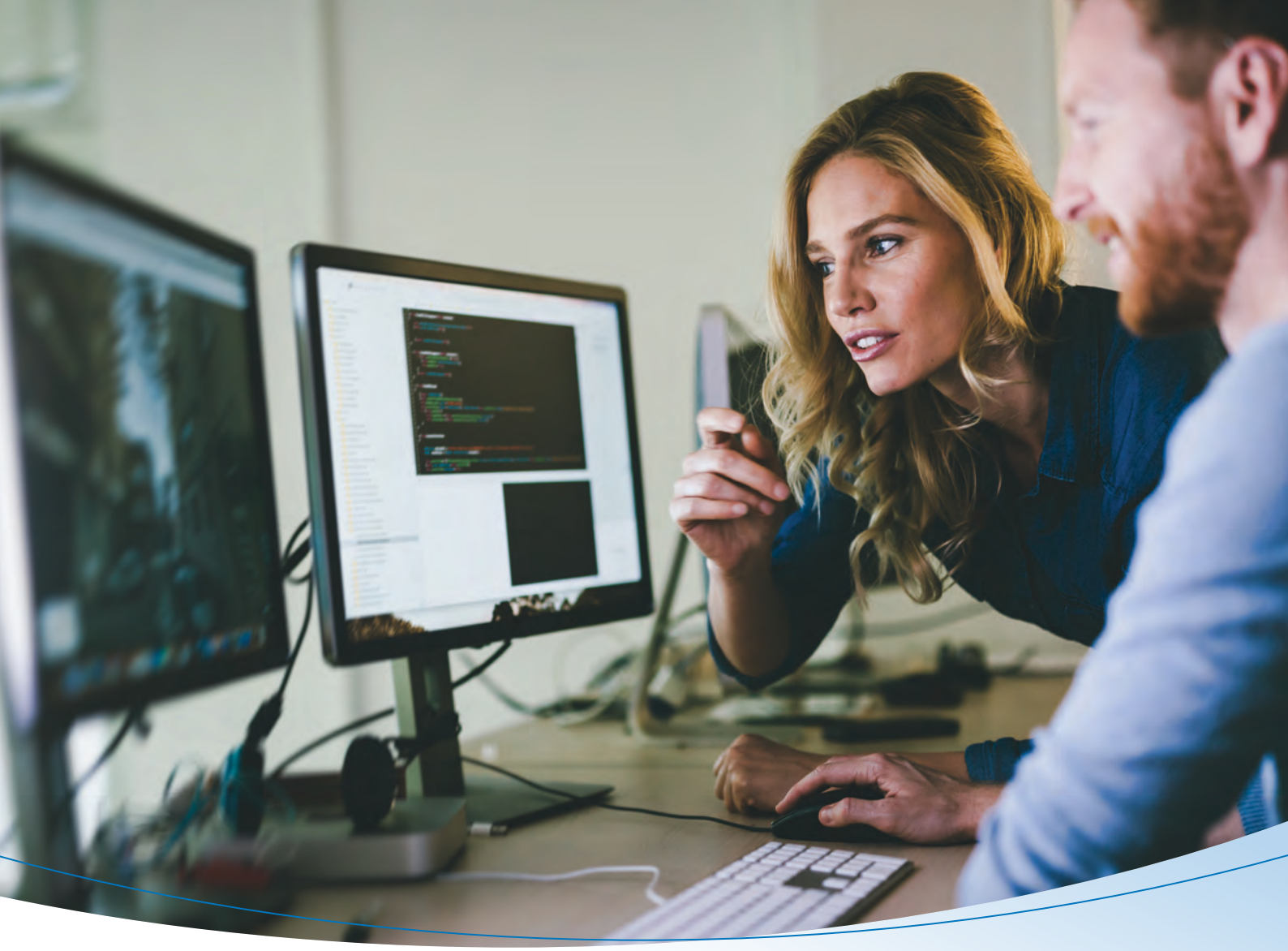

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Finding the Guardrails

What (re)insurers need to know about AI regulation

In a Global Market, Understanding the Differing Approaches of National Authorities is Crucial

Author: Freddie Scarratt

As the frontiers of AI are explored and expanded, regulators have a crucial role in setting the guardrails, and in a global market like (re)insurance, it is particularly important to understand where they lie. The risks underwritten by insurers can be thousands of miles away from the insured; think Lloyd's of London syndicates taking on Japanese quake risk, to take just one example. If AI is to play a role in the underwriting of globe-spanning risks, then insurance regulators in many different places will take an interest. So understanding their different approaches to this new technology, is just as important as understanding the impact of AI itself.

