

The Transformation of Contemporary Financial System in The Digital Age of Artificial Intelligence

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Abstract:

This study envisages to emphasize the significance of utilizing Artificial Intelligence in the currently prevailing banking and financial businesses. This article seeks to dissipate and address the possible ventures confederated with financial institutions which avail these technologies, customers or users, and investors including the market cyclicity and comprehensive risk. It emphasizes on the role of AI applications in enhancing financial organizations' contentious interests which further obliges or compels the collaboration and participation of policymakers and regulators. The pertinence and affirmation of Artificial Intelligence systems in precipitating corporate operations, risk management, and revenue growth is gaining propulsion worldwide. This article examines the inference of rapid use of Artificial intelligence (AI) in the financial sector. It also focuses on the benefits of such technology with respect to financial depth and coherence while accentuating the scrutiny regarding the expansion of digital divide between developed and developing countries. The research imparts to the conversation about the effect of AI by emanating and tabulating the threats it may initiate with respect to the integrity and stability to the financial depth while also looking into the policy issues and effective regulatory measures. AI and its application in the financial sector are constantly growing but the entire extent of its strengths and disadvantages remains unidentified. Despite being provided the potential for unanticipated consequences, there is still a need to consolidate prudential monitoring. While attempting to highlight the consequences regarding implementation of AI and to determine the benefits and risks which accompanies the use of AI, this research work aims to arrive to a conclusion with proffering and recommendations for the regulatory bodies and the policymakers in the guise of responses and suggestions to pursue stimulating innovation of AI in finance to safeguard financial investors and consumers.

Keywords: Artificial Intelligence, Banking, Finance, Cyber Security, Fraud

I INTRODUCTION

Artificial intelligence has greatly impacted while also laying a transformative impact on the financial sector whether we talk about risk management or investment banking, but this transformative effect is stressed with complexities, be it financial services or the regulation procedures. There is an urgent need to harmonize the innovations with respect to financial stability. The impact is so great that the financial sector has now become inseparable with respect to the world of the digitized technological enhancements. To unravel complex issues, financial practitioners in recent times have started leaning on artificial intelligence and this is due to a sudden shift by an augmented rise in the sources and alternative data. But the most concerning aspect of AI growth

in the financial sector is procreating a layout of the impediments and opportunities in the regulatory frameworks is something which cannot be overlooked. There is no doubt in considering that the banking industry can now be considered as the utmost undertaker of AI technology. The enhancement and upgradation of AI in the banking sector have increasingly impacted banks with the increase in online banking and networks that are self-servicing (Iryani & Yulianto, 2023). With the advanced automation of repetitive tasks, there is a benefit regarding saving costs, allowing laborers to use their energy in value-added operations and minimizing human errors and therefore, banks are rapidly manipulating large data analytics software which are powered by Artificial Intelligence in order to approach personalized and faster services and

experiences for customers. AI has been a great advantage in every respective field whether it be any industry specifically with customers being the major drivers, AI is a software which can be taken into advantage in order to obtain a better understanding of the requirements and behaviours of the customer and thus the bank manipulates the enhancement in apprehension of the customers with respect to personalizing their services and products (Arrieta et al., 2019).

A What is an AI?

The AI concept has always been a concerned controversy while being a part of continuous debates and conferences. AI crucially follows two kinds of approach; one is rationalist approach and other is anthropocentric approach. Rationalist approach is the one which emphasizes on the magnitude of machines to convert into logical reasoning abilities, whereas the Anthropocentric approach is the one which strives to sweep among machines and humans. Considering a legal approach, Artificial Intelligence deals with major challenges for all professionals and scholars in terms of defining it. According to the “Organization for Economic Cooperation and Development (OECD)”, “Artificial Intelligence system is a machine-based system which can make predictions, recommendations or decisions influencing real or virtual environments for human-defined objectives. AI is designed to operate with differing stages of autonomy”. There is an urgent requirement for providing an idea for Artificial Intelligence which is firmly positioned with international organizations and related tasks to ensure legal certainty and coordination. With the introduction of AI and its involvement in every sector, a new beginning has been marked with respect to law and technology.

B How AI is changing banking?

Artificial Intelligence with respect to banking in the corporate sector acts as a boost in terms related to customer services through chatbots, helps in detecting fraud, automates tasks, helps in optimizing investments while also predicting marketing trends which provides personalized services and enhances the productivity while also lowering the costs (Dwivedi et al., 2023). Artificial Intelligence is the game changer when referred to in terms of the

fundamentals of an industry and to which banking is also not an exception. Artificial Intelligence has its origins in the history of the banking industry, it’s just the advancements that have raised the solicitude of the syndication of private data, predictions with respect to finance and security and privacy. AI is a technology which is deployed in every step of banking industry, likely, applying for a credit card or receiving text messages from the banks for the charges verification, etc., in order to rationalize the financial services but this technology when advanced, brought many undeniable challenges in terms of usage and collection of data through AI which raises concerns regarding financial protection of the consumers (Arslanian & Fischer, 2019).

