

Machine learning for customer risk ratings

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Financial institutions are mandated to conduct anti-money laundering (AML) risk assessments to determine the overall risk rating of their customers. The assessment and subsequent rating are derived using a risk rating methodology based on industry standards and rules defined by regulatory bodies. Customer risk rating is a typical multi-class problem because financial institutions have two or more categories of ratings. Most firms highlight the importance of judgment/qualitative factors in determining the risk rating of customers. However, in practice, a mathematical model using quantitative variables/attributes plays an important role in determining customer risk ratings because the process is convenient and consumes less time. This article discusses the application of machine learning for customer risk ratings.

Objective

This document proposes a framework/methodology based on machine learning approach to establish the risk rating score (normally a low, medium or high score) of customers using various drivers/attributes as input variables. The methodology is used for AML risk assessment and rating during the on-boarding phase, and the procedure will be performed on an ongoing basis throughout the period of the customer's association with the financial institution.

Data and variables

For the analysis, granular customer-level data to determine the risk ratings is required. Also needed are independent variables (regressor) for a relatively longer period, covering an entire economic cycle. Necessary discussions with line of business and senior stakeholders to shortlist the initial set of potential drivers and independent variables also need to be considered for the model building exercise.

To identify the variables that contribute the most to the assigned customer risk ratings of the sample, the procedure is to follow correlations, pre-filtering, and forward/backward, and stepwise, variable selection approaches.

Some key variables considered for model development are:

- Customer's name and country assessment
- Type of customer and customer's industry
- Customer's source of assets/wealth
- Customer's reputation
- Anticipated account activities and purpose of the account
- Account's beneficial owners
- Known associates and network
- Customer behaviour and transaction history

Methodology: Champion/challenger approach

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Several statistical and machine learning techniques have been applied for such rating predictions. Among them, artificial neural networks (ANN) have been widely used because of their broad applicability to many business problems such as fraud detection, bond ratings, firm ratings, application and behavioural scorecard, default prediction, and financial time-series prediction. Of late, the Random Forest methodology has also become a popular choice for addressing classification and prediction problems because of its robustness and high accuracy.

Typically, classical ordered logit and probit models are used as a challenger/benchmark to evaluate the performance of the champion model built using methodologies such as ANN and Random Forest.

Hence, we propose machine learning models, namely ANN and Random Forest, to handle multi-class classification of customer risk ratings. Further, the results of these models will be benchmarked against the ordered logit/probit model.

Performance metrics

To systematically evaluate the robustness of the proposed model, use the cross-validation technique in addition to in-sample and out-of-sample testing. The performance of the machine learning-based approach and classical ordered logit/probit model will be evaluated using Hit Ratio, Confusion Matrix, Mean Square Error, and Population Stability Index.

Broader impact of the proposed methodology

The evaluation of customer risk ratings of banks and other financial organizations is very challenging due to the opaqueness of the banking sector and high variability in the sector's customer risk. Risk evaluation is, however, extremely important, given the growing number of regulations, policies, and penalties. The magnitude of losses in terms of goodwill, reputation, and fines, and its cascading effects on the financial system and economy, have enormous consequences.

The proposed customer risk rating approach can be applied to develop an accurate and objective customer risk rating model. The model would enable financial institutions to rate their customers on a proactive basis at a desired frequency and respond to the needs of developing internal customer risk rating systems.

The proposed model's role as an early warning system is extremely critical in view of

- I. the financial costs incurred by banks in case of policy and regulatory violations
- II. continued failure of banks in identifying and deterring money laundering activities over the last 30 years
- III. the risk of spill-over across the financial system and economy (from terror financing activities, drug syndicates, and child trafficking).

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