How Banks Can Manage Risk As AI Adoption Expands

By **Michael Dawson, Julie Williams and Amy Gopinathan** (May 5, 2025)

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Important signs are emerging that government attitudes and expectations regarding the use of artificial intelligence in financial services are shifting from what has been a cautious approach to a more permissive approach.

On April 3, Office of Management and Budget Director Russell Vought directed federal agencies, including the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Consumer Financial Protection Bureau to "lean forward" in adopting AI in their own operations.[1]

This shift will drive industry practice, and indeed, a day later, Fed Gov. Michael Barr said that while industry had been "appropriately cautious," there may come a time "in the not-too-distant future" where AI "becomes an imperative — a competitive necessity — in banking" and that bank-fintech partnerships may be one channel by which that competitive necessity may arise.[2]

In light of this shift, the rest of 2025 may well be a year in which banks move from initial, tentative experiments in using next-generation AI to wider adoption. As they do so, it is worth looking back on 2024 and asking, "How can we apply what we learned in 2024 to the rest of 2025 and beyond?" This note suggests some practical steps banks can take as they broaden their use of AI.

2024 was a year of significant change. While AI in various forms was already part of some technology used by banks, banks tended to be risk-averse when it came to adopting the next-generation AI tools enabled by large language models.

Many adopted broad-brush policies prohibiting the use of AI. Banks also sent surveys to vendors to learn whether they were using AI and, in particular, whether vendors were using the bank's data to train AI. The result was to freeze the adoption of AI within many banks.

Regulators reinforced this chilly environment through cautionary statements and little in the way of constructive guidance. Then-CFPB Director Rohit Chopra issued a statement reminding banks of their obligations to explain adverse actions in credit decisions and cautioned that pointing to an AI-driven black box decision tool would not be sufficient.

Michael Hsu, who was acting comptroller of the currency at the time, questioned whether it was even possible for AI to be fair, citing academic work in the criminal justice field showing that it was impossible for AI-driven sentencing models to simultaneously satisfy three commonsense definitions of fairness. And the Financial Stability Oversight Council found that the use of AI in financial institutions could constitute a significant systemic risk.

Meanwhile, the regulators did not release new guidance specific to managing these risks, pointing instead to existing guidance on model risk management and stating that banks should extrapolate from it.

But banks found previous guidance — initially written in 2007[3] — to be of little use in dealing with next-generation AI. This was principally because a tenet of this older guidance is that banks must be able to explain how their models work, but even the creators of next-generation AI cannot fully explain how their large language models and neural networks achieve their results.

By the end of 2024, the environment began to thaw — a little. Some business leaders within banks saw a business case for using next-generation AI in various use cases and asked for permission to use it. In response, the legal, risk and compliance functions of some banks (including model development and management) constructed well-governed processes to evaluate the risks and adopt strategies to mitigate them, moving forward with the use cases, often on an experimental or pilot basis.

As these use cases bear out in both the business case and the effectiveness — or at least the absence of demonstrated ineffectiveness — of the risk mitigation strategies, banks are poised to accelerate their use of next-generation AI.

Now, with the recent directive from Vought and comments such as those from Barr, what has been a slow thaw may start to bloom into spring. As the uses of AI advance in the rest of 2025, important elements of risk management need to be deployed as well, including the following.

Agile Governance

It is important that the adoption of next-generation AI be well governed. This could be done through existing risk management processes, but we observed some banks create new processes that leveraged existing risk management measures and expertise to adopt a more nimble approach equipped with personnel focused on the unique technology and risks involved.

Documented Business Case

Banks should resist the temptation to use a new technology for its own sake without a business case. A well-documented business case can help a bank evaluate whether an application produced expected results — whether it was worth the risks.

Risk-Based Approach

Banks should consider the risks of different uses of next-generation AI. In particular, they should be asking what regulatory consequences may apply to the results of the use of AI.

Banks should prioritize lower-risk use cases, such as internal workflow productivity enhancements. Learnings from those use cases can be applied to higher-risk use cases, such as the use of AI to develop and place marketing materials. Banks may wish to defer application of AI to the highest risk area — the approval and pricing of credit to retail consumers or fully automating complaint handling — until later.

Understanding How the AI Model Works

Particularly when using AI supplied by a third-party vendor, banks should seek assurances that the model does not incorporate discriminatory factors. They should also seek assurances about the data on which a model was trained, such as whether the data was free of systemic biases that might lead to impermissible outcomes or whether the data was compiled in a way that would mitigate copyright infringement risk.

Some vendors may be unwilling to provide such assurances or other elements of transparency, which increases the importance of other risk management steps.

Framing New Uses

With next-generation AI and its risk management still in the early phases, banks should frame new uses as pilots. A new pilot should have an exit strategy — how the bank can unwind the pilot if it is not successful. Banks should gather data from the pilots.

Human Oversight

Banks should not turn over any important or risky activity entirely to unsupervised AI. They should keep a human in the loop who is trained on the technology, risks, risk mitigation strategies and escalation paths. This person should keep the governance team informed of the pilot's performance.

This step is particularly crucial if AI is being used for customer communications or transactions.

Monitor Performance and Complaints

Banks should monitor their pilots in essentially real time. They need to take vital signs while the pilot is ongoing, not post-mortem. Complaint management should be attuned to complaints that might be related to the piloted uses and alert the governance team to potential matches.

Regulatory Transparency

Banks experimenting with AI should keep their regulators informed of their intent to use next-generation AI, the process they establish to govern the use, and the risk mitigation strategies they adopt. They should update regulators on the uses and the results.

Conclusion

We think it likely that in the remainder of 2025 and beyond the increased adoption of AI will lead to benefits for both consumers and banks — lower costs, increased choice and greater customization. Prudent risk management will go a long way to securing these benefits while mitigating the risks of unintended consequences.

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[1] Office of Management and Budget, M-25-21, "Accelerating Federal Use of AI through Innovation, Governance, and Public Trust" (Apr. 3, 2025) available at: https://www.whitehouse.gov/wp-content/uploads/2025/02/M-25-21-Accelerating-Federal-Use-of-AI-through-Innovation-Governance-and-Public-Trust.pdf.

[2] Gov. Michael S. Barr, AI, Fintechs, and Banks, Remarks at the Federal Reserve Bank of San Francisco (Apr. 4, 2025) available at: https://www.federalreserve.gov/newsevents/speech/barr20250404a.htm.

[3] 2021 updates to the guidance consisted primarily of standardizing guidance across the regulatory agencies.