AIFS0009

Written evidence submitted by Dr Anandadeep Mandal (PhD)

Associate Professor (Mathematical Finance), Scotcoin Distinguished Chair of Digital Finance
Honorary Research Associate at UCL Centre for Blockchain Technologies
Birmingham Business School, University of Birmingham, UK

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1.   AI in Financial Services: Current Use and Future Trajectory

1.1   Introduction

Artificial Intelligence (AI) is revolutionizing financial services, enhancing efficiency, reducing costs, and improving decision-making. The UK, a global leader in financial services, is rapidly adopting AI, with predictions that AI will contribute £22 billion to the sector by 2030 (PwC, 2023). This essay examines AI's current use, sectors leading adoption, FinTech's competitive advantage, and AI's future trajectory.

1.2   Current Use of AI in Financial Services

AI is widely used in investment banking, retail banking, insurance, and wealth management. According to McKinsey (2023), 85% of financial institutions have integrated AI into at least one business function.

1.2.1 AI in Algorithmic Trading and Investment Banking

AI drives over 75% of global market trading volumes (JP Morgan, 2024), with AI-powered quantitative funds outperforming traditional funds by 12% annually (Goldman Sachs, 2023). AI reduces execution costs by 30% (London Stock Exchange, 2023), though concerns about AI-induced flash crashes persist.

1.2.2 AI in Retail Banking and Customer Service Automation

AI-powered chatbots handle 95% of customer interactions in digital-only banks like Revolut and Monzo, reducing operational costs by 25% (Juniper Research, 2024). AI fraud detection reduces losses by 35% annually (Europol, 2023), and AI-driven credit scoring increases loan approval rates by 20% (FCA, 2024).

1.2.3 AI in Insurance: Claims Processing and Risk Assessment

AI reduces claims processing times by 60% and improves premium pricing accuracy, resulting in 12% lower claims payouts (McKinsey, 2023). AI-based telematics and personalized pricing are transforming auto and health insurance.

1.2.4 AI in Regulatory Compliance and Fraud Prevention

AI-driven compliance automation reduces regulatory costs by 50%, saving £4 billion annually (PwC, 2024). AI is 40% more effective in detecting fraudulent transactions than traditional systems.

1.3   Sectors Leading AI Adoption in Financial Services

Investment banking, retail banking, and insurance lead AI adoption, with over 70% penetration (Deloitte, 2023). By 2033, adoption rates are expected to reach 95% in investment banking, 90% in retail banking, and 88% in insurance.

1.4   Are FinTech Firms Better Positioned to Adopt AI?

FinTech firms lead AI adoption due to their digital-first nature and lack of legacy systems. According to EY (2023), 90% of UK FinTech firms use AI for customer interactions, credit risk assessment, and fraud detection. AI-powered digital lending platforms approve loans in under 5 minutes, compared to 1-3 days for traditional banks.

1.5 Is Financial Services Adopting AI Faster Than Other Sectors?

Financial services adopt AI faster than other industries, with a 78% adoption rate in 2023, projected to reach 90% by 2033. In contrast, healthcare and manufacturing have adoption rates of 55% and 50%, respectively (Deloitte, 2023).

1.6 The Future of AI in Financial Services (2024--2033)

AI will further transform financial services through hyper-personalization, risk management automation, quantum AI in trading, and enhanced compliance and fraud prevention. AI will automate 80% of financial risk assessments (World Economic Forum, 2024) and reduce compliance costs by 60%.

1.7 Conclusion

AI is transforming financial services, with investment banking, retail banking, and insurance leading adoption. FinTech firms have a competitive edge, but traditional banks are catching up. Regulatory frameworks must evolve to ensure fairness, transparency, and stability in AI-driven financial markets.

2. The Impact of AI on Productivity in UK Financial Services

2.1 Introduction

AI enhances productivity in financial services by automating processes, analyzing data, and improving risk management. PwC (2023) estimates AI will contribute £22 billion to the UK financial services sector by 2030.

2.2 Best Use Cases for AI in Financial Services

1. Fraud Prevention & Risk Management: AI-driven fraud detection reduces fraud by 35% annually (Europol, 2023), while AI-enhanced risk models improve credit risk prediction accuracy by 25% (McKinsey, 2023).

2. Algorithmic Trading & Investment Management: AI handles 75% of financial trades, with AI-managed hedge funds outperforming human-managed funds by 12% annually (JP Morgan, 2024).

3. Regulatory Compliance: AI-powered compliance automation reduces regulatory costs by 50%, saving UK firms £4 billion annually (PwC, 2024).

4. Customer Service & Personal Finance: AI chatbots now manage 95% of customer interactions, reducing response times and increasing engagement (Juniper Research, 2024).

2.3 Transactions That Benefit the Most from AI

AI enhances high-volume, data-driven transactions like stock market trading, loan approvals, fraud detection, and insurance claims processing. AI reduces loan processing times from days to minutes and speeds up claims resolution by 60%.

2.4 Barriers to AI Adoption in Financial Services

Despite clear benefits, AI adoption faces hurdles:

- **Data Privacy**: 72% of UK consumers worry about AI handling their financial data (JP Morgan, 2024).

- **Explainability**: AI models, especially in lending and trading, lack transparency, raising concerns over bias (FCA, 2024).

- **High Implementation Costs**: 40% of UK financial firms cite costs as the primary barrier to AI adoption (Deloitte, 2023).

- **Workforce Reskilling**: AI will replace 230,000 jobs by 2035 but create 100,000 AI-focused roles (World Economic Forum, 2024).

2.5 Adoption of Generative AI in Financial Services

Generative AI (GenAI) automates financial reporting, customer service, and wealth management. GenAI can cut manual reporting time by 50% and reduce customer response times by 40%.

