening as much as the Council would have expected earlier in the year, inflation is still above target, and recent macro growth and labor market data show a more resilient economy. That said, leading indicators have moderated, and Council members believe there is reason to expect both goods inflation and rent will continue to trend down over the balance of the year.

Banks, in general, faced increased liquidity pressure, fueling continued competition for deposits. Additionally, the recent banking stress (though considered idiosyncratic and contained) and the expectation of incremental capital and liquidity requirements, continued to impact both the willingness of banks to extend credit, and the cost of credit to borrowers, which itself will dampen future economic growth. From the perspective of consumers and households, excess savings and credit metrics continued to normalize, and many will feel the impact of the restart of student loan payments.

As such, Council members' consensus is that more time is needed to fully observe the expected lagged effects of monetary policy actions, and any incremental hikes should occur only in response to upside surprises in activity and inflation data. As such, it is appropriate for the Federal Reserve to pause and hold rates at these levels while continued improvement is seen in the data, and to continue to message accordingly.

While the Fed's balance sheet normalization has, and will continue, to contribute to steepening of the curve, the deeply inverted yield curve looked likely to remain until the Federal Reserve pivots. Council members' views as to whether a recession is likely have shifted more toward a soft landing, versus a mild recession, but Council members continued to highlight that recession risks are still elevated.

At the last meeting, Council members agreed that system-wide reserves remained ample; however, reserves are not uniformly distributed, and certain sectors of the banking industry were clearly experiencing more liquidity stress than others. As such, there was an elevated concern that Fed action to moderate reverse repurchase agreement (RRP) usage would be required sooner rather than later (reductions in counterparty limits or rates), particularly in light of a post-debt ceiling resolution Treasury General Account replenishment. On a positive note, Council members have observed that over the last several months, in the context of a more abundant T-bill supply and increased confidence that the end of the policy cycle is near, the money market complex has begun to extend, resulting in lower RRP usage and stable reserves. That said, RRP levels remained elevated and could still contribute to future instability and liquidity stress, so consideration should continue to be given to scaling back counterparty limits over the medium term.

Item #6: Capital Requirements

What do Council members consider to be the most significant benefits and costs of the proposed capital requirements for banks?

The Council appreciates the Agencies' (Board, FDIC, and OCC) effort to continue modernizing capital requirements and further align domestic requirements with global standards as outlined by the Basel Committee on Banking Supervision (Basel). Having an opportunity to review and comment on the Notice of Proposed Rulemaking (NPR) is also appreciated, and the Council believes the process can result in a thoughtful and balanced approach. The NPR includes some benefits, most notably, the intent to harmonize U.S. capital requirements with international standards (although not achieved, in the Council's opinion), which should enhance global financial stability. The Council also recognizes the benefits of eliminating the Advanced Approaches framework and the disparity created by internal model-based approaches, which will provide for increased comparability among firms and transparency across the banking system. The Council

members will address some benefits and costs in this response but suggest that the Agencies rigorously perform this analysis in a transparent process.
First, while there are benefits to the NPR, Council members have also noted several challenges that should be considered prior to finalizing the rule. First, the proposal diverges from Basel standards for a number of risk-weighted-asset (RWA) treatments, which results in higher RWA and therefore increased capital requirements for U.S. firms relative to international firms. The lack of alignment with international standards has the potential to limit credit availability for U.S. consumers and create competitive disadvantages for U.S. banks; it also runs the risk of pushing financial intermediation into unregulated entities. In addition to the specific challenges identified with the NPR, Council members are concerned about other unintended consequences which could result.

Second, rulemaking related to operational risk poses multiple challenges. One of which is the floor of 1x on the Standardized Measurement Approach loss multiplier. This floor would negatively impact banks that historically incur lower operational losses relative to earnings. Additionally, without alteration to existing rules, there will be incremental capital outcomes in capital stress testing if banks are expected to hold capital for operational risk through RWA as well as through conservative assumptions for operational losses in the Supervisory Severely Adverse Scenario used to determine firm-specific stress capital buffers. Additionally, increased capital requirements for operational risk will need to be allocated down to each product and service, further increasing borrowing costs. If not oriented to a specific bank's risk, at a minimum, the floor should be harmonized with international standards.

