FS Club Events

AI Regulation In Financial Services: Navigating Compliance And Strategy

11:00, Tuesday, 01 April 2025

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A Word From Our Chairman

Mike Wardle

Chief Executive Officer

Z/Yen Group

FS Club Events

Today’s Agenda

- 11:00 - 11:05 Chairman’s Introduction
- 11:05 - 11:25 Keynote Presentation - Adam Leon Smith & David Doyle
- 11:25 - 11:45 Question & Answer

FS Club Events

Today's Speakers

Adam Leon Smith
Chair
AIQI Consortium

David Doyle
Board, Kangaroo Group (EU Parliament)
EU Policy Director, The Genesis Initiative

The EU AI Act

- A vision from Brussels

Dr. David P. Doyle
EU Financial Services Regulatory Expert

1st April 2025

WHAT IS THE EU AI ACT?

- The EU AI Act: world's first initiative for comprehensively regulating AI - focusing on **risks** of **usage,** rather than **applications.** Divergent approaches being adopted by the EU, UK and USA

- Creators of AI models are liable for how the technology is **used** – even when a 3rd-party embeds it in a different system – all 'high-risk' AI systems subject to prior examination to ensure they are free of errors and bias

AI Act introduces:

- Due diligence obligations in the development of the AI system from the outset, including applications used for targeting legal and natural persons

- Mechanisms to verify the correctness of the decision/outcome

- Measures holding individuals/entities accountable if the decision is found to be incorrect.

EU Artificial Intelligence Act – focus

- Overall objective AI Act : **to increase the acceptance and trust in AI by European consumers**.
- EC opted for **“horizontal approach”** by creating one technology-focused regulation covering AI`s impacts and use-cases.
- The AI not tailored for specific AI models or economic sectors, ie, financial sector
- EC has powers to create bespoke regimes for financial services by means of secondary rulemaking , i.e. implementing acts
- AI systems clustered within 3 categories and subject to different requirements:
  - An **outright ban** for certain AI systems that pose **an unacceptable risk**
  - **Stringent requirements** for AI systems classified as **high risk**
  - A more limited set of (mainly **transparency**) requirements for AI systems **with a lower risk**.

Who is affected by the AI Act?

- AI creators, providers, deployers, importers, distributors, and product manufacturers – not users
- All actors involved in the development, usage, import, distribution, or manufacturing of AI models – to be held accountable.
- Extra-territoriality: providers and users of AI systems located outside of the EU, ie, Switzerland, if output produced by the system is intended to be used in the EU.
- AI Act requires 3rd-country providers/creators of AI systems to **appoint an authorized representative established in the EU**
- **AI creators required to identify and disclose data the systems have been trained on**
- **Ultimate responsibility and liability for mis-usage of AI remains the original AI creator, thus the licensed firm using the AI model not at fault**

Implications of AI Act for financial services - explicit references to financial potential ‘High-Risk’ use cases

- **Credit and social scoring models** and evaluation by banks of creditworthiness of natural persons in loan origination and decisioning
- Automated **insurance** claims processing and setting of risk premiums for clients
- **Risk assessment tools** in the insurance sector, used for setting risk premiums, assessment in the case of life and health insurance - poor design results financial exclusion and discrimination.
- Provision of **investment services** to natural persons or retail clients via Chatbots... Robo-advisor functions
- Use of real-time remote biometric identification in public spaces

- **High-risk FS AI models** permitted, but must be assessed by regulators first (conformity assessment) and are required to be registered in an EU database – end 2027

- **Ultimate responsibility and liability for mis-usage of AI application remains with the original AI creator, not the licensed firm using the AI model**

Financial services providers/initiators of “high risk” AI systems – requirements

- **Assign human oversight** to natural persons, with necessary skills, training and authority
- **Monitor the operation of these systems**
- Ensure that **input data is relevant/solid and remains** under their control
- **Keep automatically generated logs** by the AI system, under their control
- Carry out **data protection impact assessment**
- **Cooperate with NCAs** on any action pursued in relation to the AI system

3rd Party risks must be managed by provider

- Provider to inform 3rd parties of any risks or incidents linked with the use of AI systems and suspend the use of the system if needed

- **Obligations** of providers vis-à-vis 3rd parties:

➢ The 3rd party to assign their name/trademark to AI system
➢ Any modifications to AI system made in a way that it remains a high-risk AI system – no dilution/circumvention
➢ Any modifications to a non-high-risk AI system (ie, general purpose AI) is not transposed into a high-risk one by 3rd-party

