International Journal of Innovations & Research Analysis (IJIRA)
ISSN :2583-0295, Impact Factor: 7.662, Volume 05, No. 02(II), April- June, 2025, pp 109-113

AI and Behavioural Finance in India: Opportunities and Challenges

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ABSTRACT

The blend of Artificial Intelligence (AI) and behavioural finance has transformed the landscape of financial decision-making. Behavioural finance, which examines the psychological influences on investors, and AI, with its data-driven predictive power, when combined together offer both unprecedented opportunities and significant challenges. This paper explores how AI can manage behavioural biases, enhance decision-makingand drive strategic investment while addressing the challenges and ethical concerns that come along. Drawing on interdisciplinary research, including psychographic segmentation, deep learning models, and case studies, the paper provides a comprehensive understanding of how AI is reshaping behavioural finance.

***Keywords**: Artificial Intelligence, Behavioural Finance, Psychographic Segmentation, Deep Learning Models.*

Introduction

Behavioural Finance is a field of finance which blends psychology and economics and helps us to know how people make their financial decisions. The ground on which behavioural finance is based on deviates from the assumptions of rationality which are generally found in traditional finance theories. It analyses how human biases such as emotions and social influences have an impact on behaviour of the investor and outcome of the market (Akhtar & Das, 2020).

On a parallel level, Artificial Intelligence (AI) has become a redefining factor on how data will be processed, analysed and applied. It is expected that the blend of AI and behavioural finance will reduce the behavioural biases and enhance outcomes of investment. On the other hand, according to Hasan et al. (2023), use of excessive AI in the field of finance also opens up a risk of privacy of data, algorithmic transparency and over-dependence on machines for decision making.

India is witnessing a major financial transformation lead by fast digitization, financial inclusion and growth of retail investors. In India, where sentiments of investors are overruled by emotions rather than rationality, use of AI can help in personalizing financial advice and reduce biases (Thaler, 2016). Though AI and behavioural finance together hold a lot of potential to change India's market dynamics but they also hold challenges regarding ethics, regulation and infrastructure.

Laying the Foundation

- **Behavioural Finance**

Rational investors take their decisions based on complete information, is the basic assumption of traditional finance theories. However, reality is a bit different. According to Bikhchandani (2000), people are often affected by various biases which indulge them in taking irrational decisions. Behavioural finance is a field that combines psychology and economics and focuses on cognitive biases like overconfidence, loss aversion and herd behaviour etc. it is the characteristics of a person's personality that majorly impact their decision-making processes (Bhola, n.d.; Akhtar & Das, 2020).

Indian investors are often affected by behavioural biases due to lack of financial literacy, cultural factors and volatility of market (Goswami et al, 2020). India saw a massive increase in the number of retail investors investing in stock markets through apps such as Zerodha and Groww during the time of

covid-19. This was majorly driven by sentiments and social media rather than based on fundamental analysis.

- **Artificial Intelligence in Finance**

In the financial landscape, role of Artificial Intelligence (AI) is becoming more and more crucial. The finance sector is witnessing a major transformation on how services are being designed, delivered and consumed because of the evolution of AI. Technologies that are AI enabled like machine learning, natural language processing and predictive analytics hold a lot of importance in fraud detection, credit scoring, algo trading and customer service. These tools help systems to learn from data patterns, make predictions and adapt strategies continuously (Canhoto et al., 2021). In financial markets, AI helps in high-frequency trading, assessment of risks and detection of fraud (Albashrawi, 2016). It is all the more important in the finance field where speed, accuracy and management of risks is extremely valuable.

A very crucial role played by AI in financial institutions is detection of fraud and management of risk as many of them rely on algos which are powered by AI, which help in monitoring billions of transactions in real time and notify any suspicious activity which may result in fraud. AI powered systems instantly detect any anomalies and also help in credit assessment of customers through their online transactions, social media behaviour and payment history.

Over the past few years, AI has revolutionized stock market trading and investment management through the introduction of algorithms or algos. This has in fact helped firms and trading platforms to seize short term trading opportunities and analyse as well as execute trades at fast speed. It also helps in increasing the market efficiency. In the case of investment management, robo-advisors have made wealth management services easily accessible to public at large by offering customized services based on individual risk profiles and financial goals. AI also adheres to regulatory compliances by reporting any anomalies in financial statements. This helps in making sure that companies stick to legal and regulatory standards.

Although, AI integration in finance brings remarkable benefits but does not come without challenges. Ethical and accountable AI systems show concerns for privacy of data, algo bias and less transparency in decision making processes. With more advancement in technology and strict government regulation, AI can play a more critical role in shaping and transforming India finance sector.

How Artificial Intelligence helps in reducing Behavioural Biases

AI is based on data and it uses a data driven logically based approach to reduce or mitigate such irrational behaviours:

- **Personalized Nudges**

Individual investment behaviours and patterns can be easily recognized by platforms that are AI driven and they can introduce personalized interventions or 'Nudges' to subtly influence the choices a person makes. This helps in correcting biases (Hasan et al., 2023). For example: Paytm and ET Money are AI driven platforms and they analyse the behavioural data of customers and suggest ideas for balanced portfolios.

- **Predictive Analytics**

Using the data from social media, AI models can easily predict panic among investors or market anomalies using Natural Language processing (NLP). This in way help the financial institutions to pre-empt irrational trading patterns (Nassirtoussi et al., 2015).