Third, the magnitude of capital and costs attributed to sales/trading activities could result in significant curtailment of these activities or in these activities being conducted by entities outside the regulated banking system. Council members also raised concerns that the NPR would introduce significant operational complexities, including those related to trading and market risk and counterparty credit risk, which would be applicable to all large banking organizations regardless of their size or the materiality of their trading and derivative exposures. Further, the use of more standardized methods further disconnects the regulatory capital drivers from the tools and techniques that most large banks use to manage their risks on a daily basis, and likely means they will need to maintain certain parallel systems and processes (allowance, VaR, stress testing, etc.).

Council members noted how increased capital requirements on credit card lending and undrawn lines of credit would negatively impact consumers, while the 20 percent higher risk weight on mortgages could impact the cost of homeownership. Proposed capital requirements for credit cards will result in reduced credit lines, less credit availability, and lower credit scores, as well as a higher cost of credit for many consumers. Higher requirements for mortgages would potentially have a disparate impact on low- and moderate-income (LMI) communities and impact a bank's ability to meet Community Reinvestment Act lending requirements. Council members suggest that the Agencies consider different risk weightingfor LMI communities.

Another potential unintended consequence relates to the NPR's requirement that investment-grade corporates have an outstanding publicly traded security or be controlled by a company that has an outstanding publicly traded security in order to be eligible for a reduced capital treatment. This requirement could impact credit availability for a variety of middle-market corporates, which are already at a disadvantage due to the proposal's 85 percent risk weight, which is inconsistent with the Basel standards.

The proposal also eliminates the 100 percent risk weight for non-significant equity exposures that do not exceed 10 percent of an institution's total regulatory capital and includes a 250 percent risk weight for publicly traded equity exposures and a 400 percent risk weight for equity exposures that are not publicly traded. If implemented, these changes would directly impact the tax-equity funding structure typical in

renewable energy projects, which will impact the level of investment in, and therefore the speed of the transition to, a clean energy economy through incentives such as Investment Tax Credits (ITCs), Production Tax Credits ("PTC"), Environmental Justice Wind and Solar ITCs, and Clean Energy ITCs/Clean Energy PTCs. A possible solution to adopting the proposal would be to carve out affordable community development assets. Similarly, if implemented, the NPR's changes would increase the risk-weighted assets attributed to employee benefit plans, such as defined benefit pension plans and other deferred compensation plans, whereby investments in the form of equity securities would receive a higher risk weight to the extent that they would otherwise be covered under the current non-significant equity investment threshold.

The NPR provides clarity on the evolution of capital requirements, which should allow banks to manage capital in a more confident and informed manner. However, the challenges and potential unintended consequences are significant. Council members request that the Agencies continue to evaluate these costs and benefits through a transparent and open process, including the rationale for all deviations from international standards, so that the industry can provide meaningful feedback. Council members also commit to continuing to engage on this topic and will provide additional information as to what the NPR could mean for banks and consumers as more analysis becomes available.

Item #7: Artificial Intelligence

AI is evolving quickly. At this stage, how are banks positioning themselves to: understand AI; assess the opportunities, challenges, and risks it presents; evaluate their options for using it; prioritize and implement their uses for it; and protect themselves from its malevolent use by others?

Understanding AI: Assessment of opportunities, challenges, and risks

Council members already use AI, primarily machine learning, across internal and customer-facing products and services, though some community bank members have limited AI utilization. Council members using AI have mature risk management programs and regulatory oversight to assess and manage AI challenges and risks, such as accuracy, bias, privacy, and security concerns. Relevant policies, procedures, and other controls are based on existing regulatory frameworks, including Federal Reserve SR 11-7, safety and soundness requirements, and consumer laws. These legal requirements and supervisory frameworks help ensure that bank AI use is well governed and well managed, especially compared to fintechs that use AI to provide bank-like services but are not subject to model risk expectations or supervisory oversight.

Newer AI technologies, such as large language models (LLMs), can have substantial impact across nearly all areas of banks. In response, many Council members are involving multiple business lines and control functions to holistically understand the technologies' potential and risks. Several Council members prohibit employee access to public interfaces such as ChatGTP and are approaching the new technology cautiously pending a better understanding of its unique hallucination, privacy, and other risks. In addition, many Council members are adding data science and staff with relevant risk expertise, training existing staff, and devoting and training dedicated executive support. Council members are also partnering with industry groups and academic institutions to develop a horizontal view of new AI technologies, how industry is using those technologies, and their benefits and risks. Council members believe that bank AI talent should have the freedom to innovate in tightly controlled internal test environments, then integrate risk functions and apply appropriate controls before deployment.

