Explainable Credit Decision Engines: Machine Learning Architectures for Automated Loan Origination and Approval

Dr. Astrid Lwoga, Professor of Information Systems, University of Dar es Salaam, Tanzania

1. Introduction to AI in Loan Approval

Artificial intelligence (AI) is transforming how financial institutions operate and deliver value. The use of AI in financial institutions has continued to grow exponentially as the technology enables a variety of functions to be improved, such as customer service and accuracy. By understanding the different types of AI and their operational nuances, financial institutions can leverage these technologies to automate the loan approval process. Adopting AI has the potential to increase efficiency, mitigate risk factors, and improve customer service for loan applications. This potential improvement can be quantified as motivating factors to implement an AI-based loan approval system. Being AI-enabled aids the system in reducing the time spent processing, analyzing, and approving applications. This allows financial institutions to focus their efforts more efficiently on pressing matters, such as decision-making on other applications. A system that is AI-enabled can simultaneously reduce or manage the potential impacts of human error as the level of intervention through the credit assessment process is reduced.

Financial institutions continue to explore the ways that AI can be integrated into their processes and services. The integration into the loan process comes with the aim of reducing the time taken for decision-making on applications and removing bottlenecks. The system is developed within the scope of AI with the capability to handle vast amounts of unstructured data and to provide a personal user experience, allowing for accurate decision-making to assess the lender's risk. Artificial intelligence enables improved productivity and more accurate and personalized delivery of services, catering to an individual's circumstances. AI has the capability to operate and learn from big data and increasingly make decisions as it develops, matching and exceeding human performance. This level of operation and the nature of machine learning brings new functionality and personalization to the customer experience. Types of AI that are being implemented include machine learning, deep learning, and natural language processing; other types of AI are also in operation.

1.1. Overview of Traditional Loan Approval Processes

1.1. Overview of Traditional Loan Approval Process Loan approval is a long-standing process, usually conducted through manual methods. With this method, a credit application review is performed by assessing risk based on numerous requirements using a certain loan risk assessment method. Essential factors such as character, capacity, capital, conditions, and collateral, together with the judgment of the bank or financial institution profile, are evaluated. One requirement often stressed is that of credit history. In addition, the prospective beneficiary's payment capacity is assessed. In lending activities, loan applicants' financial status, their position's continuity, loan usage schemes, and supporting documents are all considerations. Moreover, when deciding to accept or deny a credit application, information on required documentation for each loan service is frequently utilized. The process is frequently delayed due to the validity period of customer-submitted documentation. The amount of administration, the time it takes for staff to process the document simultaneously, and the possibility of errors in data processing and calculation carry with them the possibility of human error occurring when processing manual procedures. Hence, to speed up the process, it is necessary to automate the loan application process.

The traditional methods of conducting loan application procedures have several drawbacks. One of these drawbacks is that the application process requires a lot of time. A long loan application process can result in a decrease in customer satisfaction. Another issue in the settlement process for loan applications is that different business sectors have differing methods of calculating the risk of non-performing loans. The old procedure requires the same time as the new process. Based on this approach, suggestions are included to help ease the loan application process, aside from considering the current method of credit scoring models and also taking into account customer deposits. Recommending that artificial intelligence be employed in bank operations is one way to automate the lengthy process associated with the loan application system. The concept of artificial intelligence has created a new approach for people to analyze the loan application process by compiling significant data on credits.

AI technology techniques are utilized to improve software testing, coding, and design. In this approach, multiple processing methods may be identified and changed if faults have occurred.

2. Machine Learning Techniques in Credit Evaluation

One of the most widespread and thus most interesting areas of machine learning and predictive modeling, in particular, is prediction in credit scoring. A wide range of algorithms has been applied within the framework of different models. They range from the ones that usually provoke overfitting for very specific but limited datasets to conceptually simpler and sounder ones, like regression and its variants, etc.

