AIFS0058

Written evidence submitted by The Investment Association

The Investment Association (IA) welcomes the opportunity to contribute to the Committee's inquiry into the opportunities and potential risks of Artificial Intelligence (AI) in financial services.

The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.1 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 49% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

The IA, via the HMT-led Asset Management taskforce recently produced a report on AI usage within investment management, a product of industry analysis with IA members, including fintech firms, the Financial Conduct Authority (FCA) and government. The report[1] outlines the current posture of firms across the industry, including both proven and developmental use cases utilising generative AI. It then goes onto explore the key internal and external issues that will ultimately determine the industry's success in realising the technology's true potential.

Executive Summary & Recommendations

Given the UK's world-leading asset management sector and its history of technological innovation, we are well-positioned to leverage AI's remarkable capabilities. The sector is committed to playing its part in fostering an environment where AI can drive better outcomes for investors, economic growth and providing capital to growing companies. Our goal is to harness the power of AI to enhance the sector's relative competitiveness, attract international AI companies to the UK, and promote responsible AI integration across financial services and the wider economy.

To this end our recent work with the industry, regulator and government concluded that action was required in seven areas to maximise the benefits to consumers, investors and the sector:

Skills and talent: The UK needs to invest in building a skilled and diverse AI workforce that can meet the current and future demand for AI expertise, and that can adapt to the changing needs and challenges of the AI landscape. We recommend that the UK government strengthens its commitments to promote the growth and strength of computer science, data science, software engineering and other related fields within our universities and colleges. There could also be better alignment between the content of courses and the needs of industry. Additionally, more can be done to build mutually beneficial connections and partnerships between UK post-16 education institutions and industry.

Regulation: Fundamentally, the industry desires regulatory clarity and consistency to enable developers and users of AI to plan and invest with confidence. In pursuit of this ambition, we emphasise the importance of the UK government's leadership in facilitating international regulatory coordination and alignment on AI, as well as supporting responsible international data flows. Domestically, we are supportive of the current direction of travel on AI regulation.

Malicious actors: Potential misuse of AI technology by malicious actors is a serious threat to overall public trust in AI. We welcome recent initiatives by domestic and international authorities to better understand

[1] The Investment Association: *Artificial Intelligence: Current and Future Usage within Investment Management* October 2024

and mitigate the risks that malicious actors could pose. We emphasise the importance of joint public and private sector action and appropriate policies to counter AI-enabled fraud, cybercrime and misinformation.

New systemic risks: The changing profile of systemic risk in the financial sector should not be a reason to hold back from innovating. Rather, we consider it an ongoing challenge to be managed alongside technology transformation. We support the work of the Bank's Financial Policy Committee in highlighting potential systemic risks. In addition, we see the new critical third parties regime as a positive development that will empower regulators to address potential systemic risks that may emerge.

AI risks and governance: The industry should continue to work together to develop its collective understanding of AI risks and identify best practices in risk management, governance and ethics. The IA will continue to facilitate this and work with our members to produce more detailed industry guidance on AI risk and governance.

Legal uncertainties: Legal uncertainties around AI are likely to persist for some time. In the meantime, industry-led benchmarking, best practice guidance, ethical frameworks and standards can bring confidence and reassurance to market participants. We recommend that the industry steps up its efforts to collaborate on these issues.

UK FinTech ecosystem: The IA will continue to build stronger connections between the investment management industry and FinTechs via IA Engine. We will work both domestically and with its Global Partners to ensure that firms have viable options for collaboration.

How is AI currently used in financial services and how is this likely to change over time?

For individual firms, AI presents an opportunity to drive operational efficiencies, develop innovative solutions and improve the service offering to customers. For the industry as a whole, AI represents a strategic opportunity to increase both the domestic and international competitiveness of the UK's investment sector and contribute to economic growth.

The investment management industry's relationship with AI began several years ago with classical AI, which is characterised by its predictive power and ability to draw insights from data. Mature use cases utilising classical AI include algorithmic trading and supporting anti-money laundering monitoring. More recent leaps forward in generative AI have catapulted interest in the technology to the forefront and greatly expanded the canvas of possibilities. Generative AI is a step change because such models are capable of generating new content at the user's command and can be interacted with in natural language via a chatbot interface.

There is general acceptance that we are now in a period of accelerating, potentially unprecedented, general technological advance. Harnessing that decisively in the UK will contribute to two key objectives. First to enable better products, services and business growth, helping millions of domestic investors and the UK economy. Second, as the sector is so interconnected to the global economy, to drive international competitiveness as part of the wider UK financial services cluster.