- **Sentiment Analysis**

Chat boxes and virtual assistants are AI driven tools that can provide real time insights and emotional feedback to retail investors. This can further help in making the investors avoid quick and irrational decisions (Sharma & Dey, 2021).

Opportunities when there is a Blend of AI and Behavioural Finance

- **Helps in reducing Behavioural Biases**

In todays' time, AI can be very helpful in identifying and reducing behavioural biases among investors. AI tools can identify patterns of irrational behaviour and give the required feedback to financial planners, (Hasan et al, 2023). Feedback given by AI can help financial planners and fund managers make informed and rational decisions.

- **Helps in Enhancing Investment Strategies**

Multi stock trading can be automated which continuously improves the performance based on reward signals has been stated by the Reinforcement Learning Models, proposed by AbdelKawy et al. (2021). These models have proved to helpful in reducing biases and adapt to market conditions and also reduce emotional decision making.

- **Helps in Giving Personalized Financial Advice**

Large data sets can be analysed with the help of AI which also helps in giving customized financial advice. AI when blended with psychographic segmentation, as discussed by Bhola (n.d.), can produce personalized investment plans that align with individual risk profiles and behavioural traits.

- **Fraud Detection and Risk Management**

AI helps in detecting frauds and thereby managing risks. Effectiveness of data mining techniques have identified fraud financial activities, (Albashrawi, 2016) which helps in building institutional trust and market integrity.

- **Strategic Decision Making**

AI when blended with scenario planning tools and predictive analytics helps in strategic decision-making. So, it can be said that AI enhances organizational agility and enables data informed decisions across financial institutions, (Borges et al., 2021).

Opportunities in the Indian Context

- **Financial Inclusion**

AI has increased the scope of financial advice even in India's semi-urban and rural areas with the help of chatbots which are available on all languages. Chatbots such as those by HDFC Bank and ICICI, help in educating users about long-term planning and reduce misinformed financial decisions (NITI Aayog, 2021).

- **Behavioural Segmentation**

AI helps India's huge heterogenous investor base to create behavioural personas that divide the investors based on risk appetite, biases, and psychological profiles (Varshney & Mittal, 2022). This helps in giving investment strategies that are customized as per the investors need. This also helps in enhancing long-term returns and trust in formal finance institutions.

- **Regulatory Tech**

Manipulative trading and pump and dump schemes can easily be identified by regualtors such as SEBI with the help of AI. Machine learning models can flag abnormal patterns based on behavioural triggers (Garg & Dhamija, 2021).

Challenges and Limitations

- **Over-Dependence on Algorithms**

Sometimes AI algos might not be able to detect and identify human emotions and intentions. So, over dependence on them can be harmful and also lead to algorithmic myopia, where important nuances of human behaviour are overlooked (LinkedIn, 2023).

- **Ethical and Privacy Concerns**

The use of personal data for psychographic profiling can infringe privacy rights and lead to serious ethical questions. To build and maintain user trust, transparent algorithms and data protection policies are required (Canhoto et al., 2021).

- **Bias in AI Models**

Sometime AI models can use biased historical data which can further amplify behavioural biases. This issue contradicts the objectivity that AI can bring objectivity to financial decision-making (Hasan et al., 2023).

- **Interpretability and Transparency**

Sometimes, AI models can be difficult to interpret. Deep learning networks are complex AI models which often function as black boxes. It sometimes becomes difficult to interpret them which poses challenges in regulatory compliance and investor trust. AI based recommendations given by financial professionals also need to explained by them.

- **Technology Adoption Barriers**

Traditional financial planners often are resistant towards new technology adoption. This also happens due to high costs of implementing AI systems which further reduces its widespread use. Scalable AI models need to be built to bridge this gap, (Dhanaraj et al., 2020).

Framework for Integrating AI into Behavioural Finance

A multi-pronged framework is required for effective integration of AI into behavioural finance. The framework must have the following essentials:

- **Data Governance:** Secure and ethical data handling mechanisms.
- **Bias Detection:** Algorithms that self-monitor and adjust for bias.
- **Human-AI Collaboration:** Blending human intuition with machine precision.
- **Continuous Learning:** Adaptive models that evolve with market conditions.
- **Stakeholder Education:** Training programs for investors and professionals.

Such a framework aligns with the strategic guidelines presented by Borges et al. (2021) and Canhoto et al. (2021), focusing on maximizing benefits while minimizing risks.

Future Research Directions

The blend of AI and Behavioural Finance can offer for further deep research in areas like:

- Investigating how AI can model irrational investor behaviour more effectively.
- Developing explainable AI (XAI) frameworks for financial applications.
- Exploring the socio-psychological impact of AI-driven financial advice.
- Evaluating AI's role in managing systemic financial risks.
- Conducting longitudinal studies to track AI's impact on investment behavior.

These ideas for further research can offer deeper insights into the long-term viability and ethical sustainability by integrating AI into behavioural finance.

Conclusion

AI has the power to transform the field of behavioural finance by providing tools that can detect, predict and mitigate investor biases. AI comes with many benefits such as enhanced decision-making, fraud detection and strategic personalization but it also poses many challenges such as ethical concerns related to algorithmic transparency. A balanced, ethical, and human-centric approach is essential for leveraging AI's potential in behavioural finance without compromising investor trust or financial integrity.

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