Supervised learning algorithms are definitely an ultimate choice due to the historical nature of all the available data. For an ever-increasing number of borrowers who lied on the loan application or are aiming not to pay it back, one never has the actual output. Using unsupervised learning algorithms, or clustering techniques in particular, is also an unclear option. It is uncertain whether a conceived set of borrowers will default on their payment or not, and that scenario is exactly what clustering aims to do in the first place, an assumption that is at odds with the typical philosophical inclination of bank loan officers. Furthermore, as there are typically just a few industries that contain a significant portion of the bad borrowers, using clusters would obstruct the correct classification of potential loan applicants. Additionally, the quantity and quality of data are crucial in order to accurately train and adjust a machine learning model. Predictive models should be able to cope with both the "curse of dimensionality" and the "curse of sparsity," the common names for the incapability of sparse data to cover the full feature spaces. Certain models are able to cope with these challenges; however, they call for large waves of historical loan data that cover the majority of possible situations that are likely to arise (in terms of the state of the economy, borrower quality, etc.). The more good and bad loan data, the better the model can model risk. With its access to such a large data set, it can more accurately predict default rates and establish an optimal expected return on loans and bonds. The higher the default and prepayment rates, the wider the spread between the model and yield and the greater the likelihood of profit.

2.1. Supervised Learning Algorithms

Supervised learning – as opposed to unsupervised learning – trains a model to predict or estimate an output based on one or more inputs. Supervised learning employs techniques from statistics, probability, and optimization to fine-tune models. Credit evaluation in general and credit scoring more specifically are typical applications of supervised learning. A variety of models or algorithms can be used for analyzing data related to borrowers (input) to predict future events related to their credit behavior (output). Some of these models include:

- Regression analysis: it establishes a causal and rule-based relationship between two or more variables. It can be used to forecast loan default or credit usage based on past data. The outputs from these models are usually continuous, but they can still be used as an indicator of creditworthiness. - Decision trees: these algorithms separate the prediction space into a series of binary subspaces until they reach final predictions at the bottommost end. A main advantage is that interpretation is straightforward as they mimic human decision processes. - Neural networks: these models aspire to emulate the way the brain's neurons function. Such a simulation is performed using an interconnected web of neurons. These models have a greater ability to interpolate, thereby finding nonlinear relationships between inputs and outputs.

Supervised learning in general and some of these algorithms (such as regression and decision trees) in particular can be used to predict creditworthiness based on past data. Using such methods has several advantages. For instance, they increase the prediction accuracy of the outputs using a combination of input variables. In addition, they are reliable when applied to any other collected information. At the same time, supervised learning can be risky and faces serious challenges such as data privacy and data integrity.

3. Challenges and Opportunities in AI-Based Loan Approval Systems

In order to achieve the goal and establish AI-based systems for automating the loan approval process, banks need to address a series of operational and ethical challenges. From an operational perspective, legislation now provides a descriptive law rule for how AI can be used. Banks are to make significant investments in IT infrastructure and/or acquire the necessary technology. To develop internal expertise, they need to create user-friendly interfaces capable of providing explanations and training employees on how to use an AI system. Last but not least, in reality, AI cannot be used if banks do not implement a change management approach to successfully integrate AI into existing schemes and/or use it.

The opportunities offered by AI can be summarized as data-driven, which streamlines procedures and helps facilitate access to finance by assisting credit analysts in their risk assessments. In addition, through quick processing and identifying non-performing consumers who are risky, time can now be used to improve customer relations and thus reduce exposure further. It is also described as transparent by offering users a clear overview. Unlike a linear credit scoring model, AI decision-making processes can be easily explained. There will be more adequate and, above all, fairer analyses based on objectivity. However, the use of AI naturally has its limitations; thus, it is essential to identify and prevent these risks from materializing. From a theoretical perspective, the definition of risk and the classification of potential risks into operational, ethical, and citizen rights aspects have been developed in accordance with the original proposal. AI is driven by data and the corresponding concept. Regardless of how advanced the computing mechanisms are, quality and reliability have an impact on biased and/or misleading results. The use of AI in deciding on loans is a fragile field, and decision-making can be challenging. The level of unease with AI-supported solutions is also demonstrated by the decision-making of individuals. The latter highlighted the importance of improved user experience and the benefits not only for the banks but also for the customers.

