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AI in financial services

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Artificial Intelligence (AI) is a fast-evolving technology that has the potential to have transformative effects on the financial services sector, by making financial services more efficient, accessible and tailored to consumer needs. This could deliver widespread economic and societal gain. But AI may also give rise to risks and challenges that regulators across the world are grappling with.

In this newsletter we consider what AI is and how it can be defined, use cases and concerns around the use of AI in financial services and the way that legislators and financial services regulators are responding in the UK, EU, US, and Asia.

AI is a tricky concept to define

AI is often used as an umbrella term to cover a variety of underlying computing technologies.

A UK House of Lords' Select Committee once suggested that AI encompasses

technologies with the ability to perform tasks that would otherwise require human intelligence, such as visual perception, speech recognition, and language translation. Although that is a decent attempt at defining AI for many purposes, it also illustrates the challenges of finding a single definition. It tries to define AI by reference to human intelligence (itself notoriously hard to define) and AI can often be used to achieve tasks that humans can't perform. There is no universally agreed definition, partly due to the complex technical nature of the field.

As AI becomes more prevalent in our lives, lawmakers in many jurisdictions are struggling to agree definitions of 'AI' in their proposals for regulation, for example compare the positions for AI regulation in the UK and EU. A global consensus on a universal definition would provide a common language for firms and regulators around the use and regulation of AI.

Another key concept is "generative", which is broadly AI algorithms that can be used to generate new content including text, images or software code. Generative AI has taken the world by storm recently – particularly popularised by various new generative AI chatbots. As well as posing interesting ethical questions, the proliferation of generative and other AI tools presents some novel challenges for lawyers advising financial services companies that are developing or using these tools, described in 5 things for lawyers to consider and a more detailed guide.

Firms need to mitigate risk whilst developing AI use cases

There are well-established use cases for AI but evolutions of those and new use cases are developing all the time. The benefits for both financial institutions and customers are clear in terms of efficiency, customer service and tackling financial crime. Robo advice models to assist customers in investment decisions give customers access to lower cost advice and information; chat bots for routine enquiries give customers instant help with routine enquiries whilst freeing up staff to focus on more complex requests; algorithms that analyse Big Data can identify the latest fraud schemes more quickly and reduce losses from fraud; and, credit decision-making using a wide range of data beyond traditional credit scores can reduce credit default levels and allow under-served communities to access credit that they would not have been granted based on credit scores alone.

A key challenge for firms is to design governance controls around AI use cases to build in safeguards both on day one and as the models evolve with use. Some issues will be familiar, such as the risk of coding errors or unauthorised changes, that can be mitigated by code review and governance of third-party developer processes. Other risks are emerging as regulatory attention focuses on technological developments. Algorithms used to analyse large data sets to assist with decision making can be influenced by correlation, outliers and extraneous data that could result in an unfair or biased outcome. In the UK, the Financial Ombudsman Service has already commented in a decision that a bank needs to be able to provide a reason for a refusal of credit (in that case an overdraft) and that it is inadequate to rely on an automated decision process without being able to pinpoint the underlying factors. This emphasises the need for "explainability" of a model, the ability to review factors used by the model in an individual decision and, perhaps, for a sense check when complaints arise. Another challenge is the balance between utility and data privacy protection when creating a synthetic data set for analysis. The closer the synthetic data set reflects the real data, the better the analysis but it carries the risk that underlying customers can be identified from the synthetic data unless there are sufficient safeguards in place.

Governments around the world are responding

Governments around the world are generally keen to promote innovation and competitiveness whilst mitigating their main concerns with AI. They are taking a range of approaches.

The EU proposes AI-specific legislation to regulate the use of AI across all sectors. The EU's aim is to provide for harmonised rules on the development, use and distribution of safe AI systems that respect fundamental rights of individuals with a focus on the highest risk applications. The use of AI in financial services may be regarded as a high-risk application, irrespective of the use case.

In contrast, the UK's white paper proposes a less prescriptive approach with responsibility for AI delegated to existing sectoral regulators underpinned by five cross-sectoral principles relating to themes common in other jurisdictions – namely, safety, transparency, fairness, redress and governance and accountability.