In our Q2 Global InsurTech Report, our guide to this complex picture is the global law firm Sidley Austin LLP, who have provided a clear and succinct summary of the state of AI regulation for insurers.

As the piece effectively summarizes, regulators have so far taken one of two broad approaches. The first is exemplified by the UK's cross-sector, outcome-based framework for regulating AI within its the existing framework of laws and codes. The second is the EU's ambitious approach to creating AI-specific regulation, in which it is certainly now a global leader, and has established a precedent with its "risk-based" AI Act that may prove influential.

Importantly for us, at its core, the EU Act sets out firm prohibitions on using AI to manipulate human behavior, or to enable social credit scoring. Both are among the risks that we discussed in our Q1 Global InsurTech Report — and should be carefully considered by insurers when considering pricing metrics and procedures.

Legal and Regulatory Considerations for Use of AI in the (Re)Insurance Market

Author: Sidley Austin, a global law firm advising on complex transactions and regulation

Artificial Intelligence (AI) will fundamentally transform the global (re)insurance market. It will reshape traditional practices and create new avenues for innovation. But in order to reap the benefits, (re)insurers must navigate a complex landscape of legal, regulatory, and ethical considerations.

As AI technology has evolved — and especially with the rapid progress of the last couple of years — a number of these challenges have become increasingly apparent. Regulators have taken note, and are now introducing or considering new rules in jurisdictions such as the EU, UK, and US.

Some of the issues they are seeking to tackle include:

- **Bias and Fairness:** AI models and their underlying assumptions risk perpetuating inherent biases (whether through claims handling decisions or underwriting considerations). Active consideration of the potential biases which may arise will be essential.
- **Privacy Concerns:** An assessment of the lawfulness of training and validation data sourced from third parties will be crucial to ensure any value created by new solutions is built on strong foundations. Among other things, consideration should also be given to meeting transparency requirements and how, in practice, the exercise of data subject rights will be facilitated at each stage of the AI life cycle.
- **Data Quality and Consistency:** The input of inaccurate or incomplete data can lead to flawed analyses and outputs.
- **Intellectual Property Rights (IP) and Data Ownership:** Both the input and output data of AI systems have the potential to infringe on IP rights, and licensors and/or builders of AI systems should consider data ownership rights and how IP rights and trade secrets are being sufficiently protected.

In considering these risks, market participants using AI systems will want to consider the adoption of an AI governance framework.

The Evolving Legal and Regulatory Landscape

When adopting AI solutions, market participants must comply with existing rules and guidance, and an overview of these is set out below. But (re)insurers should also anticipate further interventions. Several jurisdictions are holding elections in 2024, which may impact the future direction of AI regulatory reforms.

European Union

AI Act: The EU has adopted the AI Act, which applies: (i) to companies established in the EU, and (ii) companies established outside the EU that sell, import, distribute, and deploy AI systems in the EU or where the AI output is intended to be used in the EU. The AI Act was approved by the Council of the EU in May, and the majority of its obligations will apply two years after its entry into force. Noncompliance with the AI Act could result in a fine of up to 7% of a company's annual worldwide turnover, civil redress claims, and reputational damage.