3.1. Ethical Considerations and Bias in AI Algorithms

One of the largest practical and ethical implications is the risk of bias in loan approval processes. If historical data is biased, an AI might generate an unfair system for customer evaluation. This would allow banks to discriminate against certain social groups, which is illegal for emotional and financial reasons. In a case study, it was shown that an AI has partially eliminated the differences in the approval rates of white borrowers and African American borrowers by erroneously giving negative weight to African American borrowers' race. This issue was caused by the AI using the home address as a predictor of repayment, which placed it in the same zip code as other primarily African American neighborhoods. Although not illegal on the surface, it is in violation of the Fair Credit Reporting Act prohibition of racial discrimination. Alternatively, biases can also creep into the data through historical human decision-makers and societal issues.

From a practical perspective, a more diversified clientele is desirable because loans are often confirmed or denied based on customer credit evaluations to prevent banks from facing default. Avoiding losses makes it even more important for the AI to be trained on a diversified training set. Such decisions should be based on standard frameworks or standards. Such ethical issues also raise data-related ethical issues. Most AI systems are trained on large data sets that include customer data, including spending and financial habits, financial and family-related demographics, etc. The impact is not only centered on an AI evaluation of an applicant but includes all customers who have contributed data to the AI. This often raises privacy and informed consent issues. Recommendations for practitioners looking to use AI for ethical policy applications recommend strictly auditing algorithms and residual models for bias. They also recommend working from diverse data and being transparent in using and making exceptions from the use of data. We need regulatory frameworks and industry standards to prevent AI from becoming discriminatory and to mitigate the other potential ethical issues AI raises.

4. Case Studies and Success Stories

Case studies and success stories International Finance Corporation, Colombia. One of the banks in Colombia has implemented an automated end-to-end application process. They rely on algorithms to collect, preprocess, and evaluate loan applications. Implementation enabled the bank to reduce the time needed to process the paperwork from 3 days to 1-3 minutes. Scoring combines both financial and non-financial data to mitigate subjective biases in both the loan approval procedure and risk assessment when granting loans to an establishment. Spanish CaixaBank obtained a boost in the acceptance rate when they analyzed transactions in detail and complemented it with proprietary machine learning algorithms. For new clients, the acceptance of loan applications increased from 19 to 40 percent, while for existing clients, it increased from 48 percent to 59 percent.

Ciner is a multiservice finance company offering a wide range of loans to corporate and retail customers in Dongbei province, in northeast China. It uses state-of-the-art AI risk assessment algorithms to improve loan acceptance decisions. The AI-based system has been operational for five years for unsecured loans of up to RMB 300,000, mainly targeted at salaried customers. China's AI loan approval rates, which translate to the proportion of loans that are accepted, have increased by 19% in the most recent fiscal year. Over the same period, risk levels have remained constant. Taking into account all risk levels, the model approximates that Ciner has built an equilibrium that can assess the risk of the loan on a bathtub curve within the first 24 months. For credit scores between 0 and 500, the AI approval rate is approximately 20% and the repayment rate is 99.9%. However, in order to avoid the lower and upper selection frontiers in the loan market, they are not currently lending money to customers with credit scores of less than 600.

