Financial Services Management

AI/ML Regulation

Cite

FRB, OCC, FDIC, NCUA, CFPB; Request for Input and Comment on Financial Institutions' Use of Artificial Intelligence, including Machine Learning

Recommended Distribution

Technology, Credit Administration, Risk Management, Compliance, Audit/Examination, Legal, Government Relations

Website

https://www.sec.gov/news/public-statement/lee-climate-change-disclosures

Impact Assessment

- Federal regulators have tentatively begun exploring the regulation of AI use, focusing principally on risk management, opacity, consumer protection and fair lending. Systemic risks of concern to global regulators appear so far beyond this gambit.
- Actions following this RFI will have far-reaching impact on financial-sector innovation, entry, structure, and the populations served.

Overview

Advancing their efforts to ensure "responsible innovation," federal agencies have taken an initial, cautious step into assessing the prudential, compliance, risk-management, and fairness implications of artificial intelligence (AI) and machine learning (ML). Posing only very general questions on matters most clearly within their purview, the agencies appear open and perhaps in some ways even eager to govern AI/ML use, but most uncertain about how to do so. Congress, which is quite concerned about many aspects of AI, may well force the agencies' hand.

Impact

Requests for information (RFIs) of this sort generally advance when agencies are either unsure about how to act or unable to agree among themselves on even a preliminary rulemaking. RFIs also permit agencies to get general feedback without the constraint of each entity's legal mandate and statutory constraints, creating a platform for action by one or more agencies as deliberations continue. This RFI thus begins an assessment that could well spur significant regulatory change in the U.S. in concert with continuing assessment of AI's impact by global regulators.[1]

The RFI includes a lengthy discussion of how financial institutions use AI/ML and the benefits as well of risks of doing so as observed by the agencies. The RFI concludes that most of the risks associated with AI are not unique and thus the controls required for it are generally akin to those necessitated by other operational systems and processes. AI it is said, however, does present what may be particularly high consumer-protection risks, with the RFI emphasizing what may be unfair, deceptive, or abusive practices (UDAP). The RFI cites its authority with regard to UDAP as the FTC Act, but the CFPB – an issuing agency – has still broader authority including the "abusive" term not provided to the FTC. It has recently reinstated prior, tougher UDAP requirements to which the RFI may also refer.[2] The RFI also notes possible privacy risks with particular alarm.

Despite its statement about AI risk similarity, the RFI also describes with concern and defines risk-management concerns including explainability, data usage, and dynamic updating. These concerns are particularly problematic for supervised institutions since their opacity impedes post hoc examination and accountability. The agencies are also concerned about these risks when AI/ML approaches are used in new ways or encounter unanticipated risks. The manner in which data are used also poses significant discrimination or prudential risks.

In contrast to global regulators, the RFI does not directly address potential systemic risk due to the scalability of AI and the market clout of tech-platform companies actively advancing financial-system objectives. Some of these are not directly germane to AI per se – i.e., the extent to which financial-industry dependence on a few cloud-service providers creates risk to critical infrastructure.[3] However, the FSB in 2017 feared new monopolies or even oligarchies due to the power of big data and AI that would lead to systemic risk. Even so, the RFI does not seek comment directly on this concern. This may be because the agencies believe competition and concentration issues are beyond their mandate, but those germane to critical infrastructure and systemic risk are surely within their scope. Indeed, the 2019 Report from the Financial Stability Oversight Council noted some of these concerns, albeit without a plan to tackle them.[4]

What's Next

The RFI was released on March 29, with comment due on June 1. It does not suggest any particular course of action once comments are received.

1 See *Client Report* **FINTECH15**, November 1, 2017

2 See **UDAP7**, *Financial Services Management*, March 16, 2021

3 FedFin Issue Brief: The Crisis Next Time: The Risk of New-Age Fintech and Last-Crisis Financial Regulation, September 6, 2018

4 See *Client Report* **FSOC25**, December 9, 2019.

Instead, it states that comments will guide the agencies. That said, continuing Congressional and international scrutiny of financial-sector AI use suggests forthcoming regulatory proposals from some or all of the agencies issuing this RFI.

Analysis

Issues on which comment is solicited include:

- current AI use and risk-management approaches;
- barriers to explainability;
- post hoc methods establishing conceptual soundness;
- alternative-data quality and processing approaches and resulting risks compared to traditional data or barriers to AI use. The agencies have so far taken only cautious steps allowing regulated companies to use alternative data;[5]
- risks related to “overfitting” – i.e., unrepresentative AI data selection – and barriers to AI expansion or the need for system changes to reflect population developments;
- cybersecurity risk management techniques and challenges;
- dynamic-updating risk management;
- challenges to managing third-party vendors;
- techniques that permit comparison of AI models to fair-lending law requirements;
- AI bias risk and risk-management practices; and
- adverse-action notice processes when credit underwriting is AI-based.

[5] See **FCRA29**, *Financial Services Management*, December 11, 2019