No comprehensive approach to regulating AI in the US has emerged to date, but the White House Blueprint for an AI Bill of Rights, an AI Risk Management Framework and joint statement *on Discrimination and Bias in Automated Systems* from the Consumer Financial Protection Bureau, Department of Justice and others provide an early glimpse into priorities and concerns of federal policymakers. With respect to financial services specifically, the federal banking agencies issued a request for information regarding financial institutions' use of AI. The timeframe for any rules, however, is unclear.

Whether or not formal legislation is planned, financial services regimes will adapt or be extended to encompass financial institutions' obligations to manage the use of AI.

In Hong Kong there are no legislative proposals for AI and the approach in the US is likely to be light touch in terms of legislation. Financial services regulators, however, are filling the gap.

Although the EU draft legislation is sector neutral, AI specific risk management and governance obligations are incorporated into the existing capital requirements regulation for banks. The European Central Bank is committed to a technology neutral approach to bank regulation, so that other prudential and conduct standards will apply equally to the development of AI use cases. EU member state regulators are more engaged in the discussion and, for example, regulators in Germany and the Netherlands have issued statements on AI.

In the UK, the regulators are considering the future approach to the regulation of AI. For now, the newly introduced consumer duty requires firms to act to deliver good outcomes for retail customers and to consider the needs, characteristics and objectives of customers, including those with characteristics of vulnerability. Any potential bias in the use of AI will be relevant for these purposes. At a senior manager level, in the UK and Hong Kong those individuals will need to be comfortable with the use of AI in the areas for which are responsible and, as part of this, will need to ensure that there are strong governance controls in place. And in the US the Consumer Financial Protection Bureau has affirmed that the Equal Credit Opportunities Act against discrimination in credit decisions applies equally to credit decision-making using algorithms.

One topic that has attracted regulatory attention in several jurisdictions is robo-advice, and regulators are all on the same page in terms of consumer protection and robust governance.

For example, a US Securities and Exchange Commission risk alert on use of

algorithms and other automated digital tools investment advice provides guidance on transparency, robust risk management and compliance procedures, and periodic testing of algorithms to ensure that they are working as expected and to detect unauthorised algorithm changes.

Hong Kong Securities and Futures Commission (SFC) issued guidelines on the provision of robo-advice and the SFC CEO commented in June that 'We expect licensed corporations to thoroughly test AI to address any potential issues before deployment, and keep a close watch on the quality of data used by the AI. Firms should also have qualified staff managing their AI tools, as well as proper senior management oversight and a robust governance framework for AI applications. [As with other financial services regulators,] For any conduct breaches, the SFC would look to hold the licensed firm responsible — not the AI.'

And on the broader front, the UK's white paper, UK regulators' joint discussion paper, the White House Blueprint for an AI Bill of Rights and the Hong Kong Monetary Authority principles all cover:

- Consumer protection, data privacy and transparency - AI's reliance on large volumes of data, including sensitive personal information, increases its susceptibility to privacy breaches. Equally, AI algorithms can be complex, meaning consumers struggle to understand the rationale behind decisions that impact them. Ensuring "explainability" for AI generated decision-making is a key focus.
- Fairness and discriminatory decisions - Bias embedded in historical data or which arises as a result of the evolution of algorithms, can result in incorrect or unfair predictions. Use of AI to identify and target customers, can also foster exploitative practices, such as promoting poor-value products to financially distressed consumers.
- Safety and soundness - The need for operational resilience and safe and effective systems that minimize performance failure risks are key. Good practice for due diligence, design processes and robust testing are promoted.
- Governance and accountability – An emphasis on senior management responsibility for use of AI, governance around its development both in-house and externally, monitoring and timely changes when issues arise. As the US Acting Comptroller of the Currency commented, there is a need to allocate responsibility for misalignment between intentions and outcomes as the AI "learns".

The concerns and the principles broadly align although there are some differences in emphasis, for example the UK regulators emphasise the need to facilitate competition and innovation. US authorities, in the joint statement and elsewhere, also highlight the need for an alternative where the technology used might exclude people from a critical service.

Taking the regulatory statements and guidelines together, it is clear that financial services regulators will ensure that conduct and even some prudential regulation is extended to the new use cases for AI in financial services even in the absence of legislation.

For insights on other financial services topics, you can review our earlier editions here.

If you would like to provide feedback on this or other editions, please contact Laura Feldman.

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