As a result of that international outlook, firms have a choice of where to base and grow their business. The ability of investment managers to leverage AI is becoming a key consideration for firms due to its recent emergence as a technology with significant potential in powering future growth. Recently, the International Monetary Fund (IMF) ranked the UK at 11th place in its global AI Preparedness Index (AIPI)[i], which indicates that improvements could be made in the overall environment for AI in the UK.

The AIPI assesses 174 countries, based on a rich set of macro-structural indicators that cover the countries' digital infrastructure, human capital and labour market policies, innovation and economic integration, and regulation and ethics. The UK's score is above average for advanced economies, yet there is work to be done. If progress is made on the recommendations put forward above, it could help to bolster growth and enhance the UK's position for future AIPI assessments, particularly in the eyes of investment management firms.

To what extent can AI improve productivity in financial services?

There is potential for significant transformation in the long-term but the asset management industry is focused most immediately on driving internal business productivity gains. As a function at the heart of capital raising and with multiple points of interaction with other industries, the investment management sector has the potential to embed AI in nearly every one of its functions.

For many years, the steady rise of AI has been fuelled by a coming together of more abundant data and ever greater computing power. More recent groundbreaking developments in generative AI have brought the technology to the forefront of the industry's attention and greatly expanded the number of possibilities.

With respect to capturing the opportunities presented by generative AI, many firms have formed internal groups, such as innovation labs or cross-firm working groups, to foster collaboration and knowledge sharing among AI experts and business users. They have also been collecting potential use cases or 'wish lists' of areas where AI could add value or solve problems. Some of these use cases are being tested in the concept stage, either internally or with external partners, to validate their feasibility and impact.

The deployment of general-purpose AI co-pilots and internal chatbots is already well established at this stage within many firms.

Many firms are working through their lists of potential use cases, identifying those that have the most value and feasibility and then advancing those to be piloted.

Firms are also looking to scale-up the existing concepts that have already shown promise in the testing stage by deploying them in production environments and making them available to a wider range of business users.

Scaling-up often necessitates making key decisions around whether the firm will invest in building AI capabilities itself, or alternatively if it will buy-in these new capabilities or partner with a technology provider. Some firms are also starting to form partnerships with educational institutions to work on joint projects[ii].

Many firms are exploring the possibility of combining classical and generative AI, or using multiple or specialised LLMs, to enhance their capabilities and create more innovative solutions. These are more advanced and complex applications of generative AI, and require more research and development. Such concepts being explored include self-supervised federated AI, agentic architectures and compound AI.

Some firms are also exploring how to make generative AI models behave in a deterministic fashion. However, a fundamental shift will be required for this to be possible.

A key reference point through all of this is thinking about how AI can bring about better outcomes for clients and consumers.

Finally, many firms are preparing to significantly ramp up their efforts around the education and training of staff to understand and use AI tools. This is in part motivated by a desire to quickly upskill existing staff, rather than resort to hiring new people with AI credentials. Firms are also keen to raise the baseline level of understanding around AI within their workforces to dispel myths, reduce unwarranted fear, highlight key risks, and begin to facilitate the cultural changes that are associated with new ways of working enabled by AI.

In terms of the key barriers to adoption within the industry, these include:

- **Internal cultural resistance**: Perhaps one of the larger challenges is the resistance from internal stakeholders that can be encountered. Within an organisation, there will be those who approach AI with excitement and enthusiasm, but there may also be those who look upon it with apprehension, or are reluctant to change.

- **Measuring value**: Firms are asking themselves how they can measure the success of their AI projects. This could be in terms of the productivity gains, the amount of time saved, the amount of additional work that can now be achieved with the same level of resource, cost savings, and so on. This is an important challenge to address, as ultimately firms will expect a positive return on investment for building AI capabilities, and to be able to demonstrate it in quantifiable terms.

- **Managing AI risks**: As a regulated industry, investment management firms have mature risk management frameworks and take this responsibility very seriously. There are numerous risks associated with AI – both novel and those that exacerbate existing risks – which must be controlled as part of a responsible adoption process.

  The probabilistic nature of LLMs presents a challenge for certain applications in investment management. By probabilistic, it is meant that the models, owing to how they work, produce outputs which are not always 100% correct. Instead, outputs have a probability of being correct. This variation is unwelcome in certain applications where traditionally deterministic systems have been used. It also poses a challenge for risk frameworks in how to control for this additional dimension.

  Self-Supervised Federated AI models that can behave in a deterministic fashion, may offer solutions to this challenge in time. More immediately, firms are adapting control functions to build additional checks and assurance mechanisms over the outputs generated by probabilistic systems to control the risk.

  The AI risks can, of course, be reduced to zero by simply not using it. However, firms are mindful that failing to adopt AI is itself a huge risk to future viability.

