The Role of AI and Machine Learning in Financial Fraud Detection

Ranvijay

Galgotias University

ABSTRACT

This research explores how Artificial Intelligence (AI) and Machine Learning (ML) help detect financial fraud more effectively than traditional rule-based systems. It highlights algorithms such as Random Forest, Support Vector Machines, and LSTM networks used to analyze transaction data for fraud detection. The study compares AI models to older systems in terms of accuracy, recall, and efficiency. Using both secondary datasets and survey responses from professionals in the financial industry, the paper concludes that AI-driven models significantly reduce fraud-related losses and false positives. Recommendations for ethical implementation, regulatory compliance, and hybrid AI-human fraud detection systems are also discussed.

Keywords: Financial Fraud, AI, Machine Learning, Supervised Learning, Unsupervised Learning, Fraud Detection

1. Introduction

Financial fraud is growing with the expansion of digital transactions. Traditional fraud detection systems often fail to detect sophisticated fraud schemes. AI and ML technologies offer smarter, adaptive solutions by analyzing large datasets and identifying hidden patterns in real-time. This paper aims to investigate the effectiveness of ML and AI in financial fraud detection and understand their real-world implementation challenges.

2. Literature Review

Past studies show that traditional fraud detection methods using rules and manual checks generate high false positives. AI and ML models like Decision Trees, SVMs, and Deep Learning have shown improved fraud detection capabilities. Unsupervised techniques like clustering and anomaly detection help identify new, unknown fraud patterns. However, concerns about model interpretability, data privacy, and regulatory issues remain critical.

3. Objectives

To evaluate the accuracy of AI/ML models in fraud detection

To compare AI-driven methods with traditional systems

To identify challenges in implementing AI in financial institutions

To recommend best practices for AI adoption in fraud detection

4. Methodology

Research Type: Applied, with both qualitative and quantitative analysis

Data Sources:

Secondary: Kaggle, IEEE-CIS datasets, industry reports from KPMG, Deloitte, etc.

Primary: Surveys and interviews with banking and fintech professionals

Models Used: Logistic Regression, Random Forest, SVM, LSTM, and Autoencoders

Metrics Evaluated: Accuracy, Precision, Recall, F1-Score, ROC-AUC

Tools: Python (Scikit-learn, TensorFlow), Tableau, Excel

5. Results

Random Forest achieved the highest fraud detection accuracy (~98.6%) and lowest false positives

LSTM models were effective for detecting time-based fraud patterns

Survey showed 77% of professionals believe AI significantly reduces fraud losses

Majority of organizations are using or planning to adopt AI/ML for fraud detection

6. Discussion

AI and ML outperform traditional methods by enabling real-time fraud detection. However, barriers like data quality issues, lack of skilled professionals, and transparency concerns must be addressed. Explainable AI (XAI) and hybrid AI-human teams are recommended for balancing automation and expert judgment.

7. Conclusion

AI and ML have the potential to transform fraud detection systems in banking and finance. Their ability to learn from patterns and detect anomalies in real-time helps reduce fraud losses, false positives, and manual review workload. For wider adoption, institutions must invest in ethical AI, employee training, and compliance readiness.

8. References

(Include top 8–10 relevant references from your thesis, for example:)

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