Artificial Intelligence is progressively in use with respect to the transactions that happen in real time while rapidly monitoring patterns, strengthening fraud detection, automation of credit checks and risk management, regulatory compliance and investment portfolio management (Martin, 2024). Artificial Intelligence has enhanced in past decades, and this technological improvement has made AI more reliable, transparent, more customer-centric, technology relevant and provided explainable data inputs. Also, this technology is helping banks in many ways such as reducing costs by enhancing productivity while also making decisions relying completely on decisions which are based on the queries of consumers and thus these algorithms can easily detect fraud in minutes. As per the report by Business Insider, “nearly 80% of the banking institutions are well equipped with the fact that AI has certain potential benefits in banking”. Also, another report by McKinsey stated that, “AI’s potential in the finance and banking industry will most probably grow beyond 1 trillion dollars”. McKinsey further added to the global AI survey report that, “approximately 60% of the financial sector have executed at least one AI capability to rationalize the business process”. These reports and statements clearly state that AI and banking go together just because of the multiple benefits the technology is providing which is a clear indication that with respect to the banking sector AI is a very bright and promising aspect. Artificial Intelligence is the revolutionizing concept in terms of banking and financial sectors as it has the potential to

rationalize procedures, strengthen customer experiences and reduce errors.

II APPLICATION OF AI IN FINANCIAL SECTOR

AI is constituted as an essential element in all the sectors wherein, the banking sector has in advance incorporated this technology in its functioning. Many applications which the Banking industry has integrated are as follows:

A Cybersecurity and Fraud Detection:

Demonetization has probably been the major reason behind the world going cashless and thus there has been a big shift towards digital transactions which is occurring on a daily basis either via paying bills, depositing checks, withdrawal of money and many more through online apps and accounts which meanwhile raises an urgent and increasing requirement for the banks and financial sectors to incline towards fraud detection techniques and thus, there arises the need of artificial intelligence to come in frame with respect to banking (Constantinides et al., 2018). Artificial Intelligence plays a vital role in identifying frauds and tracking loopholes in the banking systems while minimizing risks and enhancing protection of online banking and such a vital role can be proved through the recent action taken by Denmark's largest bank named as Danske Bank to implement fraud detection mechanisms in its business which further increased the capability of the bank's fraud detection techniques by 50% and has minimized the chances of false positives by 60%. Artificial Intelligence has been proved as a major help in combating cyber threats. As per a survey of 2019, the banking and financial sector has reported 29% of the cyber-attack by considering it the primarily centered sector in terms of targets but if there occurs monitoring activities on continuous basis of artificial intelligence in finance and banking sectors, banking sector can retaliate to embryonic cyberattacks to prevent them from attacking the customers, employees and the entire internal system (Boustani, 2021).

B Chatbots:

Chatbots constitute among the most pragmatic applications of AI in the banking sector. Banks could guarantee to their consumers by including

chatbots into their banking apps that chatbots are readily accessible all the time. Moreover, chatbots may provide personalized customer care, minimize the pressure on various platforms, and promote appropriate financial transactions after studying consumer behaviour (Mhlanga, 2020). Erica, Bank of America's virtual assistant, is one of the greatest instances of AI chatbots for banking apps. The AI chatbot quickly manages credit card debt reductions and card security enhancements, allowing Erica to handle over 50 million customer enquiries in 2019.

C Loan and Credit Decisions:

Banks have already started to use AI-based algorithms to make more knowledgeable, safe, and lucrative lending and lending choices. Many banks continue to rely only on past financial performance, credit ratings, and consumer testimonials to establish an individual's or company's trustworthiness. Nevertheless, there is no disputing that these systems for reporting credit data are occasionally replete with mistakes when interpreting creditors. Furthermore, the technology warns banks about behaviours that may raise the likelihood of default. In summary, these kinds of innovations help in shaping the probable upcoming era of consumer finance (Jaksic & Marinc, 2018).

D Tracking Market Trends:

AI in the banking sector enables institutions to analyze vast amounts of information and forecast most recent developments in markets. AI is used to assess investor sentiment and recommend investment possibilities. Artificial intelligence systems for financial institutions also recommend the optimum time to buy in stocks and alert users to potential risks. By virtue of its substantial processing of information capability, this recently developed technology additionally serves to accelerate up the decision-making process while rendering trading seamless for financial institutions and their clients.

E Data Collection and Analysis:

Every day, financial companies and banks record millions of transactions. Employees find it difficult to collect and register the massive amounts of information generated (Bhattacharjee, 2001). Structured finance and recording such a large

amount of data without mistake is impossible. In such cases, an innovative artificial intelligence (AI) and banking application development business can aid with effective data collecting and analysis. This enhances the overall user experience. The data may also be utilized to identify fraud and make credit judgements.

F Customer Experience:

Potential consumers are continually seeking improved experiences and more conveniences. ATMs, for example, were a hit because they allowed clients to deposit and take money even after banks closed for the day. Integrating artificial intelligence into banking and financial services improves the overall customer experience and user convenience (Mogaji & Nguyen, 2021). Artificial intelligence (AI) minimizes the time frame needed for recording Know Your Customer (KYC) data and simultaneously obliterates mistakes. Furthermore, new items and financial offerings are available on time. Eligibility for scenarios such as asking for personal financial assistance or credit is automated using AI, saving clients the trouble of manually navigating through the full procedure. Furthermore, AI-based software decreases approval times for services such as repayment of loans (Payne et al., 2021). Artificial intelligence (AI) in financial institution support also aids in precisely capturing client information for setting up accounts without error, resulting in a seamless customer experience.

G Risk Management:

External global issues including variations in currencies, spontaneous catastrophes, and instability in politics acquire significant influence impacting the finance and banking sector, due to which making business decisions with extreme caution is critical (Alchian, 1950). AI services in banks provide apprehension of what's coming while allowing us to remain equipped and make felicitous decisions.