The legislation — which regulates certain AI use cases — applies a "risk-based" approach, which means the higher the risk, the stricter the rules. These risks have been considered against some of the key AI use cases for the global (re)insurance market below:

- **"Unacceptable risk":** AI systems that are considered a clear threat to the safety, livelihood, and rights of people are deemed unacceptable and will be prohibited. For example, an insurer who analyzes client data using AI-powered predictive models could be considered to be taking an unacceptable risk if this tips over into social scoring or behavioral manipulation.
- **"High risk":** AI systems and use cases deemed to present a "high risk" are subject to the most onerous obligations under the AI Act. In particular, there are certain use cases that might be considered high risk if used for: (i) recruitment, promotion, and termination of employees; (ii) evaluating the creditworthiness of insured clients for the purpose of offering cover; and (iii) certain instances of risk assessment and pricing in relation to clients.
- **"Limited risk":** Where AI systems interact with individuals, they will likely be subject to a more limited set of obligations, primarily focused on transparency (that is, making clear to individuals they are interacting with an AI system). For example, AI-powered chatbots can be used by an insurer to respond to simple queries from brokers.

All other AI systems are considered "minimal risk" and not regulated under the AI Act. However, the AI Act is without prejudice to existing EU laws and regulations, so market participants will still need to comply with other requirements (e.g., under the General Data Protection Regulation (GDPR) or sector-specific laws).

EU Act Liability Regime: A political agreement was reached in December 2023 on revisions to the existing EU Product Liability Directive. Amongst other things, this acknowledged explicitly that AI systems fall within the Directive's scope and expanded the definition of damage by including material losses which result from the loss or corruption of data that is not used exclusively for professional purposes. The proposals aim to offer broader protection for damage caused by AI systems by alleviating the burden of proof. A separate AI Liability Directive has also been proposed by the European Commission; however, it is now possible that this proposal will be shelved.

Data Privacy and Cyber Laws: Existing privacy laws such as the GDPR will likely apply to AI systems that are trained on, or otherwise use, personal data. While data privacy considerations will apply at each stage of the AI life cycle (and should be considered separately for each processing purpose), key GDPR considerations include: (i) accountability requirements (e.g., carrying out risk assessments and data minimization); (ii) transparency, which may present particular concerns where data has been sourced from third parties; (iii) lawfulness (i.e., identifying a valid legal basis) and fairness (i.e., ensuring that the use of the AI system does not cause any unjustified adverse impact for individuals, such as the unfair rejection of a claim); (iv) facilitating data subject rights; and (v) maintaining high cybersecurity standards. Noncompliance can result in substantial fines (up to 4% of global annual turnover or EUR20M, whichever is greater).

The EU's Digital Operational Resilience Act (DORA), meanwhile, is due to enter into force in January 2025. Its aim is to ensure that firms can maintain operations during severe disruptions caused by Information and Communication Technology (ICT) related incidents. DORA requires the implementation of various risk management measures and imposes incident notification requirements on both in-scope financial entities and, more importantly, their ICT third-party service providers. This means that ICT providers in the AI supply chain may indirectly fall into scope of DORA. In-scope financial entities will, in turn, need to put in place appropriate contractual arrangements with providers which reflect the requirements set out in Article 30 of DORA.

Solvency II: Solvency II contains provisions addressing the governance mechanisms put in place by (re)insurance undertakings, including with respect to the use of AI systems. In June 2021, the European Insurance and Occupational Pensions Authority published a report aiming to establish a set of AI governance principles for the insurance sector.[1]

Insurance Distribution Directive (IDD): The IDD's provisions on product oversight and governance are intended to ensure that new insurance products meet the needs of their specific target market and apply to all products, including AI-powered ones. Similarly, its rules on advice apply regardless of whether that recommendation is provided to a customer by a human or AI.

UK

The UK government has adopted a cross-sector and outcome-based framework for regulating AI which is underpinned by five core principles: (i) safety, security, and robustness; (ii) appropriate transparency and explainability; (iii) fairness; (iv) accountability and governance; and (v) contestability and redress. While the framework is not codified into law at present, the government anticipates targeted legislative interventions in the future.

The UK's financial services regulators, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), have published some relatively detailed recent discussion papers and guidance on AI. Through these, they have indicated their current view that the existing regulatory frameworks are sufficient to address AI risks. However, the FCA intends to monitor the situation over the next 12 months and consider any regulatory adaptations.

