Key Actions State Financial Regulators Can Take to Promote Responsible Use of Artificial Intelligence (AI) in The Finance Sector

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Financial institutions have long been at the forefront of leveraging technology for core business operations, and artificial intelligence (AI) is no different. For example, algorithms have been used for decades in underwriting and trading. However, recent advances in AI, particularly in machine learning (ML), represent game-changing advancements.

The ability of these new AI/ML models to learn by themselves, combined with the availability of enhanced computing powers, has opened the door to advanced analytics leveraging alternative and unstructured data. AI/ML provides the ability to analyze and automate with greater sophistication and efficiency and is increasingly being employed by financial institutions for both back-end and front-end operations.

There are a wide range of AI use cases in finance, ranging from powering digital chatbots and virtual assistants, to augmenting or even automating credit underwriting, to targeted marketing and fraud monitoring.

AI/ML can have many potential benefits for financial consumers, including 1) **increasing access to credit for traditionally underserved consumers** with limited credit histories, 2) **expanding the availability of new and innovative products** potentially at **lower cost**, and 3) **providing faster customer service that is available 24/7**.

<u>But in every place we use it, AI/ML is often a double-edged sword</u>. The same AI use cases that can benefit consumers also pose risks depending on how AI/ML is deployed.

AI/ML models that can **increase access** to finance **can also perpetuate and exacerbate bias against vulnerable segments of the population**.

Digital targeted marketing can be used for **aggressive marketing of predatory products** that exploits consumers' behavioral biases.

GenAI-enabled chatbots may allow for quicker responses to customer service queries, but may also result **in inaccurate responses** or **prevent consumers from reaching live agents** to resolve urgent matters.

We need strong safeguards in place to mitigate risks to consumers, so that AI/ML is deployed in a safe and responsible manner that ensures that all consumers can reap the benefits rather than suffer the harms that AI/ML can cause.

The rapid adoption of AI by financial institutions introduces new that existing laws and regulations do not always clearly or adequately address.

We need clear guidance and rules and effective enforcement of existing state and federal laws relevant to AI/ML, including on fair lending, discrimination, and unfair and deceptive acts and practices (UDAP).

This memo highlights **ten key actions** that state financial regulators can take to help ensure fair and responsible use of AI in the financial sector:

(1) **Rigorously enforce federal and state rules on fair lending and anti-discrimination, which should entail that financial institutions take active steps to mitigate algorithmic discrimination.** Algorithmic discrimination is a well-known phenomenon that has been documented to arise across the customer lifecycle wherever AI/ML tools are being utilized, from targeted marketing to credit scoring to fraud monitoring. Discriminatory results can arise from multiple sources, including incorrect, incomplete, or unrepresentative training data; data that reflects historical biases; and use of proxies for protected characteristics. A range of solutions to address algorithmic discrimination have begun to emerge. For example, the CFPB recently highlighted that, as part of fair lending compliance under ECOA, institutions are expected to evaluate AI/ML models for disparate treatment (including use of proxy variables for prohibited characteristics) as well as disparate impact and to actively search for and implement less discriminatory alternative (LDA) models.

- *State financial regulators can help to ensure that these expectations are consistently being met when examining regulated institutions for fair lending compliance and by taking enforcement action against serious and harmful violations. State agencies can also issue guidance that further elaborates on the specific steps financial institutions should take to reduce the risk of algorithmic discrimination under both federal and state fair lending and anti-discrimination laws. For example, the New Jersey Office of Attorney General recently clarified that state anti-discrimination laws require careful and ongoing testing of AI/ML models for bias.*

(2) **Require financial institutions clearly disclose to consumers when they are subject to decisions that involve AI/ML models and the factors that led to adverse decisions and provide consumers with due process rights.** Without information about the factors that led to a negative decision or the underlying data used, consumers are left with limited ability to hold financial institutions accountable for unjustified or discriminatory practices or to understand what steps they can take to achieve a better outcome. The CFPB has issued guidance highlighting that adverse action notices must include specific and accurate reasons and that if "black box" AI/ML models do not allow for this, they should not be used. Yet there continue to be widespread concerns regarding the adequacy and specificity of such notices, particularly when dealing with complex AI/ML-driven underwriting.