H Regulatory Compliance:

Financial services are amongst the most strictly supervised sectors in the world economy. Governments make sure that their regulatory authorities guarantee that banks are not defrauded by the clients when committing financial fraud and that financial institutions maintain adequate risk profiles

in terms of avoiding enormous scale defaults (Nicholls et al., 2021). Banks though constitute manual staff to look after such matters, but it is time taking and requires significant investments (Kaur et al., 2021). AI in banking employs deep learning and natural language processing to read novel regulations for financial firms while strengthening decision-making processes.

I Predictive Analytics:

Broad-application conceptual and spontaneous language applications, as well as generally applicable predictive analytics, are some of the most prevalent AI use cases in the banking business. AI can identify patterns and connections in data that traditional technologies could not previously discover. These patterns may imply latent sales prospects, cross-sell potential, or even measures based on operational data, resulting in immediate effect on revenue.

III SETTING THE AGENDA FOR AI GOVERNANCE AND THE EFFECTS OF REGULATION

Financial regulation encompasses the laws and regulations that supervise the banking sector such as banks, brokerages, and investment funds. The goal is to maintain the integrity of the banking system, protect investor trust, prevent financial crimes, and promote economic stability (Kahyaoglu, 2021). The impact of banking regulation on society may be examined from two angles: the referees' (public good) and the risk-takers' (private good) viewpoints. According to the referees, financial regulation is necessary for preserving economic stability and protecting consumers, as well as guaranteeing justice as well as effectiveness in financial markets. This pertains to a result of pervasive hazards and information asymmetry among the parties involved. The risk-takers say that regulation is not always desirable and might have negative consequences such as limiting innovation and incurring high compliance costs. Furthermore, this viewpoint is based on concepts regarding consumer choice and surveillance, which argue that regulators may be swayed by the exact organizations that they are intended to control, resulting in judgements that benefit the business rather than the public. The

appropriate degree of control is somewhere among these two fluctuations and is still being debated.

A Complex financial regulation over the time - still a query

AI has been utilized to address complicated financial challenges (Giudici, 2018). For instance, artificial intelligence transformer algorithms endowed with financial theory - the technology that powers ChatGPT - have been utilized to solve the challenging supervisory challenge of decreasing inaccurate identifications in fraudulent exchange trading (Khan & Rabbani, 2021).

B Towards effective regulation using AI:

Artificial intelligence has gigantic potential to reconstruct financial regulation. Regulatory agencies can enhance their extent to comprehend and implement complicated financial regulations with the help of AI technology. Financial institutions are complex enterprises with numerous moving elements, making compliance monitoring a difficult endeavor. Artificial Intelligence systems, with their ability to examine massive information and detect patterns, have the potential to revolutionize the field. These might be indicators of noncompliance, fraud, or other illegal activity. By identifying these concerns, AI enables speedier and more effective regulatory actions. In addition, artificial intelligence may computerize much of the reporting required by the regulation process, rendering it more precise and labor-saving. Nonetheless, while AI's potential to help with financial regulation is encouraging, it also poses significant obstacles (Alchian, 1950). To guarantee that AI's incorporation into the banking and financial regulatory environment goes smoothly, regulatory agencies and financial institutions must take these factors into account. Given the importance of the judgement of black-box issue and others as well, regarding banking rules and regulations, a lack of knowledge of AI operations might result in unexpected and perhaps harmful effects. This secrecy might jeopardize accountability, which is a key component of successful regulation. In fact, artificial intelligence systems are susceptible to bias, which may be introduced accidentally via the information that is used to educate them. This might lead to biased

regulatory choices, thus establishing a discriminatory financial climate. AI poses data security and confidentiality risks. Since AI in the banking sector will need considerable data gathering and analysis, safeguarding the confidentiality of personally identifiable financial information is critical. AI may potentially raise the system's susceptibility to cyber-attacks (Rai, 2023).

These problems necessitate a thoughtful and equitable approach to incorporating AI into the regulation of finance. The present laws and regulations might have to be reconsidered and revised to address these difficulties. One potential answer is to create a responsible AI platform for financial regulation.

C Tracking down criminals with artificial intelligence

There are additional learning-based approaches for combating financial crime. The artificial intelligence model "Black Forest" analyzes transactions and logs questionable cases. For each capital transfer, in particular, numerous factors are scrutinized, namely, the currency, destination country, and type of transaction (online or over the counter).

If a criterion does not fit the expected patterns, "Black Forest" notifies the account manager. If he considers the transaction suspect, he reports it via the Anti-Financial Crime Department. As the AI receives more feedback, it learns to accurately identify transactions and only notify those that pose an actual threat of criminality.

The "Black Forest" system has existed in use until 2019 and has by this time revealed numerous crimes, such as one involving money laundering, organized crime, and tax evasion. "As such artificial intelligence algorithms are quite adaptable and thus an excellent supplement to present platforms," says Thomas Graf, the developer of "Black Forest." "These companies are capable of processing enormous quantities of information efficiently and therefore assist in keeping on top of the enormous task of combating crime."

IV OPPORTUNITIES AND BENEFITS OF AI FOR THE BANKING SECTOR

Artificial intelligence is the future of banking and finance because it leverages sophisticated statistical analysis which helps in fraud prevention while also increasing compliance. Anti-money laundering tasks that would normally take days are completed in a matter of seconds using AI algorithms (Benhamou, 2020).