Some of the key requirements under existing prudential and conduct regulations include:

- **Operational Resilience:** Insurers, reinsurers, brokers, and MGAs need to develop contingency plans for AI system failures, including workaround systems.
- **Governance:** Governance measures should ensure appropriate oversight of AI systems with clear lines of accountability. Any use of AI would fall within the responsibility of the relevant senior manager under the Senior Managers and Certification Regime.
- **Consumer Protection:** Insurers, reinsurers, brokers, and MGAs will need to consider how the use of AI systems impacts their obligations under the Consumer Duty.
- **Risk Management Frameworks:** Insurers, reinsurers, brokers, and MGAs are also expected to have strong model risk management frameworks that are commensurate with the complexity and materiality of the models used. This includes models that incorporate AI and machine learning (ML).
- **Competition:** The FCA can carry out market studies and use its competition powers to address competition-related concerns arising from the use of AI.
- **Data Privacy:** The UK GDPR sets out requirements which are applicable in the context of AI.

In addition, for those working in the Lloyd's market, Lloyd's has itself released a detailed paper on generative AI and Lloyd's Principles for Doing Business. Principle 10 (Governance, Risk Management, and Reporting) and Principle 12 (Operational Resilience) focus on the suitability of governance structures, internal risk management, and related topics, for which the use of AI could have significant implications.

US

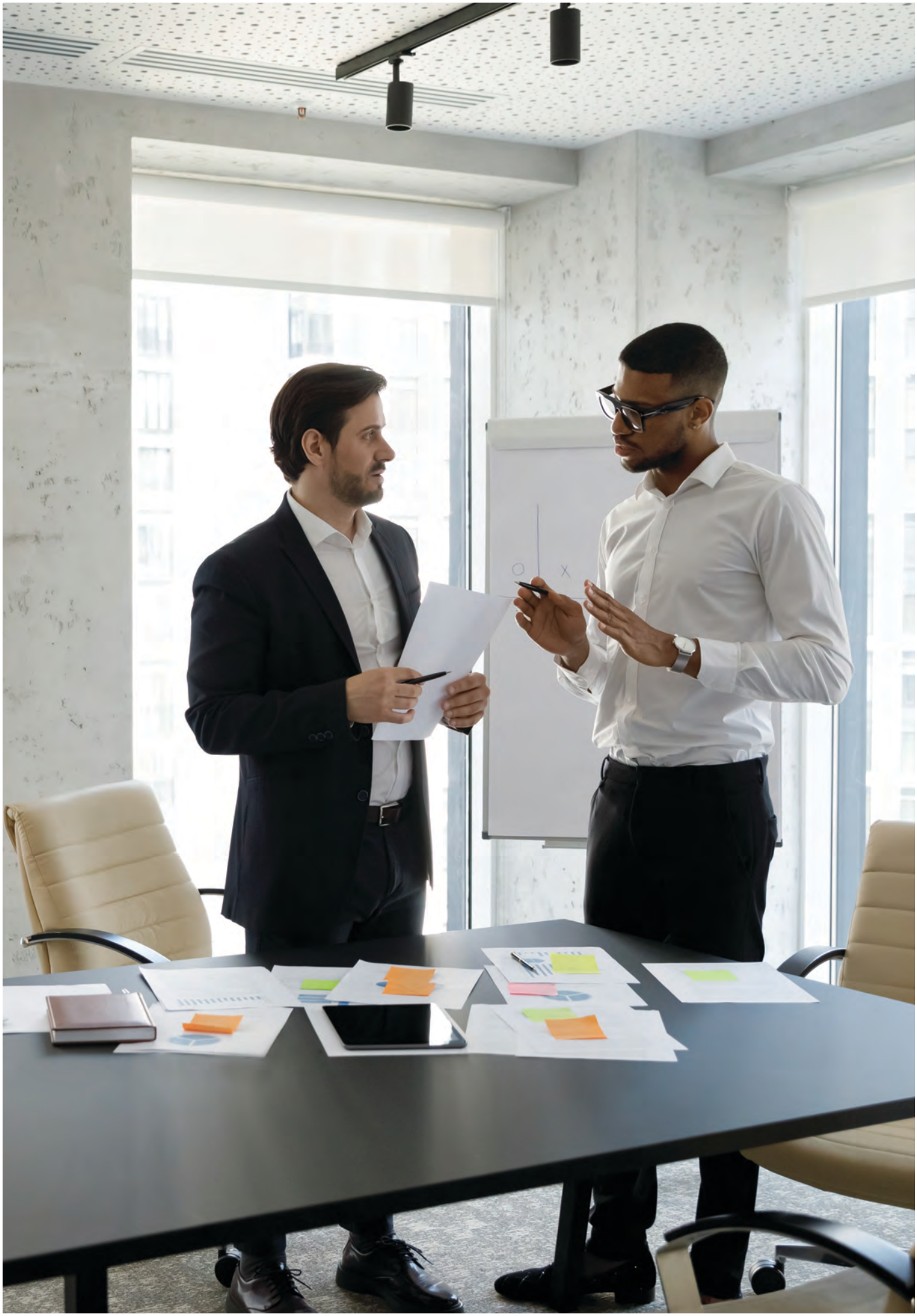
In December 2023, the National Association of Insurance Commissioners adopted a model bulletin on the use of AI systems by insurers. This sets out expectations on how insurers should govern their development and use of AI technologies in compliance with existing law.