- *State financial regulators can help to strengthen compliance by reviewing adverse action notices, highlighting deficiencies, and calling for concrete enhancements that improve the usability of such notices by consumers. State agencies can develop or call for requirements to be put in place for financial institutions to inform consumers when they are subject to consequential decisions made by an AI/ML system. Such requirements should include that consumers be provided with the right to appeal for human review, as required in Colorado's AI Act, as well as to disclose the sources of data used for such decisions, as required by the New York Department of Financial Services (NYDFS) for insurers using AI/ML models.*

(3) **Ensure that consumers have access to timely and appropriate channels to resolve customer service issues, particularly when digital chatbots and GenAI-enabled virtual assistants are employed.** Financial institutions are increasingly leveraging digital chatbots and virtual assistants for customer service, often to increase efficiency and reduce operational costs. Recent estimates indicate that more than half of leading banking apps offer chat assistance, 28% of bank chatbots offer advanced capabilities like natural language processing (NLP), and 11% of banks offer virtual assistants that combine NLP, GenAI, voice analytics, predictive analytics, and recommendation algorithms. While providing potential benefits, digital chatbots and virtual assistants can pose real risks to consumers if deployed irresponsibly. CR research found that consumers interacting with digital chatbots were three times more likely to say they did not get the help they were looking for compared to consumers who interacted with a live representative, while nearly half indicated difficulty in reaching a live representative. As a result, consumers may be unable to resolve urgent issues relating to their finances and run the risk of receiving inaccurate information or inappropriate advice.

- ➢ *Several states have already taken action to address constraints consumers face when trying to reach customer service at financial institutions, including California and New York. State agencies should continue to monitor these challenges and take further action as needed where digital chatbots and virtual assistants are found to be preventing consumers from reaching adequate support.*

(4) **Leverage long-standing authority under UDAP regimes where digital targeted marketing and personalized pricing are being employed in an unfair or deceptive manner.** Widespread digitalization of the economy has resulted in the availability of enormous amounts of granular data on individual consumers. When combined with advancements in AI/ML tools that enable efficient analysis of big data, financial institutions now have the capacity to develop detailed behavioral profiles of individual consumers. These capabilities can be used for digital targeted marketing (i.e. targeting specific types of individuals with specific advertisements and offers) and personalized pricing (i.e. setting individualized prices for a product or service, often based on an assessment of a consumer's willingness to pay). While tailoring of offers and prices can benefit some consumers, these practices can also be deployed in a predatory manner. Vulnerable consumers may be steered towards poorer quality, higher risk products or excluded from better products, while personalized pricing can result in higher prices being charged to consumers who are least able to afford it simply due to an inability to shop around or a lack of information.

- ➢ *States such as Washington, California, and New York have begun taking action against digital targeted marketing practices that have discriminatory impact. State agencies should take further action by providing clear guidance on when digital targeted marketing and personalized pricing constitute violations of federal and/or state UDAP regimes and by taking enforcement action against instances of digital targeted marketing or personalized pricing that are deceptive, manipulative, and exploitative and result in substantial harm to consumers.*

(5) **Require financial institutions take strong, proactive measures to combat the increasing prevalence of AI-powered financial frauds and scams.** Investment frauds and scams have been increasing at alarming rates, with the FTC reporting consumer losses of more than $4.6B in 2023 alone, while losses from imposter scams totaled nearly $2.7B. Bad actors are now often leveraging AI tools to target vulnerable consumers at scale via sophisticated phishing attempts, increasingly realistic voice cloning or deepfakes, synthetic IDs, etc. These

techniques are particularly useful for fraudulently inducing consumers into authorizing payment transfers, which represents a significant gap in the existing legal framework that leaves defrauded consumers on the hook.