Rigorous DORA compliance from 17th January 2025

European Commission

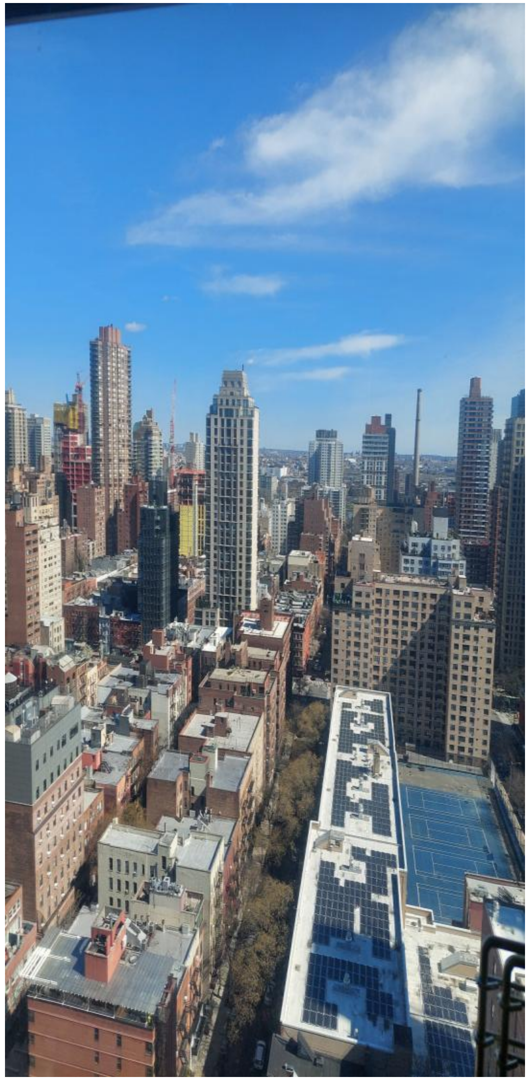
Regulating AI at transnational level – a diverging picture

- Regional divergences worldwide in regulating AI – most in early stages of development, but EU setting the standard
- UK adopting pro-innovation framework – regulating the AI applications by sector, rather than underlying technology behind the GAI products
- US pursuing self-regulation, with all Tech majors agreeing to voluntary set of commitments with White House (July 2023), ie, internal & external testing of AI systems before going public, increased transparency on systems' capabilities & limitations
- Divergence: UK, US and Europe on AI copyright rules:

✓ 'fair use exemptions allowing AI firms use of copyrighted material via short excerpts but media, artists disagree

✓ Allow AI firms use of copyrighted material without consent, unless the owner opted out (EU)

✓ Either way, processing and enforcement of systems across numerous platforms and use cases, unreliable



Potential AI risks – Focus of EU regulators in supervising AI actors

Explainability

- Lack of transparency-understanding (client)
- Lack of expertise (supervisors)

= impairs risk management

Data quality, protection, availability

- Data Privacy (GDPR)
- Data security
- Intellectual Property
- Data access
- Scope filters (before collection)
- Exclusion of certain data

Concentration, systemic risk, inter-connectedness

- 3rd-party distributor/ICT-provider dependant
- Operational resilience

Algorithmic bias

- Representativeness
- Bias and fairness
- Factual inaccuracies
- Traceability
- Potential copyright /IP infringements

Operational risk

- Malicious actions (theft, fraud)
- Unauthorized use of AI
- Deepfakes

Challenges identified by Regulators

- **Geo-political tensions**
  US Government new rules requiring US cloud companies to disclose when foreign actors train powerful AI models using their system (February 2024)

- **Data centres emissions**
  Growing power-intensive usage in energy and water associated with AI data centre infrastructure, triggering increased emissions. National restrictive measures introduced on development of new datacenters , ie, Ireland, Singapore.

- **Digital Services Act policing of fake information**
  Industry platforms failing to adequately manage their AI-powered disinformation or deepfakes face fines up to 6% of global turnover

- UK engineering firm ARUP lost $25m due to fraudsters using a digitally-cloned, hyper-realistic video of a senior manager requesting transfer of funds – world's biggest known deepfake scam.

- **Risks of using AI to fight cyber-crime**
  Cyber-criminals inject false data into AI Large Language Models (LLM) of generative AI systems used by banks: injecting normal finance transactions as fraud, and visa-versa, resulting in AI model learning to classify these activities incorrectly.

- Standard Bank Group (South Africa) 2016 cyber attack stole $13m by forging 1600 credit cards

EU Energy Efficiency Directive

- EU-wide scheme to rate sustainability of data centres - consume 3% of electricity demand

- Requires data centre operators to report the key performance indicators to the European database by 15 September 2024 and 15 May in 2025 and subsequent years.