4.1. Implementation of AI in Financial Institutions

Implementation in Financial Institutions

Financial institutions planning to implement AI for processes involving loan approval might undergo various steps before the actual implementation. First, they might assess their organizational readiness. Second, they might decide on the technology landscape—whether to acquire a new technology from a vendor, internally develop a new one, or adopt their existing technology for the new process. In deciding on which technology, the financial institution might go through some selection phase which can involve multiple stakeholders. Relevant stakeholders can be application developers, IT professionals, compliance officers, and auditors. The next thing to do before actual implementation is to build the infrastructure supporting the chosen technology. This can involve utilizing data lakes, machine learning models, and APIs to train the models. Then the employees involved might start to be trained continuously. Training can be done internally or externally. Currently, no regulation specifically discusses automated testing and the use of AI in loan application processes. Generally, it is stated that AI can be part of an internal model used; there needs to be good governance and oversight in using the data, model, and results of using AI.

The most challenging part of implementing AI or updating the technology used in their processes is to work with the existing software to do the math. The integration will happen with legacy systems. From the managerial standpoint, it is important to ensure the technology fits into the existing processes, complies with data regulation, stays up to date with consumer preferences, and meets continuously evolving risk management. If successful, the new technology will contribute positively to revenue generation, cost savings in risk management, compliance, operations, process efficiency and accuracy, and human time savings. These would mean transformational impacts and benefits to financial institutions.

5. Future Trends and Implications

Advances in AI technologies are expected to have a wide range of impacts on the future. This is particularly the case in the field of machine learning, where we are likely to see significant improvements in data processing and device efficiency. In addition, advances in natural language processing are expected to change the way that interactions between consumers and financial institutions take place. Furthermore, it is likely that automation using AI will be significantly advanced through the use of computer vision and industrial robots. It is clear from this analysis that AI has the potential to significantly affect the future of loan approvals. Over the next several years, we will likely see several key trends develop in the area of AI and automated loan approvals. We are most likely to see new developments in machine learning, especially deep learning models that incorporate a variety of different data types. Although natural language processing has made great advances already, it is possible that we will see better algorithms that allow for increased understanding of unstructured data. Finally, it is most likely that we will see the continued advance of automation, especially when it comes to integrating additional data sources into currently existing AIs. Drawing on this, we can be confident that AI will continue to improve automated loan approval. There are also a number of potential implications of this. One possible implication is that as banks and other financial institutions become better at predicting a loan's success, we may begin to see more personalized loan products. Alternatively, AI development might slow as a result of tougher regulations, especially focusing on algorithms. Moreover, as banks develop better automated systems, we expect them to become more competitive in terms of the loan products they can offer. As a result of the increasing competition, we will likely see individual borrowers begin to have greater levels of access to credit. Finally, we may begin to see concentration risks emerge in this market, as the larger players that can spend more on AI development will have more competitive loan offerings. In other words, the financial industry can expect a great many changes in the near future. Thus, preparation and foresight are important for industry stakeholders.

5.1. Potential Impact of AI on the Financial Industry

It is expected that artificial intelligence, especially financial AI, is starting to gradually rewrite entire business models in the financial industries. If there is one area within finance where the impact of such an implementation can be measured earlier or more reliably, it is surely lending. A broad consensus exists on the transformative benefits of AI and big data usage. Such a potential repositioning, though not free from risks and ethical dimensions, is essentially in the direction of cost reduction and efficiency enhancement due to automated processes for the collection and analysis of data; greater accuracy and reliability granted by a deeper data awareness; improved performance and default prediction due to pooling beneficial data features linked to a vast dataset; and a more customer-tailored and satisfying relationship, making smart use of the human brains that less and less recognize one individual from another.