A AI is strengthening the competitiveness of banks through:

- Improved customer experience: Using previous contacts, AI has a significant knowledge of consumers and their behaviour. This allows banks certain personalized attributes and simplified interactions for financial goods and services with a reason to provide a meaningful consumer engagement and initiate strong connections with the clients.
- The identification of potential trends and outcomes: this ability helps to predict future situations based on previous behaviour, AI assists the banks in forecasting upcoming consequences and drifts. This enables the banks to spot frauds, discover anti-tax evasion behaviours, and offer customer recommendations. Tax evaders, via a sequence of steps, pretend the whereabouts of their unlawful funds is legitimate (Boukherouaa et al., 2021). Moreover, AI helps in discovering sceptical data drifts within gigantic amounts of data to aid in fraud control. Similarly, with analyzing primary recommendation engines, AI forecasts upcoming data point behaviour, while allowing the banks to effectively pitch.
- Potent decision-making: Cognitive structures that operate and react like specialists offer optimal solutions based on co-existing data. These systems preserve a store of knowledgeable data in their database, known as the knowledge database. Bankers rely on these cognitive mechanisms to make strategic judgements.

B AI-driven future:

Artificial intelligence will additionally strengthen the banks through smart automation of entire

knowledge based processes, eliminating cyber concerns and opposition from competitors (Lee & Chen, 2022). AI is crucial to the bank's operations and procedures while also evolving and innovating without requiring significant manual interaction over time. AI has a potential to allow banks to properly combine manual and robotic skills to generate operational and cost-effectiveness and impart personalized services and such benefits are no longer a distant goal for banks. Executives in the financial sector got hold of proactive steps to enjoy the benefits of AI.

The **influence of AI in banking is enormous**, which has caused numerous banking and financial firms to keep themselves informed with the latest trends:

- Artificial intelligence-powered chatbots and robotic assistants are being utilized in banking to enhance client service, provide personalized help, and handle routine enquiries more effectively.
- RPA automates typical manual tasks such as data entry and processing documents, boosting productivity and reducing banking procedure mistakes.
- AI is rapidly being used to detect and prevent fraud by analyzing vast amounts of data, identifying patterns, and identifying fraudulent activity in real time (Darby & Karni, 1973).
- Banks may utilize AI to give personalized product recommendations, specialized offers, and specialized services based on consumer information and preferences.
- In recognition of the enormous benefits of AI in banking, businesses are increasingly investing in AI for banking, which aids with complex computation of data, market pattern prediction, and risk assessment, allowing for more accurate risk oversight and choice-making.

V BANKING ON AI & THE NEED FOR EMBRACING ARTIFICIAL INTELLIGENCE

Leveraging technological innovation with Intelligent Systems (AI) has given banks the advantage of digitization while also guiding them to compete with competitors. As per the concerted study carried out by the “National Business

Research Institute and Narrative Science”, “over 32% of financial service providers now use AI technology such as predictive analytics and voice recognition”. Artificially intelligent technology is set to transform banking because it leverages cutting-edge data analysis to deter fraud and increase asset.

For banks, the most appealing aspect of AI-driven automation is operational simplicity. Banks may replace human processes, which are prone to unexpected failures, with dependable AI tools at a low cost when combined with a strong AI risk administration and governance framework (Dunleavy et al., 2005). This framework enables an organized approach to risk management connected with AI deployment while also giving guidance for largely accountable and secure use in the financial environment. Forecasting and recommendation models are the most impacted sectors of the industry.

These fields take use of AI's capacity to analyze massive volumes of data and identify concealed trends that would be difficult for a person to detect without careful review and effort. This has allowed for more accurate and timely predictions, suggestions, and decision-making (Marda, 2018). This pattern identification has been particularly useful in identifying fraud and financial forecasting, with over 40% of financial services organizations relying heavily on machine learning for both cases, based on recent market surveys.

Despite the existing hurdles, banks are racing to develop into AI-first, and with good cause. Transition of the banking sector from human-centric to consumer-centric model has compelled the banks to adopt a better comprehensive strategy to meet their clients' needs and expectations. Given the spotlight now on the consumer, banks must consider how to best serve them. Customers today want banks to be accessible whenever they want a day, seven days a week, and to do so on a large scale. To achieve client's expectations, the banks will have to first address inside conflicts, which include outdated infrastructures, disparate databases, asset quality, and restricted resources. Financial institutions can do this with artificial intelligence.

A The Generative AI Impact:

As this constitutes only a few of the difficulties that prevent banks from changing rapidly enough to meet their customers' requests, it's no surprise that numerous banks have utilized artificial intelligence as a change enabler. Artificial intelligence (AI) is also showing up as a viable answer to many of the difficulties that banks confront today. Intelligent artificial intelligence may improve predictive analytics and simplify complicated decision-making processes by utilizing its capacity to analyze and synthesize large volumes of data. This not only improves productivity but also considerably decreases operational hazards caused by human mistake and supervision. Furthermore, Generative AI applications in banking include the generation of genuine synthetic data sets to boost model training while maintaining privacy (Dwivedi et al., 2019). In addition, the system can create automatic, context-sensitive customer interactions, sophisticated reports on finances, and regulatory documentation in real time, all of which are crucial for conformity and customer service improvement. The potential uses of generative artificial intelligence in banking are many, notably in the development of advanced fraud detection systems. These systems are meant to evolve and gain knowledge from transaction patterns, hence improving security in a dynamic manner. By adopting these technologies, banks may efficiently address operational difficulties while also transforming how they interact with consumers and manage hazards, leading the pathway for a safer and more effective banking environment.