AI use, prioritization, and implementation

For more mature AI methods, Council members follow their existing established methods for prioritizing, implementing, and monitoring new models, tools, and products in a way that aligns with their business needs, strategic goals, and risk appetite. These existing risk frameworks, including those on model risk

management and vendor oversight, provide a structured foundation for responsible AI implementation, ensuring that AI-driven initiatives align with the banks' overarching risk and governance protocols. For newer technologies such as LLMs, some Council members are conducting feasibility studies and exploring prototypes in internal controlled environments, using limited and well-understood training data with human oversight, so they can better understand the potential and risks of these new technologies. These pilots, which often focus on how to use AI to enhance business-as-usual processes, will help Council members learn how to configure, train, and use LLMs in more complex use cases going forward. Council members are also considering revisions to relevant governance practices as well as to policies and procedures before implementing these new technologies.

Protection from malevolent use

Council members have been working to identify potential malevolent use cases of AI and then build responsive tools and controls. They have also been leveraging internal experts to study new technologies and threats, and working with industry groups to share new intelligence and best practices. Some Council members also collaborate with cybersecurity firms and with government and research agencies, such as NIST and MITRE, to develop mitigation strategies. These approaches are most effective when Council members have wide latitude to share sensitive information regarding cyber and fraud threats with peers. Council members also rely on third-party cybersecurity and fraud products that leverage cutting-edge AI capabilities. Using such advanced tools for anti-fraud and cybersecurity purposes is critical to ensure the industry does not remain technologically behind malicious attackers, even if the AI methods used by these tools might not be explainable or appropriate for customer-facing or certain other use cases.

Item #8: Payments Innovation and Financial Inclusion

In the Council's view, how can payment system improvements -- such as instant payments or faster settlement or funds availability for other instruments such as checks -- support broader financial inclusion and the financial well-being of individual and small business customers? In particular, how are Council members' institutions, and the banking industry more broadly, working to ensure that their products and services meet customer needs, particularly those of low-income customers who may turn to other service providers (such as check cashing services)?

The Council doesn't believe payment improvements such as instant payments or faster settlement or funds availability will increase broader financial inclusion by themselves. To participate in the improvements that have been made in payments, a consumer is required to have a bank account. To increase inclusion in the banking system, many banks have invested in innovative products and services including Bank On certified and free checking accounts, low-balance warnings, reduced or eliminated overdraft and insufficient fund fees, financial literacy, cash management, early payday, and early direct deposit.

Despite these efforts, other barriers remain that have little to do with faster payments, including consumers' privacy concerns, poor credit history, lack of required ID or KYC (Know Your Customer) documentation to open a traditional bank account, and a distrust of banks and related fees. Although a study by the FDIC showed that less than 5 percent of U.S. households lacked access to a checking or savings account in 2021—the lowest percentage since the survey began in 2009—another 15 percent were still considered "underbanked" (i.e., still regularly used alternative financial services). Council members discussed how continued digitization and more consumer-friendly KYC requirements could have a big impact on inclusion—more so than faster payments would—because those changes would make it easier for certain consumers to open accounts and participate in the banking system. Benefits of continued digitization, combined with easier account opening, would also lead to quicker access to funds than checks, reducing the need to use check cashing or payday lending services, and also reducing banking deserts.

Council members also discussed (1) the need for a continued focus on security and (2) how the emergence of faster payments should not erode protections consumers currently have. While payments innovations are certainly helpful to many consumers and small businesses through funds availability, accessibility, and transparency, faster is not always better and these aspects do not necessarily safeguard consumers against the continued rise in fraud and scams. Digital wallet technology supports instant payments, but consumers face challenges in disputing unauthorized payments along with exploitation of payment apps by fraudsters. A critical balance needs to be struck between faster payments and increasing security risks.

Once in the banking system, individuals and small businesses can benefit from faster payments. For individuals, especially those with lower incomes, instant access to funds reduces the incidence of overdraft and late fees as well as a reliance on payday and other high-interest loans, or check-cashing services, which often charge excessive fees. For small businesses, improved cash flow from faster payments is critical for covering immediate expenses, such as payroll and inventory, thereby promoting stability and growth while improving operating margins. Additionally, the convenience of instant payments and digital wallets encourages underbanked populations to use banking services, reducing their reliance on alternative financial services.

While financial institutions are making significant strides in promoting financial inclusion through innovative products and services, a balanced approach that addresses access, financial literacy, fraud prevention, and associated costs is essential in facilitating increased financial inclusion and the financial well-being of individual and small business customers.