In particular, insurers must: (i) ensure that AI-supported decisions affecting consumers are accurate and do not violate unfair trade practice laws or other legal standards; (ii) maintain a governance framework, risk management framework, and internal controls for oversight of AI systems; and (iii) maintain standards for the use of third-party AI systems (including required contractual terms). With regard to oversight, the bulletin clarifies that US insurance regulators may request (i) information on an insurer's compliance with the terms of the bulletin and (ii) documentation related to AI systems developed by third parties that are used by an insurer.

At the state level, the situation is evolving fast. An example of this can be seen in Colorado, where the state's AI Insurance Regulations came into effect in November 2023. These apply to Colorado-licensed life insurers and are designed to ensure that the use of AI, external consumer data and information sources (ECDIS), and other predictive models does not discriminate against disadvantaged groups. Colorado-licensed life insurers are obligated to develop a governance and risk management framework designed to determine whether the use of AI and ECDIS could result in unfair discrimination and remediate this if so.

International

In 2023, the International Association of Insurance Supervisors (IAIS) conducted a thematic review of existing guidance on AI/ML and model risk management from 12 supervisory authorities and international organizations. The goal was to facilitate the exchange of supervisory practices to address new or heightened risks associated with AI/ML, and the IAIS plans to develop an application paper on this topic sometime this year.



Conclusion: Balancing Innovation with Responsibility

AI is reshaping the global (re)insurance market, and its potential is immense. However, as insurers, reinsurers, brokers, MGAs, and service providers navigate this new technology, it seems clear that regulators will want to see responsible implementation in three particular areas:

- **Ethical Guardrails:** Transparency, fairness, and accountability are key — the need to ensure that AI decisions are explainable and devoid of bias.
- **Privacy and Responsibility:** AI systems have the capacity to process vast amounts of data, meaning that existing laws such as the GDPR will likely apply and, in turn, impose various requirements on those utilizing data as part of their AI systems. Consideration of applicable privacy laws at each stage of the AI life cycle is therefore crucial when both deploying or developing any AI system.
- **Human-AI Synergy:** While AI has the capability to streamline processes, human oversight remains essential to ensure appropriate systems and controls are in place. Companies will also have to be able to demonstrate that such oversight is effective.

Firms must weigh the benefits of AI adoption against the risks and complexities. As noted previously, it may be worth considering the establishment of a formal AI governance framework for the company to help structure these considerations.

AI innovation offers fantastic promise for (re)insurers, but it must align with privacy and other regulatory requirements. Thoughtful implementation and ongoing ethical awareness will be key.

[The views expressed in this article are exclusively those of the author(s) and do not necessarily reflect those of Sidley Austin LLP and its partners. This article has been prepared for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers.] [Authors: James Phythian-Adams, Stephanie Dobecki, Francesca Blythe, Jacob Grossman, Julie Rodriguez, Subha Kumar]

Sources

[iv] "EIOPA publishes report on artificial intelligence governance principles." EIOPA, 17 June 2021.

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