Some of the most significant Generative AI use cases in banking:

- Its models may mimic multiple fraudulent scenarios to enhance recognition algorithms, making fraud protection systems more resilient and responsive.
- It is transforming risk evaluation and credit rating in the banking industry. Generative AI techniques give more information about credit risks by simulating financial situations in detail. This helps financial organizations enhance the precision of their rating algorithms, resulting in better lending choices.

- It excels at automating the development and processing of complicated banking documents, hence reducing mistakes and increasing efficiency.
- Its use in banking is analytic in revolutionizing client experiences. Banks may use generative AI to analyze large amounts of consumer data and create personalized advertising initiatives that are tailored to specific client tastes and behaviors, considerably increasing the efficacy of their marketing efforts (Davenport et al., 2019).

VI REGULATING THE BANKING SECTOR IN INDIA IN COMPARISON TO THE EU AND ADAPTATION TO DIVERSE REGULATORY FRAMEWORKS GOVERNING AI

Financial institutions may adapt to different regulatory regimes by developing corporate AI policies and processes based on AI risk management concepts that are widely used in regulation. The authorities' key concerns are data dependability and bias, consumer protection, governance, and transparency. For example, the United States Executive Order titled "Safe, Reliable, and Credible Development and Use of Artificial Intelligence" specifically addresses financial services and emphasizes the importance of data reliability in protecting consumers from discrimination, fraud, privacy, and security hazards while maintaining financial stability.

Additionally, there is the EU AI Act, which, while not particular to the financial industry, mandates financial institutions to guarantee clear documentation, transparent processing, and the implementation of security precautions when using AI technology (Suryono et al., 2020). Banks may assure compliance with various regulatory frameworks by ensuring that their policies and processes satisfy the principles of privacy, openness, clarity, auditing fairness, safety and security, dependability, accountability, and responsibility (Varma et al., 2022).

A Regulating the banking sector in the EU:

The European Parliament has taken a similar approach to banking law, as indicated by its early focus on this issue in the European Communities

Directive. This directive sought to integrate laws, rules, and administrative measures governing the founding and operation of credit institutions, therefore encouraging competition in member states' banking markets. In a nutshell, financial regulation is a collection of laws that are primarily intended to deter individual intermediaries or groups from taking on excessive risks, and thereby to protect the overall system's stability. In accordance with these principles, the European legislature has made more steps in this direction, as evidenced through EU Directive 2013/36 of the European Parliament and of the Council on June 26, 2013. Among its regulations, the CRD emphasizes the importance of banks establishing solid governance mechanisms. This requires an explicit and well-defined organizational structure with visible and predictable lines of accountability. The directive's goal in encouraging such governance frameworks is to enable the implementation of effective processes that allow for well-informed choices, managing risks, and general operational effectiveness in the banking industry. These policies help to build stability, trust, and solid practices, which benefits both the institutions and the whole financial environment.

B How AI is helping banks support sustainability transformation:

The capacity to swiftly digest vast volumes of information makes AI models appealing in other sectors, such as sustainability. Beginning in 2023, European Union banks are going to be required to declare which financial transactions are green. To do this, they will follow the EU's categorization, which specifies which financing options for renewable energy subsequent ones, for instance, are considered green. Financing a medium-sized company's investment in technology or infrastructure that will render it more environmentally friendly is likewise green. To accurately identify the transactions, banks require a large amount of fresh data from their business customers.

VII CHALLENGES IN IMPLEMENTING ARTIFICIAL INTELLIGENCE IN CENTRAL BANKS

Banks can also supply "high-risk AI systems". The concerns linked with the usage of AI include health,

safety, and basic rights. Two specific concerns are emerging: on the contrary, insufficiently designed AI systems may increase the risk of discrimination (e.g., sustaining current instances of discrimination based on ethnic background or race, disability, age, or sexual orientation, or creating novel kinds of discriminatory effects) (Kraus et al., 2021). Regarding these presumptions, the Artificial Intelligence Act draft includes various sections that allude to the CRD, nonetheless. The goal is to avoid any conceivable conflicts with existing EU regulation. As a result, the criteria for managing and regulating high-risk AI systems will be included into the existing financial regulatory framework, which already includes a complicated set of standards. To this aim, the AI Act proposal states that the financial sector supervisory authority, and where applicable, the European Central Bank, would be the responsible body to monitor on a regular basis the fact that the financial institution adheres with the provisions of the European AI law.

According to a 2017 Financial Stability Board study, AI is the implementation of computer technology to complete activities that would otherwise require the implementation pertaining to human complexity. However, it is vital to remember that different terminologies are routinely used while discussing AI (Gabriel, 2020). The system of payments must function properly for the economic system to remain stable. In this scenario, identifying ordinary operations from disproportionate ones in information that occurs frequently with an extensive range is a significant problem. Accurately recognizing anomalous transactions enables the early discernment of potential financial frauds, bankruptcies, cyberattacks, etc. To identify transactions which are suspicious, neural networks of graphs, unsupervised learning approaches, and can be taken into consideration. To effectively supervise financial firms, central banks must analyze a large amount of data. Lately, it is gradually considered important that data related to cyber and climate threats should be reviewed, as adequate observation of these requires additional information than is required for traditional hazards. NLP (natural language processing) approaches may be used to categorize supervisory documents, in conjunction with enhanced supervisory content models.

