The Banking Union at Ten – European Banking and Capital Markets Law between 2014 and 2024,
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AI in Financial Markets: From Risk Prevention to Risk Redress

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The Questions

Assumption:

The European legislator is seeking to deploy a cross-sectoral approach to AI, both from an ex ante regulatory perspective (AI Act) and an ex post liability perspective (proposals on AI-related liability)

Questions:

Which are the implications of this general regulatory strategy in the sectoral domain of the financial system?

Which are the concrete regulatory techniques relevant to coordinate general AI-related regulations and sectoral financial requirements?

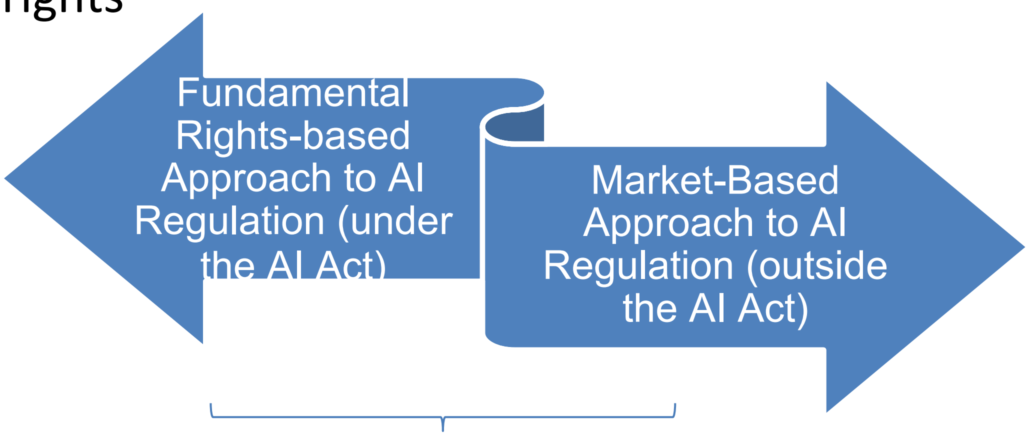
The AI Act

The AI Act is

i) a horizontal regulation, regulating AI models in every sector of the European internal market;

ii) a risk-based regulation, for it targets the minimization of the risks arising from the manufacturing and employment of AI systems

is not a holistic regulation because it targets the protection of personal fundamental rights



The case of Financial AI

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The AI Act in Finance: the direct regulatory effects for high risk systems

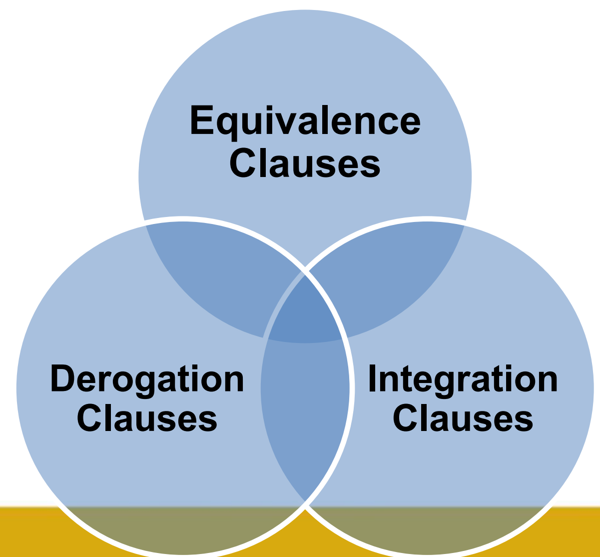
Annex III
High Risk Systems

Credit scoring → Health Insurance Scoring → Life Insurance Scoring

Recital 80 AI act "Union legislation on financial services includes **internal governance and risk management rules and requirements** which are applicable to regulated financial institutions in the course of provision of those services, including when they make use of AI systems. (…)".

AI Act

Sectoral Financial Regulation



The AI Act in Finance: the Supervision of high risk systems

Annex III
High Risk Systems

Credit scoring

Health Insurance Scoring

Life Insurance Scoring

Recital 80 AI act: “**the competent authorities for the supervision and enforcement of the financial services legislation»**

Art. 63(4) designates sectoral supervisory authorities as market surveillance authorities for financial AI systems falling under the scope of the AI Act.