2.6 AI and Job Losses in Financial Services

AI is expected to displace 230,000 jobs in UK financial services by 2035 but will create 100,000 new high-skilled roles (World Economic Forum, 2024).

2.7   Is the UK Well-Positioned for AI in Financial Services?

The UK is Europe's AI leader in finance, attracting £15 billion in AI investment in 2023 (Innovate Finance, 2024). However, stronger AI education and workforce training are needed to maintain global competitiveness.

2.8   Conclusion

AI enhances productivity in financial services, but challenges remain in data privacy, skills shortages, and regulatory oversight. The UK must invest in AI education and infrastructure to maintain its global leadership.

3.   The Risks of AI to Financial Stability and Mitigation Strategies

3.1   Introduction

AI introduces risks to financial stability, including cybersecurity vulnerabilities, third-party dependencies, and market distortions. The Bank of England (2024) warns that AI can increase risks if left unregulated.

3.2   AI and Cybersecurity Risks in Financial Services

AI-powered fraud and cyberattacks could cost UK financial firms £20 billion annually (UK Finance, 2024). AI deepfakes, adversarial attacks, and model vulnerabilities create systemic security concerns.

Mitigation Measures:

- **AI-driven security** tools for fraud detection.

- **Stronger regulatory cybersecurity frameworks**.

- **Quantum-resistant encryption** for financial transactions.

3.3   Risks of Third-Party Dependencies and AI Model Complexity

90% of UK banks rely on AI from Google, Microsoft, and Amazon (Deloitte, 2024), creating systemic risks if a major provider fails.

Mitigation Measures:

- Mandating AI audits for third-party providers.

- Developing UK-based AI solutions to reduce dependency.

3.4   Generative AI Risks: Hallucinations and Herding Behaviour

GenAI can generate false financial information, leading to incorrect risk assessments. AI trading algorithms can cause herding behaviour, resulting in market volatility. Regulators should require AI content verification tools and human oversight in AI trading.

3.5   AI Concentration Risks: Dependence on Large Tech Companies

85% of AI-driven financial services are controlled by five major tech firms (World Economic Forum, 2024), increasing vulnerability to AI model failures.

Mitigation Measures:

- Expanding UK's AI innovation funding.

- Regulatory frameworks requiring AI model diversification.

3.6 Conclusion

AI introduces risks to financial stability, including cybersecurity threats, third-party dependencies, and market manipulation. Stronger regulations, AI transparency mandates, and diversified AI models are essential to mitigate these risks.

4.   The Benefits and Risks of AI in Financial Services for Consumers

4.1   Introduction

AI offers personalized financial management, improved access to credit, and fraud protection. However, risks include data privacy concerns, algorithmic bias, and ethical issues.

4.2   Benefits of AI for Consumers in Financial Services

AI-driven financial tools help consumers manage money, detect fraud, and access credit. AI increases loan approval rates by 20% for underserved consumers (FCA, 2024) and reduces fraud losses by 35% annually (Europol, 2023).

4.3   Risks of AI in Financial Services: Embedded Bias and Discrimination

AI models may unintentionally discriminate against certain groups. Black and ethnic minority applicants are 20% more likely to be denied credit by AI models (Harvard Business Review, 2023). Financial institutions must implement AI fairness audits and ensure explainable AI (XAI).

4.4   Data Sharing, Privacy Concerns, and Legislative Needs

AI requires broad access to consumer data, raising privacy concerns. 72% of UK consumers worry about AI handling their financial data (JP Morgan, 2024). New legislative frameworks are needed to regulate data sharing and protect consumer privacy.

4.5   Safeguards to Protect Consumers from AI Bias and Data Misuse

Regulators should establish AI compliance regulations, mandate bias detection mechanisms, and ensure consumer control over AI decisions. AI systems must be transparent and explainable.

4.6   Conclusion

AI offers significant benefits for consumers but introduces risks of bias and data privacy concerns. The UK must balance AI innovation with consumer protection through strong regulatory safeguards.

5.   Striking the Balance: AI Innovation and Consumer Protection in UK Financial Services

5.1   Introduction

AI presents opportunities for efficiency and risk management but introduces risks like algorithmic bias and cybersecurity vulnerabilities. UK regulators must balance innovation with consumer protection.

5.2   The Need for New or Modified AI Regulations in Financial Services

AI decision-making transparency is a pressing concern. Consumers denied loans by AI algorithms may not receive clear explanations. Regulators should mandate explainable AI (XAI) standards and require regular AI audits.

5.3   AI Risk Management and Financial Stability Concerns

AI-driven algorithmic trading can lead to market volatility. Regulators should implement AI stress testing and develop emergency kill-switches for AI trading systems.

5.4   AI Bias and Fairness in Financial Services

AI models may reinforce systemic biases. Ethnic minorities and women are 20% more likely to be denied loans by AI credit models (Harvard Business Review, 2023). Regulators should mandate fairness audits and diverse AI training data.

5.5   Do Regulators Need Additional Resources to Monitor AI in Finance?

60% of financial regulators lack in-house AI expertise (Deloitte, 2024). Regulators should establish AI-focused teams, provide AI training, and invest in AI monitoring tools.

5.6   Balancing AI Innovation with Consumer Protection and Financial Stability

The UK should foster AI innovation while ensuring consumer protection and financial stability. Regulators must modernize laws, enforce fairness audits, and develop AI-specific governance frameworks.

5.7   Conclusion

AI offers unprecedented opportunities for financial services but introduces significant risks. UK regulators must balance innovation with responsible oversight to ensure AI remains a force for positive transformation.

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