Cross Border Payment System with the AI Act

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I. Question

1. Do you perceive that the reporting requirements adequately cater for the situation where the PSP has already reported the same data to the authorities?

No. There is no consideration of the recently legislated Artificial Intelligence Act (AI Act). As the AI Act specifically addresses the risk of cross-border transactions between jurisdictions that have identified the risk posed by high-risk AI Companies and related financial assets, an exchange of assets between financial institutes should consider this further systemic risk during transactions and in the structure of their respective payment systems.

As a core objective is to assure against rejected transactions, a proactive step towards PSP stability in consideration of the AI Act is required, that necessitates the transactions undertaken between such differentiated jurisdictions based on the AI Act, as it poses a systemic risk to the stability of PSPs due to rejected transactions on specific grounds of the AI Act.

Further reporting, that states the transactions that are being undertaken with jurisdictions where AI Act is denied, as opposed to legislated as in the EU, should be reported as a proactive monitor to assess the culminating risk due to exposures of transactions between such heterogeneous markets.

A discussion and possible options of levels of Payment Systems is presented. PSPs should be required to report based on the levels of Payments Systems engaged and categorize data under such headings. A current approach to provide a systematically aggregated data, without stating the levels of Payment System engaged, becomes insufficient data points for appropriate analysis of systemic risk management.

II. Asset Based InterBank Transactions

The AI Act ensures safety and security of the economy and individuals in the market. It is not left to any algorithmic manipulation, the details of which are undisclosed and thereby unsafe. The AI Act introduces new requirements for compliance of CET 1 Assets. Assets of a high risk AI company would not automatically qualify as a CET1 Asset, as may have been prior to such legislation.

Accordingly, the banking system has to adopt such new developments. Financial assets supplied from jurisdictions that allow high risk AI in the market, would be a higher risk banking transaction, as the probability of a denied payment is higher either due to regulations or due to a materialized risk of AI as is consisted in such assets. It is a known fact, that severe failures can eventuate, as has been with critical failure of infrastructures such as with airlines, telecommunication and cybersecurity, in recent times. Financial institutes undertaking cross-border transactions that deals in such assets would now have to consider if there is any added risk to the local financial market from transacting with a higher risk jurisdiction, and implement such solutions that would adequately mitigate the risk of inheriting such cross-market risks.

As such high risk AI Companies would now have to operate in a global environment with higher regulation, the flight risk from transactions by such non-compliance is higher, putting an added pressure on the regulating markets to ensure adequate security measures are adopted to prevent any consequential bank runs that maybe executed in a differentiated market. From a cybersecurity consideration, using AI to create, process and collect funds from connected institutions is higher, using companies that operate at the threshold of AI and implement such algorithmic structures in their operations, including collection of funds.

The presented Growth Approach for multilateral platforms in cross-border payments [1], provide a basis for such analysis. It correctly identifies that an agreed Payment System should be formed for transactions between heterogeneous jurisdictions. However, it also presents a growth option from such transactions, presumably pointing towards financial institutes that are relatively risk-averse and therefore have not yet availed such growth opportunities. The introduction of AI Act, decreases the overall risk appetite for risk taking from AI, and such financial institutes who were previously risk averse due to such market unknowns, have further reasons to justify this averseness. Still, the need to integrate with the global financial system is on every agenda.

A continuity of the Growth Model, presented below expands the implications of market transactions in consideration of the AI Act, and its bearings on CET1 Assets that are held between transacting institutes and consists of a cross-border payment. It is important to highlight that the requirements for CET1 as set by the Basel III Committee, is to ensure the systemic stability of the global banking system, especially during cross-border transactions. The CET1 levels are specifically set to ensure that a financial institute at a cross-border location is stable and well-funded in order to conduct transactions in a global market place. The classification of assets as CET1 is therefore introduced, however, has to consist of such assets that are legally valid and as per the current regulations. For example, an Equity or a Bond held by a financial institute for a high risk Medical AI company, could not qualify as a CET1 Asset, as it is unregulated as per the AI Act.