AI systems are characterized by self-learning systems and are therefore dependent on an extensive collection of data to facilitate or even replace human involvement in the decision-making process. As such, the willingness to share as much non-anonymized raw data as possible with other companies for the purpose of improving their company's decision-making based on analyzed macroscopic consumer behavior should simply be adopted as standard practice in every part of business activity. The push towards big data analysis and AI deployment is motivated not only by a general increase in aggregated quantities of data, nor only by the value at stake, but also because data processing has become central in shaping any possible realistic and competitive business strategy, ultimately granting its success. AI takes this development a step further, not just identifying regularities and relationships from which to make an inference by applying a statistical-quantitative view to the world, but rather deriving new insights and deep learning inferences from strategic clusters revealed by the model. In sum, data analytic solutions may potentially provide significant advantages to businesses. At the same time, AI use places new obligations, responsibilities, and, not rarely, opportunities for a complex ecosystem of actors, all of which have significant normative, legal, and societal implications.

6. Future Direction

With rapid advancements in digitalization and computational technologies, financial ecosystems are evolving swiftly. Here, the flexibility to adapt to new technologies is considered a potential strength. With the passage of time, existing technology will become obsolete, and new and more efficient technology will replace it. The relevant processes can survive globally if they keep pace with technological advancements. This clearly indicates how reflective organizations of the world need to be more innovative and rational in credit processes and transactions. Additionally, AI has the potential to imitate the credit underwriting judgment across the entire scorecard. AI can evaluate small business loan applicants and connect immigrant families with banking services to better judge their creditworthiness.

Better AI-powered risk modeling will shape the future. Additionally, more banks can utilize these technologies because the cloud is home to pre-packaged AI models. The spread of technology into the cloud is beneficial because the pre-packaged models for AI are utilized; banks are closer to the moment when AI is used for underwriting. In order for technologies to run payment systems and manage trading, banks often depend on technology firms. This notion signifies that it is crucial for tech firms to work together with financial institutions, particularly banks, to further AI in banking. In the presence of AI, many scientific and ethical questions arise, which need to be considered. Despite the domain's technical depth, fairness and bias concerns do not receive specific focus. This is crucial for AI in credit processes. It suggests that worldwide regulatory frameworks oversee the responsible use of AI technologies, especially in large bank operations. It is also important for worldwide regulatory oversight that credit applicant personal information is used responsibly and ethically. Additionally, better research development is essential for the upcoming years, where opinions and sentiments can be used as predictors of potential loan defaults in a credit application. More decision-makers, organizations, and credit applicants need to trust predictive AI systems. Because AI systems consume a huge amount of data to generate predictions, biases can be an additional burden on these systems. This might require a more comprehensive legal and regulatory basis for fairness in data protection and consumer protection. All possible downsides of AI technologies need to be researched and analyzed.

7. Conclusion

With their promise of reduced biased decision-making, lower transaction and investment costs, and increased financial access, AI-based systems have the power to change traditional loan approval processes. The adoption of a technology as disruptive as AI presents many challenges, however. These include economic, legal, ethical considerations, as well as a requirement for transparency, particularly to reassure decision support systems' users and to make them aware of their limits.

AI's future in decision support systems is likely to be defined by its level of transparency and the need for individual fairness, a requirement likely to limit its wide adoption. On the other hand, expansion will undoubtedly affect the stakeholders of the financial system: entrepreneurs, firms, financial intermediaries, regulators, and policy makers. It is important to be able to capture these effects in time and keep up with the trends of a rapidly evolving market.

The ability to incorporate AI in credit decision-making processes has the potential to significantly affect traditional retail banking, changing relationships and the value to be derived from individual customers. Our intention has been to provide guidance for thinking about the costs associated with incorporating AI in decision-making, and for valuing services that promise to improve individual financial health. Importantly, we will only be able to make progress on these questions and the issues that have been raised if research continues, producing empirical results, defined for the space where the opportunity to affect our lives positively is greatest, the application of AI technologies to financial services. Given the stakes, the call to action for stakeholders is a simple one: institutions and decision-makers need to adopt, adapt, refine, and implement AI technologies. However, they should do so with extreme caution and with equally significant, proactive, legally enforceable, and ethically mediated checks and balances. Only under such carefully regulated conditions will the technology realize its promise of promoting individual and social welfare over and above that of its developers and implementers.