- ➢ *While effectively combatting frauds and scams will require a multi-stakeholder approach, there are several actions state financial regulators can take to contribute to this broader effort. State regulators can require regulated entities strengthen security measures and fraud monitoring, including with respect to recipient accounts for fraudulent payments. Regulators can encourage greater data sharing across industry and can also collaborate with other stakeholders to share data and monitor trends across states. Regulators can call for stronger safeguards to be put in place to prevent fraudulent payment transactions, such as mandatory holding periods for larger transactions or universal windows for easy reversal of payments. State agencies can also foster greater consumer awareness and provide tips and tools for consumers to better recognize and avoid fraud and scams.*

(6) Ensure financial institutions have in place appropriate governance, controls, and risk management frameworks to adequately address the risks to consumers arising from use of AI. Given the wide range of AI use cases within the financial sector as well as the range of risks that AI can pose to consumers, financial institutions should be required to take a systematic and enterprise-wide approach to monitoring and mitigating risks. Appropriate governance structures and risk management frameworks and processes should be put in place to effectively identify, assess, control, and monitor risks that may arise from use of AI/ML. While guidance on general AI risk management frameworks has been developed by NIST and interagency guidance from federal financial regulators on model risk management and third-party risk management can be applied to partially address AI-associated risks, there remains a clear need to clarify and enhance existing risk management frameworks to ensure AI-associated risks are adequately addressed, particularly with respect to GenAI.

- ➢ *State regulators can play an important role in filling in gaps and elaborating on the specific governance and risk management needs to mitigate the risks arising from use of AI/ML in the financial sector, particularly for fintechs and non-bank financial institutions. For example, Colorado and Illinois have both issued guidance on governance and risk management framework requirements for insurers when employing AI/ML systems.*

(7) Rigorously examine financial institutions' governance and risk management frameworks with respect to AI-associated risks as well as other aspects of responsible use of AI/ML.

- ➢ *State financial regulators should fully leverage their supervisory and enforcement authority to rigorously examine financial institutions' governance and risk management frameworks to determine whether AI-associated risks are adequately addressed. Examination manuals should be updated to explicitly incorporate the AI-related topics discussed above, including review of governance and risk management frameworks and as well as review of processes during the design, deployment, and monitoring stages of AI/ML models. Regulators can also leverage the licensing process to ensure that appropriate governance and risk management frameworks are in place at financial institutions from the start.*

(8) Build up internal technical capacity and leverage suptech tools to effectively monitor AI/ML use cases that pose the greatest risks to consumers.

- *In order to effectively supervise use of AI/ML at regulated entities, state financial regulators will need to build up sufficient internal capacity in AI/ML. This will likely entail increasing staff with specialized expertise in data science and engineering. It will also entail making strategic investments in infrastructure in order to evaluate AI/ML systems effectively, such as bias detection tools and automated debiasing tools. More broadly, suptech solutions should be leveraged in order to enable more advanced and efficient data analytics, such as suptech solutions for analyzing unstructured complaints data or suptech solutions that leverage natural language processing (NLP) for non-traditional market monitoring and document review.*

(9) **Actively collaborate with other state agencies and AGs, across states, and with federal agencies, and engage with non-profit organizations.** Effectively mitigating the risks to consumers posed by AI/ML in the face of limited capacity and resources will require collaborating with a range of stakeholders. Collaboration will also help to achieve stronger and more consistent regulatory and supervisory approaches across the market, which is beneficial for both industry and for consumers.

- *State financial regulators should seek to collaborate opportunistically with a range of entities. For example, state AGs can help to address gaps in regulatory guidance and investigate and take action against serious violations. Cross-state investigation and enforcement efforts could help to more efficiently leverage resources. The Conference of State Bank Supervisors' advisory group on use of AI in the financial services sector may be a useful forum for developing shared resources for supervisors. State and local human rights commissions and other state and local agencies working on discrimination, as well as legal services groups and consumer advocacy organizations, may have useful information to share on AI/ML harms observed among vulnerable segments of consumers.*

(10) **Take steps to increase consumer awareness and literacy regarding the risks that AI/ML may pose and how consumers can protect themselves.** Consumers generally appear to be wary and unclear about how financial institutions are leveraging AI/ML. CR research has shown that 60% of Americans are not aware that banks and other lenders may use AI in managing loans and credit approvals, while 46% of Americans believe that the risks of use of AI in lending outweigh the benefits.

- *As part of broader financial and digital literacy efforts, state financial regulators could help to educate consumers regarding the implications of use of AI/ML in financial services, highlighting both potential benefits as well as risks. Educational efforts should emphasize consumers' rights and how to exercise them, such as with respect to adverse action notices or the right to complain to financial institutions as well as to regulators. Advice and tips could also be provided on how to engage safely with digital chatbots and virtual assistants.*

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