Information duties to the ECB, which remains competent only for prudential supervisory tasks (ECB Opinion on AI Act, 2021)

The AI Act in Finance: The Regulation for Low Risk Systems

Art. 4a: General Principles as i) the non-exclusivity of automated decision-making or ii) the sustainability of AI Systems

Art. 4b: providers and deployers of AI systems (not qualified based on a risk-based approach but generally intended) are required to “ensure, to their best extent, a sufficient level of AI literacy of their staff and other persons dealing with the operation and use of AI systems on their behalf»

= DORA: cyber hygiene (recital 45 DORA)

Art. 52 AI Act: Transparency of certain AI systems

Indirect effect of the AI Act onto the regulation of financial AI systems:
Gold Plating Effect resulting from the use of same foundation models for different tasks (e.g. credit scoring and IRB models- EBA)

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From the AI Act to DORA

- **The Regulation on Digital Operational Resilience of Financial Institutions (Reg. 2022/2554)**

- Art. 2(5) DORA defines "ICT risk as any reasonably identifiable circumstance in relation to the use of network and information systems which, if materialized, may compromise the security of the network and information systems, of any technology dependent tool or process, of operations and processes, or of the provision of services by producing adverse effects in the digital or physical environment" = **also AI risks!!!**

- Corporate Governance: the board's duties
- Contractual Integration for greater transparency
- Supervision of Third Critical Providers

Market-based regulatory model in respect to financial ICT risk

AI and Systemic Risk: from micro- to macro- risk prevention

- The systemic risk bearing of AI systems: standardised AI models or algorithms are frequently trained on similar data streams and could thus produce herding and uniformity of predictions and behaviour in financial markets.

- AI is transforming both the financial system and the way in which that system is regulated and supervised, creating new — and still largely understudied — sources of systemic risk

- Already in 2020 the European Systemic Risk Board acknowledged that technology-driven financial systemic risk (or 'systemic cyber risk') creates threats that 'require further work by macroprudential authorities' (ESRB 2020).

- A field open to research is the emerging conduct of business regulations in the field of AI (as the AI Act) and the field of prudential regulation, with particular attention to the dimension of operational and conduct risk.

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The Ex Post Liability Dimension of Financial AI Risk

- Neither the AI Act nor the DORA provide status recognition, procedural rights (e.g. to seek redress), nor complaint mechanisms (i.e. right to an effective remedy and a fair trial) for victims of harm caused by AI systems

- Within financial markets, civil liability operates both as a compensatory device and as deterrent against violations of the standards of conduct set by the legislator for financial markets agents and entities.

- The application of general civil liability rules and mechanisms to AI-related harms is challenging due to the inherent features of AI systems:

Autonomous

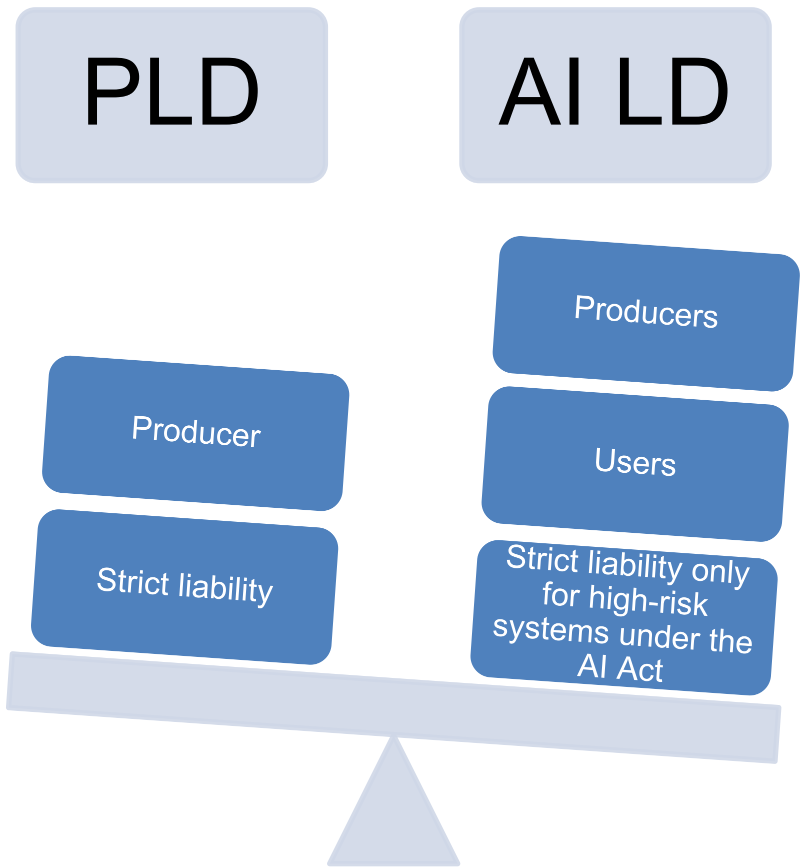
Opaque

Complex value chain

The Reform Proposals on AI-related Civil Liability

- **September 2022, Proposal for a Revision of the Product Liability Directive and Proposal for an AI-related Liability Directive**

- Financial Institutions (users) or end clients can seek redress from producers of any AI system resulting defective and harmful



- Financial Institutions (users) or end clients can seek redress from producers of credit/health & insurance scoring systems
- End clients can seek redress from financial institutions (users) of credit/health & insurance scoring systems

The Missing Piece of (Financial) Users' Liability

- The European Reform pose greater emphasis on the producers' liability

- Exception made for Users of high-risk systems under the AI Act, no attention is given to the liability of low-risk AI systems

- Under DORA, board's monitoring and oversight duties… but…

- When is a monitoring activity conducted negligently? Which is the monitoring standard that the user has to prove so as to prove its diligence? How should this liability be matched with the manufacturers' one? How is the human-machine interaction to be designed?

- **AI literacy requirement can be a first source of a new diligence standard of AI users!**

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The Uncertain Insurance Path

- **European Parliament's solution (2017): Users' Insurance!**

- "Uncertainty regarding risks should not make insurance premiums prohibitively high and thereby an obstacle to research and innovation"

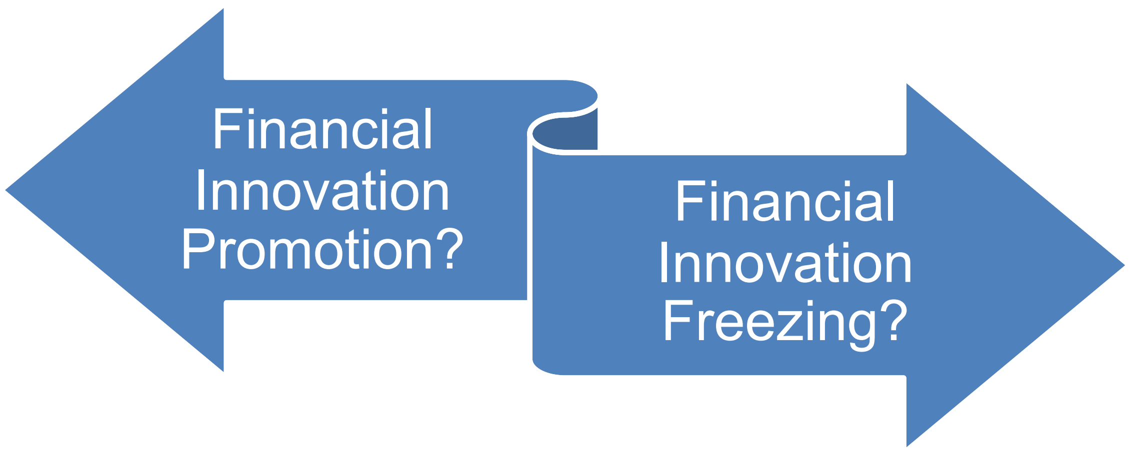
- "The Commission should work closely with the insurance sector to see how data and innovative models can be used to create insurance policies that offer adequate coverage for an affordable price".

- But EIOPA in September 2022 published two supervisory statements on exclusions related to systemic events and the management of non-affirmative cyber exposures, which may restrict the insurability of cyber risks

- What effective viability of the option of substituting civil liability solutions with insurance policies?

Conclusions

- Fragmented Regulatory Framework on Financial AI risk from both an ex-ante regulatory standpoint and an ex-post liability perspective, in accordance with a market-based approach to financial AI regulation



- Market-based regulatory model should be a point of conjunction between EU and US so as to find common regulatory solutions vis à vis an international tech market