Proceedings of CONF-SEML 2025 Symposium: Machine Learning Theory and Applications
DOI: 10.54254/2755-2721/2025.TJ24493

Application of Machine Learning and Artificial Intelligence in Financial Pricing: A Review

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Abstract. The proliferation of artificial intelligence (AI) and machine learning (ML) has catalyzed a transformative shift in the financial sector, redefining the construction and implementation of pricing models. By leveraging advanced algorithms capable of processing heterogeneous datasets, these technologies enhance predictive accuracy and enable real-time adaptation to volatile market conditions. Conventional models such as CAPM and Black-Scholes are constrained by their dependence on linear frameworks and backward-looking data, limiting their adaptability to dynamic market conditions. In contrast, ML and AI algorithms possess the ability to analyze vast and diverse datasets, uncover intricate patterns, and adapt dynamically to changing market environments. This review delves into the various applications of ML and AI in financial pricing, highlighting significant advancements in algorithmic trading, asset pricing, and risk management. Furthermore, it discusses the integration of these cutting-edge technologies with big data analytics, which facilitates improved decision-making processes. By examining current trends and future directions in the financial landscape, this review aims to provide a comprehensive understanding of how ML and AI are reshaping financial pricing, ultimately leading to enhanced market efficiency and more informed financial practices.

Keywords: Machine learning, Artificial intelligence, Financial pricing, Risk management

1. Introduction

The financial industry is characterized by its dynamic nature, where prices of assets fluctuate based on a myriad of factors, including market sentiment, economic indicators, and geopolitical events. Traditional financial pricing models, such as the Capital Asset Pricing Model (CAPM) and the Black-Scholes option pricing model, have been widely used to estimate asset values and manage risks [1][2]. However, these models often fall short of capturing the complexities of real-world financial markets due to their reliance on linear assumptions and historical data [3][4].

In recent years, the integration of machine learning (ML) and artificial intelligence (AI) into financial pricing has emerged as a game-changer. These technologies leverage advanced algorithms to analyze large volumes of data, identify patterns, and make predictions with greater accuracy [5][6]. By employing techniques such as supervised learning, unsupervised learning, and reinforcement learning, financial institutions can enhance their pricing strategies, optimize trading decisions, and improve risk management practices [7][8].

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This review aims to explore the intersection of machine learning (ML), artificial intelligence (AI), and financial pricing, highlighting the advancements, challenges, and future directions in this rapidly evolving field. By analyzing existing research and practical applications, this review aims to provide insights into how machine learning (ML) and artificial intelligence (AI) can reshape financial pricing and enhance overall market efficiency.

2. Literature survey

The comparison between traditional pricing methods and machine learning-based approaches is crucial for understanding the advancements in financial pricing. Traditional models, such as the CAPM and the Black-Scholes model, often rely on simplifying assumptions and linear relationships among variables. For example, the CAPM assumes a linear relationship between expected return and systematic risk, which may not hold in volatile markets [1]. In contrast, machine learning models can capture non-linear relationships and interactions among multiple variables, leading to more accurate pricing predictions [4][6].

Table 1: Comparative analysis of pricing methodologies

Aspect	Traditional Pricing Methods	Machine Learning Approaches
Assumptions	Linear relationships, constant volatility	Non-linear relationships, adaptive to market changes
Data Requirements	Limited historical data, often static	Large datasets, including alternative data sources
Predictive Power	Limited in volatile markets	High accuracy through pattern recognition
Flexibility	Rigid, based on predefined models	Dynamic, can adapt to new information

The rise of machine learning in financial pricing has been documented in numerous studies. For instance, empirical studies by Krauss et al. [7] reveal the superior performance of deep learning architectures in stock price prediction, attributed to their ability to capture non-linear market dynamics. Similarly, Bontemps et al. [8] highlighted the effectiveness of ML algorithms in risk assessment, showing that they can identify potential risks more accurately than traditional models. Furthermore, He et al. [5] emphasized the role of AI in enhancing asset pricing models, allowing for a more comprehensive analysis of market dynamics.

3. Advanced applications of ML and AI in financial pricing

3.1. Algorithmic trading

Algorithmic trading has revolutionized the way financial markets operate. By utilizing ML algorithms, traders can automate their trading strategies, executing orders at optimal prices based on real-time market data. Techniques such as reinforcement learning allow algorithms to learn from past trading experiences, continuously improving their performance over time [7].

Table 2 systematically outlines key machine learning (ML) techniques applied in algorithmic trading, highlighting their strengths and limitations. Decision Trees, built through recursive data partitioning, offer interpretability and visualization advantages, making them suitable for stock price prediction, though they are prone to overfitting with noisy data. Neural Networks, as deep learning models, excel at capturing complex nonlinear patterns and are widely used in high-frequency trading, but they demand substantial computational resources and large datasets while lacking interpretability. Support Vector Machines (SVM) perform well in high-dimensional classification

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tasks, such as risk assessment, yet their efficiency declines with large-scale data and sensitivity to parameter tuning. Reinforcement Learning dynamically optimizes strategies through trial-and-error, enabling adaptability to market shifts, but it requires careful reward mechanism design to avoid suboptimal outcomes. These techniques emphasize trade-offs between efficiency, accuracy, and interpretability, necessitating scenario-specific selection.