AI presents several benefits for banks, notably enhanced fraud and risk management, enhanced client service, automation of routine work, and the implementation of improved, highly customized financial plans. To successfully capitalize on these potential, legal counsel may assist entities by consulting on the ethical, legal/regulatory, and practical dangers, as well as helping on how to reduce them through sustainable, safe, and responsible AI usage and risk management. This involves education and training, as well as the creation of an AI risk and oversight framework to guarantee the inclusion of rules and processes that adhere to AI risk management concepts and regulatory standards that safeguard both customers and banks.

A Risk and Policy Considerations:

The fast implementation of artificial intelligence (AI) in banking will have a huge impact, necessitating strong governmental measures to safeguard the security and reliability of the banking industry. Concerns are growing about a variety of concerns, including concealed prejudices in AI systems, the capacity to explain the reasoning behind their conclusions, their robustness (especially in terms of cyber risks and confidentiality), and their possible influence on financial stability. This chapter addresses those problems.

a) Embedded Bias:

The expanding use of artificial intelligence in the banking industry, particularly adheres to strict regulations and relies heavily on public confidence, has sparked debate over the potential of entrenched bias. Friedman and Nissenbaum (1996) describe embedded bias as software programs that systematically and unjustly discriminate against some persons or groups of people in favour of others. AI-based customer categorization algorithms might introduce bias into the banking industry by varying price or service quality. Bias in AI judgements is frequently caused by biased training data derived from previously biased procedures and information sets, which teaches algorithms to be biased as well (Wang 2016). Data biases, or erroneous and inadequate information, have the potential to increase financial exclusion and foster

distrust in technology, particularly among the most disadvantaged (Sahay and others 2020). Human bias can cause bias in algorithm design and training for AI systems.

b) Cybersecurity:

AI usage expands the breadth of malware and while adding distinct cyber hazards. These risks focus on modifying data at some point in the AI life cycle to exploit AI systems' intrinsic weaknesses (Comiter 2019). AI cyber threats have the potential to damage the financial sector's integrity and trustworthiness. Tampered systems may hamper the financial sector's ability to effectively evaluate the cost, and manage risks, leading to the accumulation of unrecognized systemic problems. Attackers might potentially get training datasets including critical personal and financial data. The legislative perimeter of cybersecurity standards in the financial sector may be enlarged to include AI-specific cyber risks. Suppliers and consumers of artificial intelligence in the financial industry should be compelled to implement mitigation methods, being their overall cybersecurity strategy which might cover monitoring and delineating systems, strong protection for training data sources, and measures for model and data privacy.

c) Impact on Financial Stability

The extensive use of artificial intelligence in the financial industry will be transformative, and its effect on financial stability has yet to be adequately explored. As previously stated, with carefully developed and evaluated algorithms that satisfy an extensive set of regulates to mitigate risks and performance issues, artificial intelligence (AI) systems may bring greater effectiveness, better risk assessment, management, and pricing, improved regulatory compliance, as well as novel instruments for cautious monitoring and enforcement—all which when combined will make a difference positively to financial stability. On the other hand, AI systems provide new and distinct hazards because of the opacity of their conclusions, vulnerability to manipulation, robustness challenges, and privacy concerns. These might erode the public's confidence in the reliability and confidentiality of an AI-powered financial system.

Furthermore, AI might possibly create novel sources and channels of transmission for systemic threats.

The fast progress of AI has resulted in a variety of regulatory reactions. While some jurisdictions have taken a more comprehensive approach to addressing the issues at hand, certain others have concluded that existing regulations and expectations of good governance are adequate to address the emerging issues. Whether via new or existing legislation, authorities have primarily concentrated on governance of artificial intelligence structures, handling risks, internal controls, and improved model and data controls. Addressing these difficulties necessitates extensive regulatory and collaborative initiatives (Cath, 2018). Given the inherent interconnectedness of challenges surrounding the implementation of artificial intelligence (AI) in the financial sector, coordination across the banking industry, central banks, financial regulators, and other stakeholders is critical to avoiding duplication of effort and mitigating possible dangers. Many prominent authorities in the field of artificial intelligence depend on well-defined national AI plans to promote AI research while avoiding regulatory gaps (Brunetti et al., 2020).

VIII ETHICAL AND LEGAL CHALLENGES ASSOCIATED WITH AI IN THE BANKING INDUSTRY

The primary ethical and regulatory concerns related to Intelligence in the banking business are like those faced by other industries, but with the additional obligation to defend potential financial risks that might jeopardize customer and bank financial stability. The use of artificial intelligence in banking has created various ethical and legal problems, including security, confidentiality, lack of transparency, and algorithmic prejudice. In the context of privacy, artificial intelligence systems raise concerns about how they can process or keep confidential information without the necessary permits (Kroll, 2018). The security threats addressed concern the possible susceptibility of artificial intelligence systems to malicious assaults, which might interrupt operations and result in financial losses. There is also a worry about a lack of transparency because it is impossible to determine

where information comes from and how the AI produces or makes judgements. Finally, and arguably the most difficult difficulty, is how AI systems acquire and replicate biases that may exist in their training data, resulting in unjust decision-making and discriminatory consequences. Given these issues, AI conclusions may be implicitly biased, erroneous, or, as in some recent examples, discriminating. Furthermore, when insufficient security measures are in location, artificial intelligence may be utilized for malicious objectives including illicit financial transactions and trade in secrets, which occurs quickly and may go undetected due to the speed at which artificial intelligence processes information. As a result, financial institutions must have policies, processes, and protocols in place to enable the deployment of AI while limiting the related ethical and legal risks.

The widespread use of advanced technology, such as AI, is not without obstacles. Several problems exist for banks employing AI technology, ranging from a lack of authentic and high-quality data to security risks. So, without additionally further ado, let's look at them.