Therefore when transacting with a cross-border financial institute that is consisting highly of a relatively unregulated CET1 Asset (say greater than 10%), whilst it still may concur with the requirements of CET1 (at least 6%), would still be a higher risk in a market where an AI Act exists.

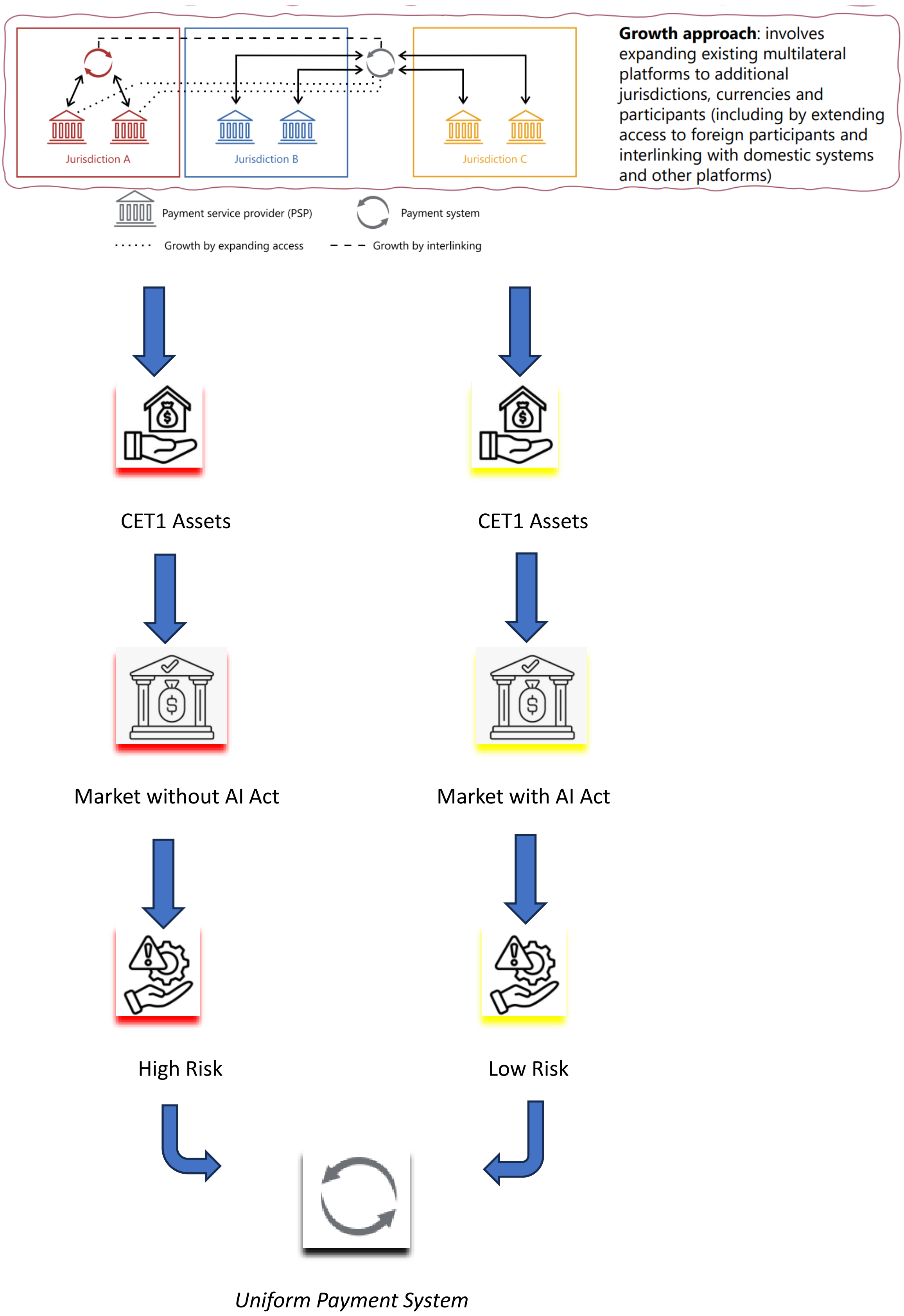

Diagram 1: Growth Approach for Multilateral Platform using AI Act

III. Payment System Risk Inductions

When a high risk jurisdiction requires transaction with a low risk jurisdiction, a systemic risk is passed on via induction from the high to the low risk jurisdiction. This risk can be defined as a cost of heterogeneous market structures when the risk elements would flow from the higher setting to the lower setting amongst the markets. Formulating, as per,