Table 2: Various ML techniques used in algorithmic trading, their advantages, and their applications

Technique	Description	Advantages	Applications
Decision Trees	A hierarchical model employing recursive partitioning for predictive tasks	Easy to interpret and visualize	Stock price prediction
Neural Networks	Deep learning models that mimic human brain functions	Capable of capturing complex patterns	High-frequency trading
Support Vector Machines	A supervised learning model for classification	Effective in high-dimensional spaces	Risk assessment
Reinforcement Learning	Learning through trial and error to optimize strategies	Adapts to changing market conditions	Dynamic trading strategies

3.2. Asset pricing

Machine learning has made significant strides in asset pricing, providing tools to analyze complex datasets and improve valuation accuracy. Traditional models often struggle to account for non-linear relationships and interactions among variables. In contrast, ML algorithms can analyze multiple factors simultaneously, leading to more accurate asset valuations [5][6].

For example, gradient-boosting machines and ensemble methods have been employed to improve the accuracy of stock price predictions by considering various market indicators and economic factors [7]. The following table 3 summarizes some of the prominent ML techniques used in asset pricing:

Table 3: Different ML techniques used in asset pricing and their applications

Machine Learning Technique	Description	Application in Asset Pricing
Random Forest	An ensemble learning method that constructs multiple decision trees	Used for predicting stock prices based on historical data
Support Vector Machines	A supervised learning model that finds the optimal hyperplane for classification	Effective in predicting asset price movements based on market signals
Neural Networks	Deep learning models that can capture complex relationships	Applied in predicting future asset prices based on historical trends
XGBoost	An optimized gradient-boosting framework	Widely used for regression tasks in asset pricing

3.3. Risk management

Effective risk management is crucial for financial institutions to mitigate potential losses. ML and AI technologies enhance risk assessment by analyzing historical data and identifying potential risk

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factors. Techniques such as anomaly detection and clustering can help in identifying unusual patterns that may indicate financial distress or market volatility [4][8].

For instance, a study by Chen et al. [4] demonstrated that using ML algorithms for credit risk assessment significantly improved the accuracy of default predictions compared to traditional logistic regression models. Additionally, Bontemps et al. [8] highlighted the use of clustering algorithms to segment portfolios based on risk profiles, allowing for more tailored risk management strategies.

The following Table 4 illustrates the application of ML techniques in various aspects of risk management:

Table 4: Application of machine learning techniques in various aspects of risk management

Risk Management Aspect	Machine Learning Technique	Description
Credit Risk Assessment	Logistic Regression, Decision Trees, Random Forests	Used to predict the likelihood of default based on borrower characteristics and historical data.
Market Risk Analysis	Neural Networks, Support Vector Machines	Analyze historical price movements and market indicators to predict potential losses in market downturns.
Operational Risk	Anomal Detection, Clustering	Identify unusual patterns in operational data that may indicate fraud or system failures.
Liquidity Risk Management	Time Series Analysis, Regression Models	Forecast cash flow needs and assesses the ability to meet short-term obligations based on historical liquidity data.
Fraud Detection	Supervised Learning, Ensemble Methods	Detect fraudulent transactions by analyzing patterns and anomalies in transaction data.
Portfolio Risk Assessment	Monte Carlo Simulation, Reinforcement Learning	Evaluate the risk of investment portfolios under various market scenarios and adjust strategies accordingly.

Table 4 categorizes ML applications across risk management domains: logistic regression, decision trees, and random forests predict credit defaults; neural networks and SVM forecast market risks; anomaly detection and clustering identify operational risks like fraud; time series models analyze liquidity risks; and Monte Carlo simulations with reinforcement learning optimize portfolio strategies. Beyond these, ML drives intelligent risk mitigation through real-time anomaly detection for fraud monitoring, clustering to segment clients by risk profiles, ensemble learning for robust predictions, and NLP to assess market sentiment from news or social media. However, challenges such as data quality gaps, limited model interpretability, and algorithmic bias persist. Addressing these requires ethical frameworks and transparent practices to ensure compliance and sustainable integration of ML in risk management systems.

4. Future directions

The future of ML and AI in financial pricing holds immense potential. As technology continues to evolve, we can expect further integration of these tools with big data analytics, enabling more sophisticated pricing models that account for a wider range of variables [7][8]. Additionally, the rise of alternative data sources, such as social media sentiment and satellite imagery, presents new opportunities for enhancing pricing accuracy and market predictions [5][6].

However, the adoption of ML and AI in financial pricing also raises ethical considerations, including data privacy, algorithmic bias, and transparency in decision-making. It is essential for

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financial institutions to establish ethical guidelines and frameworks to ensure the responsible use of these technologies [4][8].

5. Conclusion

The convergence of AI and ML technologies has redefined financial pricing paradigms, fostering unprecedented advancements in predictive accuracy and operational efficiency. By enhancing algorithmic trading, asset pricing, and risk management, these technologies have improved the accuracy and efficiency of financial decision-making. The ability of ML and AI to process vast amounts of data and identify complex patterns allows financial institutions to make more informed decisions, ultimately leading to better investment strategies and risk mitigation.

As the field continues to evolve, the potential for further advancements in pricing models and strategies is significant. The incorporation of alternative data sources, such as social media sentiment and satellite imagery, presents new opportunities for enhancing pricing accuracy and market predictions. Moreover, the ongoing development of more sophisticated algorithms will likely lead to even greater predictive capabilities.

However, addressing ethical considerations will be crucial to ensure the responsible and equitable use of ML and AI in finance. Issues such as data privacy, algorithmic bias, and transparency in decision-making must be prioritized to build trust among stakeholders. Financial institutions should establish robust ethical guidelines and frameworks to navigate these challenges effectively. By doing so, they can harness the full potential of ML and AI while promoting a fair and sustainable financial ecosystem. The future of financial pricing, enriched by these technologies, promises to be more dynamic, insightful, and responsive to the complexities of global markets.

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