A Data Security:

The amount of data gathered in the banking business is massive and requires proper security measures to prevent breaches or infractions. So, it's critical to choose a technology vendor who knows AI and banking and provides a variety of security choices to guarantee your consumer data is handled properly.

B Lack of Quality Data:

Banks require organized and excellent information for validation and training before launching a full-fledged AI-based banking system. Quality data is essential to ensure that the algorithm works in real-world settings. Furthermore, if information is not readable by machine format, it may result in unanticipated AI model behavior. Banks that are increasing their AI use must adjust their information policies to mitigate any privacy and regulatory issues.

C Lack of Explainability:

AI-based solutions are frequently used in decision-making processes since they reduce mistakes and

save time. However, they may be guided by biases learnt from prior incidents of bad human judgment. Small irregularities in the AI system create large-scale difficulties while also risking the bank's reputation and operations. To avert disasters, banks should provide a sufficient degree of comprehensibility for all choices and suggestions made by AI models. Banks must comprehend, confirm and clarify how the system makes judgements.

IX IMPROVEMENT IN FRAUD DETECTION AFTER THE IMPLEMENTATION OF AI

AI is significantly better than humans in analyzing massive volumes of information to detect fraudulent transactions. Apps or online accounts allow users to manage their expenses, withdraw money, deposit checks, and execute a variety of other tasks (Narang et al., 2024). As a result, there is a pressing requirement for the banking industry to increase its diligence in fraud detection. Here's where intelligent technology in banking comes in. AI and computerized learning assist banks in detecting fraudulent activity, tracking system flaws, mitigating risks, and improving overall online financial security. AI can also assist banks manage cyber dangers. In 2019, the banking sector saw 29% of all cyber assaults, which rendered it the most targeted industry. For example, AI-based solutions, such as Transmit Security's detection and response, can assist in preventing identity fraud regardless of a successful phishing assault. The platform continually collects data on hundreds of characteristics, such as device fingerprinting, behavioral biometrics, bot identification, network analysis, authentication strength, and app activity patterns. These are cross correlated with worldwide threat intelligence, fraud tendencies, and individual user behavior, thus, as previously stated, even if the proper user credentials are stolen during a hack, fraud may be discovered and halted.

A Personalized customer experiences

Banks may use AI to give personalized experiences to their consumers. Data analysis allows banks to understand their clients' interests and financial behaviour to provide personalized financial solutions. This can result in higher consumer satisfaction and loyalty. Within the context of

communication with clients, conversational assistants are among the most effective instances of AI throughout banking. Once deployed, they operate 24 hours a day, seven days a week, allowing people to devote more time to inquiries that demand personalized attention. American Express and its AmEx chatbot are examples of chatbots used in financial applications. American Express credit cardholders may connect their payment methods to the MasterCard chatbots on Communicator to receive personalized suggestions and notifications. Contextual suggestions, reminders of exclusive card advantages, and so on are examples of learning-based techniques.

B Operational efficiency

The automation of regular tasks and the optimisation of processes constitute two of the most important aspects of AI in banking. Automating procedures results in not just considerable cost reductions but also increased operational efficiency. AI in banking enables organizations to effectively implement a wide range of mundane processes such as data input, checking accounts, document processing, and more. It also helps the financial institution to speed up some online operations by providing real-time offerings, since some papers are now processed by AI rather than people, improving the overall service quality. VASS is now leveraging artificial intelligence to optimize procedures, such as producing test cases for code. This form of automated processes additionally frees up human resources, allowing them to focus on more important activities, but it also lowers the chance of mistakes and speeds up process completion.

C Risk management

External global issues including currency fluctuations, natural catastrophes, and political instability have a significant influence on the financial industry. During these volatile times, it is critical to use extreme prudence while making business judgements (Lancaster, 1966). AI in banking can undertake predictive analysis that offers a reasonably clear indication of what is to come, allowing the industry to be prepared and make timely choices. Because AI can analyze enormous volumes of data, its predictive models may find behavioural patterns and use them to anticipate

danger. This procedure saves time and money while also providing safer loans for both parties. Absolutely, AI is a fantastic tool for making decisions, but we must remember that specialists should have the last say in all procedures.

D Risks and challenges of AI in banking

While there are obvious benefits to using AI in banking, like combined with any technological innovation that develops and alters in an instant of seconds, we shouldn't ignore the hazards that its usage entails. There are significant obstacles to overcome to employ artificial intelligence in a responsible and ethical manner (Hughes et al., 2019).

E Data Privacy and Security

Banks gather massive quantities of data from their clients, and AI algorithms must have accessibility to this data to work properly. If sensitive data exists, which is frequently associated with monetary information, any security breach might have significant ramifications. In addition, there is the issue of complying with privacy requirements, such as the European Union's General Data Protection Regulation. The EU has produced a draft regulation to govern artificial intelligence, outlining when it may and cannot be employed. Specific rules governing the use of AI are critical to ensuring security and confidentiality of data, preventing data breaches and protecting consumers' sensitive information. Furthermore, AI models must be regularly verified and monitored to guarantee they are performing as planned. One example is the "HIL" (Human in the Loop) approach, which integrates humans and technology through experimentation and observations from both sides. Because AI algorithms cannot always forecast with absolute certainty, humans play an important role through offering feedback (Winfield & Jirotko, 2018). They may train and refine the algorithm, gradually improving it. Considering the dynamic and intricate nature of AI systems, this presents a significant difficulty.