- **Technical limitations**: Firms are taking into account the technical limitations of AI models, including well known issues such as the propensity for LLMs to hallucinate, but also constraints on the amount of context that can be provided to models, as well as capacity limitations at the data centres where models are hosted.

  Firms are also acknowledging the types of tasks that generative AI are not yet suited to, such as planning or reasoning.

- **Cost**: Firms note that the cost of running certain queries can be quite high, particularly in LLMs, with some firms already having put cost monitoring in place. While overall costs are not prohibitively high at this early stage, firms are aware that as AI usage become more widespread which requires increased computing power, costs will increasingly become a key factor.

What are the risks to financial stability arising from AI and how can they be mitigated?

In the below tables we group key AI related risks into three areas (risks arising from the data and AI model itself; risks arising from external factors; and issues arising from inside the firm) along with potential mitigants.

1. DATA AND AI MODEL RISKS

Item	Description	Potential mitigants
Inaccurate or insufficient data quality	Risk that AI systems rely on outdated or misleading data, leading to inaccurate outputs.	• **Creating controls and safeguards**: Organisations should actively identify and manage AI risks by integrating business-minded legal and risk management teams early in the AI development process. This approach ensures models conform to social norms and legal requirements while delivering maximum business value. • **Transparent and explainable AI**: Developing AI systems that are appropriately transparent and explainable can mitigate risks associated with black-box models. This transparency allows for better understanding and trust in AI decisions, making it easier to identify and rectify potential issues. An explainable model ensures better review mechanisms which can help ensure human oversight and verification. • **Scope control:** Understand and appropriately restrict the dataset on which the AI model is functioning. A model that utilises data from the internet is likely to be more creative and generalist than one with the scope to refer to a carefully crafted set of internal documents. • **Data Verification Procedures**: Establishing robust data verification procedures is crucial. This includes data quality checks, validation techniques, and data cleaning methods to maintain consistency throughout the AI development process. This may include regularly updating and validating the data used by the AI system to ensure its accuracy and relevance as well as using multiple sources of data to cross-validate and corroborate information. • **Third party checks**: To ensure a more rounded mitigation process and checks, it is critical to conduct thorough due diligence on third-party AI providers' compliance and also enter into legal arrangements to clearly outline obligations and to ensure accountability. • **Thorough review and collaboration**: In addition to implementing the right controls, it is important that firms regularly review and audit that their AI models are operating as intended. Further, in carrying out these checks, it is essential that firms collaborate with industry peers as well as regulators to develop and promote best practices for managing risks including but not limited to AI explainability and transparency. • **Clear Disclosure Guidelines**: Firms should exercise caution in using AI and particularly from a legal and transparency perspective, be careful to ensure disclosure of the use of AI within offering documents, fund prospectuses, website disclaimers to ensure consumers are informed of the uses and extent of AI involvement in data processing.
Hallucination	Risk of LLMs producing plausible sounding but incorrect outputs.	
Probabilistic nature of AI models	LLM outputs are probabilistic in nature rather than deterministic.	
AI model drift	Risk that models may become less accurate over time.	
Privacy violations	Risk that external AI models may collect and misuse proprietary or personal data.	
Lack of appropriate explainability	Risk that AI models are complex and that the firm is then unable to demonstrate how decisions are made.	
Bias	Risks that AI models amplify any bias in the data and discriminate towards or away from a particular group of people or a specific outcome.	
Disclosure of use	Risk that consumers are not informed that AI has been used in processing their data / providing an output to them	

2. EXTERNAL RISKS

Data loss	Risk that data breaches or unauthorised access can result in proprietary data loss.	• **Effective regulatory framework**: As countries implement AI regulation, firms - particularly those that operate across jurisdictions - will need a good strategy to ensure coordination and compliance. Firms should rely on proportionality to approach the level of risk posed by various AI technologies, particularly in cases where AI autonomously drives decisions. • **Assessing cybersecurity risks**: With AI models being reliant on network infrastructure, and with vast datasets, firms should seek to assess and mange cybersecurity risks effectively by identifying potential vulnerabilities in systems and data. This includes harnessing an effective cyber threat intelligence strategy to identify and analyse cyber threats before they impact the firm. • **Comprehensive risk register**: Implementing an effective incident and error management process. This may include escalating incidents to line management and the Risk and Compliance functions, logging and recording errors as per policy and conducting root cause analysis. • **External threat-aware personnel**: Firms should ensure sufficient and skilled personnel to undertake activities related to cybersecurity and external threats such as phishing and deep fakes, maintaining efficient and well-controlled processes, resilient systems and controls, and oversight of third-party relationships. • **Third party oversight**: Monitoring of supplier usage of AI and mapping this to the provision of services to the firm and consumers, understanding where functions may need to be substituted in the event of a failure or incident.
Cyber threats	Risk that AI is used to develop sophisticated cyberattacks on firms.	
External fraud	Risk that vulnerabilities in AI systems can be exploited by bad actors for malicious intent.	
Lack of effective third party / supplier management	Risk that third parties utilise AI models that acts on a firm's behalf without sufficient oversight / permission; Risk that third parties' reliance on AI impact service quality, reliability or resilience.	
Legal risks / liability implications	Risk that unchecked AI presents unexpected or novel opportunities for litigation.	