- Binding target of reducing the EU energy consumption by 11.7% by 2030

The EU Financial Service Regulatory Agenda

Dr. David P. Doyle
EU Policy Expert

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UK Approach to Regulating AI in Financial Services

A Principles-Based Framework

Adam Leon Smith DEng FBCS

Chair, AIQI Consortium

March 2025

UK Regulatory Philosophy

- **Principles-based approach** rather than prescriptive rules
- **Technology-neutral stance** - focus on outcomes not specific tech
- **Pro-innovation** while ensuring appropriate safeguards
- **Sector-specific regulation** rather than horizontal AI legislation
- In contrast to the EU's more prescriptive AI Act

UK's Five AI Principles

The UK government's framework is built on five core principles:

1. **Safety, Security and Robustness**
2. **Appropriate Transparency and Explainability**
3. **Fairness**
4. **Accountability and Governance**
5. **Contestability and Redress**

These principles guide regulators in developing sector-specific approaches

Safety, Security and Robustness

Key regulatory frameworks:

- FCA Principles for Business (especially Principles 2[1] & 3[2])
- Senior Management Arrangements, Systems and Controls (SYSC)
- UK AI Cybersecurity Code of Practice
- Critical Third Parties framework (proposed)

Key considerations:

- Unique cybersecurity/robustness concerns
- AI needs to be within firms' risk management frameworks
- Third-party dependency increasing (33% of AI use cases)

Key technical standards:

- ETSI xxx (Cybersecurity); ISO/IEC 24029-x series (Robustness)

[1] firms must conduct their business with due skill, are and diligence

[2] take reasonable care to organise and control their affairs responsibly, effectively and with adequate risk management systems

Appropriate Transparency and Explainability

Key regulatory frameworks:

- Consumer Duty (acting in good faith requirements)
- Principles for business - communications clear, fair and not misleading
- UK GDPR requirements on automated decision-making

Key considerations:

- 81% of firms use some kind of explainability method
- Feature importance (72%) and Shapley values (64%) most common
- 46% of firms report only 'partial understanding' of their AI systems
- Particular challenges with third-party models and foundation models

Key technical standards:

- ISO/IEC 12792 (Due 2025, Transparency); ISO/IEC TS 6254(Dyue 2025, Explainability)

Fairness

Key regulatory frameworks:

- Consumer Duty - positive consumer outcomes
- UK GDPR fairness principles
- Equality Act 2010
- Vulnerability guidance

Key considerations:

- Data bias and representativeness is a top-5 risk
- Consumer protection is a priority for regulators

Key technical standards:

- ISO/IEC TR 24027 and TS 12791 (Bias); ISO/IEC 5259-x series (Data)

Accountability and Governance

Key regulatory frameworks:

- Senior Managers & Certification Regime (SM&CR)
- SYSC requirements on governance
- Consumer Duty governance requirements

Key findings:

- 84% of firms have an accountable person for their AI framework
- 72% allocate accountability to executive leadership
- Responsibility often split between multiple accountable persons

Key technical standards:

- ISO/IEC 42001 (Management); ISO/IEC 38507 (Governance); ISO/IEC 42005 (2025, Impact assessment)

Contestability and Redress

Key regulatory frameworks:

- Dispute resolution rules on complaints handling
- Financial Ombudsman Service
- UK GDPR rights regarding automated decisions
- Financial Services Compensation Scheme

Key considerations:

- Firms remain responsible for AI decisions
- Clear complaint and redress mechanisms required
- Consumers need effective means to challenge AI decisions

AI Materiality and Automation Levels

Materiality of AI applications:

- 62% of AI use cases rated as low materiality
- 22% rated as medium materiality
- 16% rated as high materiality
- High materiality cases concentrated in general insurance, risk and compliance, and retail banking

Automation levels:

- 55% of AI use cases have some degree of automated decision-making
- 24% are semi-autonomous (human-in-the-loop for critical decisions)
- Only 2% have fully autonomous decision-making

Source: Bank of England survey, 2024

Regulators' Own Use of AI

- **FCA:**
  - Web scraping to detect and triage scam websites (33.5% increase in warnings)
  - Synthetic data for sanctions screening testing
  - TechSprint for AI-powered trade surveillance
  - 75+ data scientists recruited
- **Bank of England:**
  - Predictive analytics for economic research
  - Analysis of large datasets
  - Cognitive search tools to identify patterns in firm management information

Key points

- UK taking a principles-based, sector-specific approach to AI regulation
- Existing frameworks largely deemed sufficient for current AI risks
- Focus on outcomes rather than technology-specific rules
- Increasing concerns about third-party dependencies and concentration
- Foundation models present new challenges for explainability
- Proportionality balances innovation with appropriate safeguards
- International alignment will be important going forward
- Regulatory approach will evolve as AI adoption increases

Contact Information

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Thank you for your attention

FS Club Events

Today's Speakers

Adam Leon Smith
Chair
AIQI Consortium

David Doyle
Board, Kangaroo Group (EU Parliament)
EU Policy Director, The Genesis Initiative

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Comments, Questions & Answers

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Forthcoming Events

- Wednesday, 23 April 2025 (15:30 - 16:15 BST)   Fewer Rules, Better People: Why Discretion Makes For Better Decision-Makers
- Thursday, 24 April 2025 (09:00 - 09:45 BST)Launch Of Global Green Finance Index 15
- Wednesday, 30 April 2025 (10:00 - 11:00 BST)   Taiwan's AI-Driven Financial Innovation & Digital Transformation

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