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Statement by

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of the

Committee on Financial Services

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Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for the opportunity to discuss supervision and regulation as it relates to innovation in the financial system.

The Federal Reserve is committed to supporting responsible innovation, both by the firms we oversee directly, and in the financial system broadly. We recognize that innovation can reinforce the safety and soundness of banks and the stability of our financial system, increase operational efficiencies, and reduce costs. Innovation can increase opportunities for financial inclusion and pave the way for new financial products and services that benefit the public.

However, innovation can also lead to risks, some of which are familiar and others more novel. The Federal Reserve Board, alongside the other federal bank regulatory agencies, has a statutory responsibility to supervise banks to help ensure they operate in a safe and sound manner and in compliance with all applicable laws. In keeping with that mission, we require the banks we oversee to identify and manage the risks associated with the new technologies they use.

Our approach to supervising and regulating innovation in banking is based on the following overarching principles. First, activities that present fundamentally the same risks should be regulated in the same way, regardless of where or how the activity occurs or the terms used to describe the activity. If, in other words, a novel product or service raises the same risks as a traditional activity, it should be subject to the same regulation, even if it is based on new technology or described using different terminology.

Second, the Federal Reserve has not taken and does not take a position on who banks can offer services to, so long as they remain within the confines of the law. Banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.

Third, we have sought to be transparent about our expectations and approaches to novel activity supervision and regulation to provide a pathway for responsible innovation. We articulate those expectations through a variety of channels, including guidance, statements, and other resources.

Finally, we recognize that we also must continue to learn, which is why we engage in regular outreach. Federal Reserve staff frequently meets with banks, nonbank fintechs, academics, and others to exchange views on how technology is changing the banking sector and the financial system as a whole. These meetings provide an important window into how innovation is shaping the banking sector and are vital to helping us develop appropriate supervisory and policy actions.

In keeping with these principles, the Federal Reserve recently announced the creation of a novel activities supervision program to focus on the supervision of risks posed by novel, technology-driven activities at banks.[1] These activities include those involving crypto-assets, distributed ledger technology, and complex technology-driven bank partnerships with nonbank fintechs. We expect this program to evolve as new technologies emerge. By dedicating a team of supervisory experts to the oversight of novel, technology-driven activities, our aim is to provide clarity as well as timely, consistent, and relevant feedback to the institutions we supervise. We want banks to continue to take advantage of innovations, while also operating in a safe and sound manner.

As I noted previously, distributed ledger technology and crypto-asset-related activities

[1] Board of Governors of the Federal Reserve System, "Creation of Novel Activities Supervision Program," SR letter 23-7 (August 8, 2023), https://www.federalreserve.gov/supervisionreg/srletters/SR2307.htm.

are a focus of the novel activities supervision program. Distributed ledger technology offers the potential to increase efficiencies, lower costs, and increase access to financial products and services. Crypto-assets leverage the technology and are generally issued on open, public, decentralized networks. Both crypto-assets and the technology underlying them also present risks, including those related to governance and risk management of the network, and legal uncertainties around issues such as settlement finality and ownership rights. And crypto-assets' pseudonymous nature can create heightened illicit finance risks. As with all of their activities, banks engaging with the crypto-asset sector are expected to do so in a manner that is safe and sound. For example, banks with a high concentration in crypto-asset-related deposits may face heightened liquidity risks, given the significant volatility and interconnectedness in the sector, and should appropriately manage such risk.[2]

Beyond crypto-assets, some banks have expressed interest in more directly engaging in distributed ledger technology and tokenization of traditional assets, such as currency or securities, to expedite and automate payment, clearing, and settlement services.

Digital tokens that aim to maintain a stable value relative to a government-issued currency—often referred to as "stablecoins" or "dollar tokens"—have rightly garnered significant attention, given their implications for payments and financial stability. To provide clarity for banks interested in engaging with dollar tokens, we recently issued guidance on the process by which a Federal Reserve-supervised bank can seek to obtain a supervisory non-

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[2] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities," news release, February 23, 2023, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf.

objection before issuing, holding, or transacting in dollar tokens.[3] This process will allow the Federal Reserve to verify that a bank has appropriate risk management systems in place to identify and control potential risks with respect to dollar tokens, including those related to operations, cybersecurity, liquidity, illicit finance, and consumer compliance.

Novel banking activities involving complex partnerships between banks and technology-intensive third parties have also been an important area of focus. Third-party relationships can offer banks, particularly community banks, access to new technologies and innovation but can also introduce risks that need to be managed, such as, for example, operational risks and consumer compliance risks. As I mentioned, the novel activities supervision program will be helping to oversee complex technology-driven bank partnerships with nonbank financial technology companies.

The federal bank regulatory agencies have also recently issued guidance on third-party risk management, which lays out the agencies' supervisory expectations for all types of third-party relationships, including relationships with financial technology companies.[4] In addition, the agencies have released a guide designed to assist community banks to assess risks in constructing and considering relationships with fintech companies.[5]

Another technology that holds potential is artificial intelligence (AI). Banks are

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[3] Board of Governors of the Federal Reserve System, "Supervisory Nonobjection Process for State Member Banks Seeking to Engage in Certain Activities Involving Dollar Tokens," SR letter 23-8 (August 8, 2023), https://www.federalreserve.gov/supervisionreg/srletters/SR2308.pdf.

[4] Interagency Guidance on Third-Party Relationships: Risk Management, 88 Fed. Reg. 37,920 (June 9, 2023), available at https://www.federalregister.gov/documents/2023/06/09/2023-12340/interagency-guidance-on-third-party-relationships-risk-management.

[5] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Conducting Due Diligence on Financial Technology Firms: A Guide for Community Banks" (October 2023), https://www.federalreserve.gov/publications/files/conducting-due-diligence-on-financial-technology-firms-202108.pdf.

leveraging AI for a variety of applications, such as fraud monitoring and customer service. While the technology offers several benefits, it also poses risks, including data challenges, explainability, bias, cybersecurity, and consumer protection. Given these risks, it is important that banks using AI are doing so in a safe, sound, and compliant manner. Federal Reserve staff continues to work closely with the other federal bank regulatory agencies to track and learn more about emerging practices regarding banks' use of AI and related risk management.

Finally, it is important to note that innovation is not confined to the private sector. The Federal Reserve is focused on finding opportunities to use innovative technology to enhance our supervision of the banking industry. We are evaluating industry-leading technology to determine if adoption of such tools will enhance our supervision technology and increase efficiency.

Conclusion

The Federal Reserve is committed to supporting responsible innovation so that the financial system and the public can enjoy the many benefits innovation can offer. At the same time, we are mindful of our mission to keep the financial system safe and sound and so are focused on ensuring that any risks associated with novel financial products and services are properly managed.

Thank you. I look forward to your questions.