F Ethical considerations

The implementation of artificial intelligence in banking creates ethical problems, including prejudice in the making of choices and

discrimination. This may result in unjust or biased choices, including loan rejections based on demographic criteria. Banks must guarantee that their artificial intelligence technologies are translucent, fair, and unbiased. Warning mechanisms can be used to notify personnel of odd or unexpected activities for further investigation. As previously stated, with people in the loop procedures, AI choices will be performed only after approval by a person. Both methods have limits, but they are important instruments for risk minimization.

G Customer centered work

Aside from adhering to legislative and industry-specific requirements, banks must constantly act in the best interests of their customers. As a result, financial organizations must operate with a thorough grasp regarding how artificial intelligence (AI) and its incorporation into the customer's everyday lives affect them. Failure to fully understand this element may endanger the consumer, and the entity's credibility would suffer greatly. Companies that rely completely on an outside source, such as AI, may find themselves incapable of adequately clarifying the way AI algorithms make judgements. As a result, compliance and security teams play a critical role in guaranteeing the dependability of AI-powered systems. AI's presence in banking brings both great prospects and severe concerns. To achieve successful and responsible use of AI, banks must carefully assess its moral, regulatory, and security consequences (Warner & Wager, 2018). This allows banks to improve client experiences, optimize procedures, while handling risk more efficiently. The key to effective AI deployment in banking is achieving the correct mix of technological advancement and risk management.

X CONCLUSION AND SUGGESTIONS

Artificial intelligence (AI) has caused a significant disruption in digital commerce that has impacted the whole financial services industry in the twenty-first century. This is partly because AI solutions have the potential to assist banking organizations in innovating, making better informed decisions, and resolving difficult challenges with more efficiency and efficacy. In addition, automated forecasting, adversarial networks, learning algorithms, and

numerous additional AI technologies may be utilized to help banks make better forecasts and respond to emergent challenges more quickly and effectively. Thus, AI is an equipment that can help banks remain ahead of the competition. Meanwhile, there are other hazards that must be addressed to guarantee that the potential presented by AI are fully utilized. Some notable examples include privacy violations, employment losses, data accessibility and accuracy issues, and deliberate AI-business alignment challenges. Although there is a vast body of research about AI prospects and problems in the banking industry, most studies are descriptive and rely on additional information from sources. As a result, future studies should use rigorous empirical research approaches to provide tangible information about AI prospects and difficulties in the financial industry. Central banking institutions examine an extensive variety of data to meet their primary objectives more effectively, which include inflation and financial stability. The expanding volume of data, especially considering new threats to the banking industry, such as environmental and cyber hazards, presents a significant challenge. Consequently, artificial intelligence is increasingly being applied in many aspects of central banking. Central banks should provide training programs that include the evaluation of data, and the tools used in this sector. This would help people to understand the principles of artificial intelligence as well as how to use them in their regular duties. Recruiting artificial intelligence workers with specialized abilities can help central bank personnel and ensure the effective use of these technologies. It is critical that there be accountability regarding artificial intelligence-based decision-making. Central banks ought to promote innovation and flexibility among their employees, but it is also vital to set specific objectives and standards for the application of artificial intellect within central banks (Martin, 2024). This allows for more effective allocation of resources to fields such as analyzing information, risk mitigation, and financial and monetary stability. The cooperation with research centers and universities would offer the opportunity for cutting-edge research and technological developments in artificial intelligence. This partnership has an opportunity to promote the creation of new ideas and technological



alternatives for central banking. Finally, it is commonly agreed that artificial intelligence will not substitute for regulators and administrators in central banking since the human aspect is necessary for making key choices in an unpredictable environment. The limited application of AI in decision-making has a considerable risk, and the human component must thoroughly investigate all aspects to satisfy central banks' fundamental aims of pricing and financial stability.

The implementation of the use of AI technology in the financial industry is expected to accelerate. This trend is being driven by substantial gains in computing power, information retention productivity, and massive data sets, as well as considerable advances in modeling and use-case adaptation (Gill et al., 2022). The COVID-19 epidemic is hastening the transition to a completely wireless communication of the surroundings and progressively digital financial services, boosting the attraction of AI technologies to financial service providers. The use of AI will provide substantial benefits, but it will also pose significant financial policy concerns. AI systems could significantly reduce costs and increase efficiency, open up new markets, and improve risk management for financial institutions; provide customers with novel experiences, products, and cheaper costs; and provide robust instruments for compliance with regulations and prudential monitoring. However, these technologies raise ethical concerns and introduce new threats to the integrity and safety of the financial system, the full scope of which has yet to be determined. The challenge ahead of financial sector authorities is exacerbated further by the reality that these breakthroughs are continually developing and transforming as new technology enters the market. AI system deployment in the financial industry has been shown to be of greatest benefit when national AI plans are in place, involving all key public and commercial authorities (Almustafa et al., 2023). Collaboration and their understanding exchanging at both the international and regional levels are becoming more vital. This would enable the coordination of measures to ensure the safe implementation of AI systems, as well as the exchange of experiences and expertise. Cooperation will be especially critical in ensuring that less-

developed conveniences have access to information about techniques and processes, application instances, and government agencies. and supervisory approaches. Finally, because artificial intelligence (AI) and its possibilities regarding finance are constantly growing, neither consumers, technology suppliers and developers, nor regulators fully comprehend the technology's merits and shortcomings at this time. As a result, there may be numerous unanticipated hazards that have yet to emerge, and governments will need to increase their monitoring and careful oversight.

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