3. INTERNAL RISKS

Skills gap	Risk that insufficient staff expertise and/or training can lead to lack of understanding or failure to realise the upsides of AI.	• **Implement robust governance frameworks for use of AI including data handling**: Firms must endeavour to set out clear internal governance frameworks that provide clear risk appetites and tolerances for fraud, both internal and external. Such frameworks should also clearly consider and set out legal risks and liability

		implications, which includes the loss of data due to misuse of personal data. This will also help promote and streamline transparency and accountability across workstreams in an organisation.
Reputational loss	Risk that sub-optimal outcomes for customers or other external impacts result in reputational damage for the firm.	• **Investing in Employee Training**: As AI continues to develop, it is important for firms to not just ensure employees are trained to use the technology for productivity gains but also train to recognise the gaps in the technology and what risk mitigation mechanisms must be exercised when using the technology.
GDPR / Personal Information loss	Risk that personal individual identifiable information is lost during HR or customer data processing.	• **Test business uses of AI safely**: Testing provides an opportunity to experiment in a controlled environment and to learn and develop further tests. Ultimately it allows for learnings to be shared more widely within firms as well as encouraging new ideas to come forward.
Loss of control on usage of AI within the firm	Risk that understanding of where and how AI is used is lost as more use cases are deployed and/or roll-out becomes uncontrolled.	• **Innovative education and engagement initiatives**: Investing in educating colleagues and ensuring engagement with senior management with initiatives in AI. Engaging in educational initiatives, such as all-staff meetings or webinars to showcase the firm's work and expertise. This can help in building a positive reputation and mitigating the risk of reputational damage due to sub-optimal outcomes. • **Continuous Monitoring**: Risk mitigation is an iterative process particularly when using AI which is evolving at an accelerated rate. Internal use case test teams should maintain a register of where AI is utilised, provide progress updates and guidance on use, including information on productivity and AI training sessions, data visualisation tools, and upcoming training that accounts for evolving developments.

How can Government and financial regulators strike the right balance between seizing the opportunities of AI but at the same time protecting consumers and mitigating against any threats to financial stability?

While we do not consider current regulatory arrangements to be a serious barrier to innovation at this stage, the prospect of potential future regulatory interventions may be fuelling a degree of caution among firms.

Investment management is an international industry. Consequently, most UK-based firms will realistically need to comply with the EU AI Act owing to their distribution strategies, fund domiciles or physical office presence.

As global businesses, investment management firms are dependent on ready access to and free flow of data across jurisdictions. However, a proliferation of data regulations globally has increased the complexity of data sharing across borders. We therefore underline the importance of ongoing multilateral efforts to safeguard responsible international data flows.

As a principle, we favour leveraging existing rules as far as possible, and where necessary, bolstering them through the provision of timely sector-level regulatory guidance to bring clarity to market participants on how those existing rules apply with respect to AI.

It is essential to steer clear of legislating and regulating in ways that may quickly become redundant, fall behind technological advancements, or hinder innovative progress.

Greater adoption of AI within financial services may potentially lead to new systemic risks to the financial system, or otherwise exacerbate existing systemic risks, such as concentrated reliance on a small number of large technology vendors, or the effect of AI agents exacerbating market risks especially during times of global financial stress[iii]. Indeed, regulators are already alive to this possibility and are thinking about how to deal with this challenge.

However, we do not consider that the emergence of new systemic risks stemming from the widespread use of AI in the finance sector should be reason in itself to hold back from innovating. Rather, AI should be seen as having the potential to change and reshape the nature of systemic risk in the sector, which is a challenge to be managed alongside technological transformation.

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[i] International Monetary Fund: *AI Preparedness Index* Accessed October 2024
[ii] Edinburgh University: *abrdn and University of Edinburgh Join Forces to Develop an AI Investment Tool* July 2024
[iii] As examined further in Table 4 within *Bank for International Settlements Working Paper No 1194 - Intelligent financial system: how AI is transforming finance* June 2024, which looked at the theoretical impact of AI agents during the 2008 financial crash.