Client Alert

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A CASE FOR ARTIFICIAL INTELLIGENCE IN ACHIEVING REGULATORY COMPLIANCE IN FINANCIAL SERVICES

The Kenyan Landscape

A majority of institutions providing financial services are regulated under innumerable laws and regulations. These include the Constitution of Kenya 2010, The Central Bank of Kenya Act and the various Central Bank of Kenya Prudential Guidelines, the Banking Act, The Microfinance Act, The Banking (Credit Reference Bureaus) Regulations 2013, The National Payments Systems Act and its Regulations, the Capital Markets Act and its Regulations, The Proceeds of Crime and Anti-Money Laundering Act 2009 just to mention a relevant few.

These pieces of legislations, regulations and guidelines place certain reporting obligations on financial institutions to the respective regulator key among them including: -

1. Disclosures to be made when seeking licensing and approvals to operate and continue operating in the country as well as routine annual regulatory reports;
2. Corporate governance requirements relating to the duties, responsibilities and code of conduct for shareholders, directors, chief executive officers, management and employees of an institution. These

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obligations further spell out board competences and composition as well as the various committees required;
3. Capital adequacy and liquidity management requirements on the level of capital that is adequate for any institution to protect its depositors and creditors and that is commensurate with the risks associated with activities and profile of the institution;
4. Requirements on risk classification of assets and how to manage loans aspects that the financial institution issues out. These obligations require a lot of disclosure from financial institutions on their books of lending, how they manage the interest on loans and reports of non-performing loans.
5. Prohibited business disclosures to ensure that the institutions are undertaking what they have been licensed to do and that the same is within their internal policies and procedures. Other prohibited aspects such as insider trading, market rigging or manipulation are required to be flagged and reported;
6. Mandatory requirements on effective controls, policies and procedures regarding the prevention, detection and the control of possible fraud, money laundering activities and terrorism financing;
7. Requirements on how these entities make their disclosures to the public for various undertakings such as annual audited financial statements, mergers and acquisitions, or public offerings; and
8. Cyber security framework, customer data management as well as cyber and data resilience policies put in place to ensure overall consumer protection compliance. This requires disclosures to be made on threats and breaches to the institution's systems.

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Artificial Intelligence

Artificial Intelligence (AI) is a series of underlying technologies such as machine learning, natural language processing, deep learning, smart contracts, robotic process automation and predictive analysis that can be brought together within a cloud-based environment to store and process huge amounts of data so that machines can perform sophisticated tasks without the assistance of humans.

In 2018, the UK Financial Conduct Authority pioneered the AI regulatory technology in collaboration with the Bank of England and a number of financial organizations. They leveraged on machine-reading technology to expedite compliance on two different regulations -that on minimum capital requirements and another on mortgage lending criteria used by lending institutions.

A CASE FOR AI

The global business scene has seen a paradigm shift from manual to heavily digitized processes and offerings albeit the slow process of enacting bespoke legislation. It is a fact there are regulatory requirements to still meet and this will not cease soon. Most financial service providers are now better paced to leverage on technology to undertake compliance if the regulator would adopt technologies such as AI to facilitate this.

AI can help stakeholders in the financial services maximize and expedite on regulatory compliance which are mostly repetitive process within set parameters. Currently, most regulated entities must submit manually prepared reports and disclosures for further manual inspection by the regulator. This method has proved ineffective in the Kenyan scene as occasioned by the collapse of various banks in recent years and dragged out investigations into insider trading in other institutions. The banks in this case were not making accurate disclosures and had manipulated their records to 'tick the boxes' on what the regulator normally required. Upon investigations into their systems various anomalies were raised on the operations that could not have been easy to cover up if technology was being used in real time basis.

When it comes to requirements such as annual licensing and approvals, AI would help understand the requirements or the obligations contained in the specific regulations and identify how they apply to the financial service institution and continuously monitor compliance based on information programmed into it. Further, this would do away with certain aspects of physical inspection that have to be routinely carried out by some regulators.

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Further areas that AI technology would contribute to compliance include by streamlining the vast amount of data, evaluate and analyze monitoring reports and indicate exposures. It could also be used to enhance customer experience and protection based on data mining and predictive analysis thus reducing cases of fraud and money laundering.

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In the risk environment, AI can give the service provider a picture of the consequences on non-compliance by linking specific rules to the consequential penalties. The resultant effect of the above functionalities would be increased reporting accuracy. It would also lead to a reduction of the compliance and financial risk consequences arising from inappropriate interpretation or ineffective risk assessment.

When it comes to data protection and cyber resilience, AI can be used to continually monitor any breaches and take remedial actions immediately. In this aspect, data would be shared across secure platforms in an almost predictive manner as opposed to manual methods of transmitting information by correspondence or emails. This would also help with confidential disclosures to the regulator that would go into ensuring a safe environment for the stakeholders.

One of the major drawbacks of AI that stakeholders must address their minds to is that, AI is not accompanied by management judgement. This means that in using AI, institutions must be able to interpret and explain the data or information generated by AI. Failure to explain this can lead to less accurate reporting thus attracting penalties or liabilities.

Secondly, data privacy is a key challenge which must be overcome. Almost every aspect of regulatory compliance implicates in some way data that is subject to privacy protections. Adherence to the data privacy legislation is inevitable.

Conclusion

All in all, regulators and stakeholders must work together to adopt AI and come up with solutions that will ensure efficiency, accountability, accuracy, and transparency in compliance and service delivery. It is important to note that AI will not necessarily replace human resources but will go a long way in ensuring that these resources are put towards working with AI to achieve optimum organizational compliance.