$$R(Im) = \sum Mp(i) \quad .... \quad \text{(Formula 1)}$$

R(Im): Inducted Market Risk;
Mp(i): Propensity of heterogeneous market elements (i)

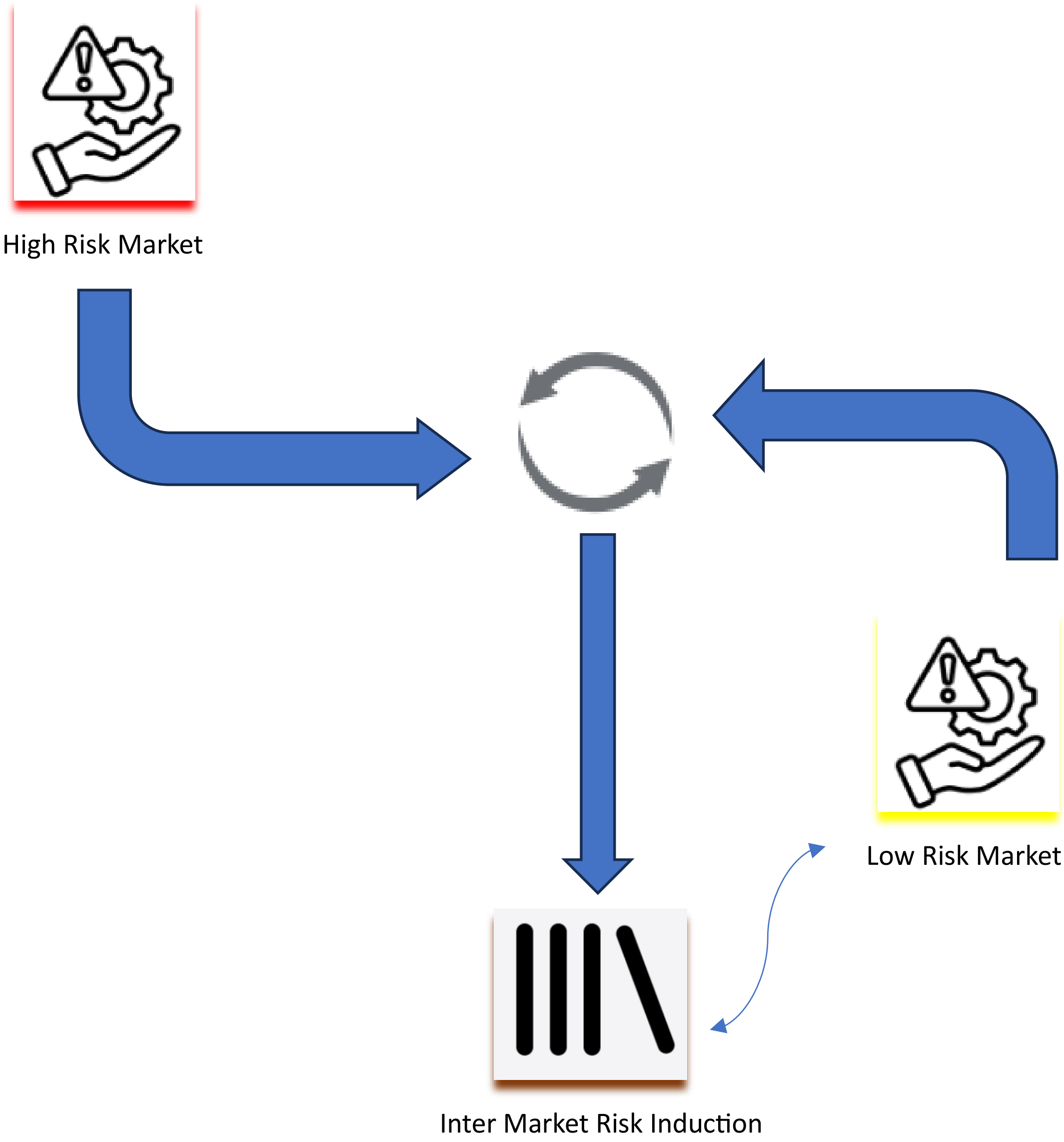

Diagram 2: Cross-Border Risk Induction Mechanism

To minimize the risk of an Inter Market Risk Induction, not all cross-border or intermarket payments could be considered on the same basis. The more similar two jurisdictions are, the inherited risks are minimal, such as in the Single Common Market of the EU. With mostly similar jurisdictions, such as between the EU and markets as per English Commonwealth jurisdiction, the risk induction is expected to be medium, whereas with significantly varied markets, the risk induction would be severe.

As per such risk levels that are induced during transactions, three levels of Payment Systems should be defined, that would work as per the requirements for adequate risk assessments at each inherited levels of transactional risks.

Low Risk Payment System (L1)	Medium Risk Payment System(L2)	High Risk Payment System (L3)

<u>Diagram 2: Classification of Payment Systems</u>

a. Tabular Representation of Cross-Border Induction

Risk Levels	AI Act	Divulged AI Act	Denied AI Act
AI Act	L1	L2	L3
Divulged AI Act	L2	L2	L3
Denied AI Act	L3	L3	L3

<u>Table 1: Risk Induction of Cross-Border Transactions</u>

<u>AI Act:</u>
Jurisdictions with legislated AI Act.

<u>Divulged AI Act:</u>
Jurisdictions without legislated AI Act but with regulated implications.

<u>Denied AI Act:</u>
Jurisdictions that have explicitly denied regulating AI.

IV. Payment Systems Classifications

a. L1 Payment Systems

- Low Risk Induction
- Instant Payment System
- Low regulatory checks
- Low Interbank Transaction insurances
- Fully digitalized

b. L2 Payment Systems

- Medium Risk Induction
- T+2 Transaction times
- Some regulatory checks
- Medium Interbank Transaction insurances
- Semi-digitalized

c. L3 Payment Systems

- High Risk Induction
- Indefinite transaction times
- Heavy regulatory checks
- High Interbank Transaction insurances
- Minimal digitalization

Utilizing further instructions on cross-border transactions that includes classification of transaction based on the above levels of Payment System processed would be advantageous. The data collected can be used to identify any growing trends towards transactions between heterogeneous AI jurisdictions.

It also defines that a jurisdiction with a Denied AI Act, could not expect the benefit of doubt in a cross-border transaction, just as a jurisdiction with AI Act, as the risk of this transaction is well-identified and needs to be borne to reduce the systemic risk, as opposed to being leveraged as per the existing standards of a jurisdiction with AI Act. It is also a systemic expectation that the asset based values of a Denied AI jurisdiction would leverage the reduced risk proposition of a AI jurisdiction, although it is not the stated objective of such legislations.

Characteristically, what differs between the levels of Payments Systems, are the scrutiny that each transaction is expected to face from each jurisdiction, with increasing checks from L1 to L3. Whilst L1 PS can expect an instant transmission of funds due to mutual compliance, using Phone Apps, Online Banking etc., an L3 PS could not expect the same, as the transaction maybe held till adequate funds released from the requested institute across borders. Increasing cybersecurity and money laundering checks are also expected, as the time advantage gained between heterogeneous jurisdictions would be invaluable for those seeking to undertake criminal activities, or to liquidate assets prior to eluding a high risk AI venture. Direct and in-direct insurance for transactions between heterogeneous jurisdictions are also dependent and calculated on the propensity of transactions that are being undertaken between such participants in each jurisdiction with an increasing cost from L1 to L3.

References

1. G20 Cross-border payments roadmap: Overview, progress and next steps [ecb.europa.eu/paym/groups/pdf/omg/2023/230323/item_2_cross_border_payments.el.pdf]