

1 EFFICACY OF LOAN DEFAULT LIKELIHOOD PREDICTIVE MODELS FOR LENDING CLUB DATASET

In this section we compare the models that predict the likelihood of a given loan defaulting. We first describe the experimental setup that was used to compare the predictive models, followed by the comparison itself.

1.1 Experimental setup

All our experiments in this section are performed on the Lending Club¹ dataset obtained from [LendingClub 2016]. This dataset contains complete loan data from the period 2007 to 2011. There are 42,538 loans with a total 114 features for each loan. Similar to the Prosper dataset, we first cleaned/analysed as described in Section 3.1. After clean the dataset, we end up with 38,331 loans with 18 features (include response variable). The 17 selected features and the response variable are described in Table 1.

Amongst these 38,331 loans, there are 5,517 defaulted loans. To avoid negative impact of such an unbalanced dataset on the prediction models, we apply the under-sampling technique [Drummond et al. 2003]. Without loss of generality, we construct 5 sample datasets by randomly choosing 5,517 non-defaulting loans along with all 5,517 defaulting loans together as the sample dataset 5 times and show the average performance in this section. For training and testing the prediction algorithms, we split each sample dataset into a ratio of 80:20, indicating 80% of the loans will be used to train the predictive models and the remaining 20% used for testing.

1.2 Comparison of models predicting the likelihood of loan default

In this section, we compare Support Vector Machine (SVM), k-Nearest Neighbors (kNN), Logistic Regression (LOGIT) and Random Forest (RF) models to predict the likelihood of a given loan defaulting, and thereby find the best predictive model. For comparison purposes, we select accuracy, True Positive Rate (TPR) and True Negative Rate (TNR) as the criterion to evaluate the goodness of fit of the model. The definition of these three measures are described in Section 3.2. In particular, the higher the accuracy, the better the model fits the dataset.

Tables 2, 3 and 4 show the results of accuracy, TPR and TNR for five sample datasets based on SVM, kNN, LOGIT and RF models, respectively. From Table 2, it can be observed that RF achieves the highest average accuracy of 0.64 (64%). LOGIT also fits the sample datasets well with average accuracy of prediction of 0.62 (62%). In addition, the average accuracy of SVM and kNN are 0.49 (49%) and 0.54 (54%), respectively. From Table 3, it can be observed that LOGIT achieves the highest TPR of 0.74 (74%) amongst these five machine learning models. From Table 4, it can be observed that RF achieves the highest TNR of 0.70 (70%) amongst these five machine learning models. Hence, RF and LOGIT are the two best models to predict

¹www.lendingclub.com

Table 1. Features and response variable description

Feature	Explanation	Type
loan_status	The current status of the loan.	Categorical
dti	Debt to income ratio.	Numerical
delinq_2yrs	The number of delinquency for the past two years.	Numerical
int_rate	The borrower's interest rate for this loan.	Numerical
installment	The monthly payment owed by the borrower.	Numerical
home_ownership	Specifies if the borrower is a homeowner or not.	Categorical
inq_last_6mths	The number of inquiries in past 6 months.	Numerical
emp_length	Employment length in years.	Numerical
revol_bal	Total credit revolving balance.	Numerical
annual_inc	The borrower's annual income.	Numerical
pub_rec_bankruptcies	Number of public record bankruptcies.	Numerical
loan_amnt	The listed amount of the loan applied for by the borrower.	Numerical
grade	LC assigned loan grade.	Numerical
open_acc	The number of open credit lines.	Numerical
addr_state	The state of the borrower.	Categorical
Term	The length of the loan expressed in months.	Numerical
revol_util	Revolving line utilization rate.	Numerical
total_acc	The total number of credit lines.	Numerical

Table 2. Results of SVM, kNN, LOGIT and RF for five sample datasets with the measure: accuracy.

Sample dataset	1	2	3	4	5	Average
SVM	0.49	0.49	0.48	0.51	0.50	0.49
kNN	0.53	0.54	0.55	0.53	0.52	0.54
LOGIT	0.60	0.62	0.63	0.61	0.62	0.62
RF	0.63	0.66	0.65	0.62	0.64	0.64

the likelihood of a given loan defaulting. However, compared to LOGIT, RF may take longer to execute with a large dataset, and one may select LOGIT as the predictive model with a trade-off of 0.02 (2%) reduced accuracy of prediction.

2 RESULT OF PORTFOLIO OPTIMISATION COMPARISON FOR LENDING CLUB DATASET

In this section we compare the quality of the generated portfolio, by comparing the average portfolio return rates and risk obtained after solving the proposed technique, *MV* model (10)

Table 3. Results of SVM, kNN, LOGIT and RF for five sample datasets with the measure: True Positive Rate (TPR).

Sample dataset	1	2	3	4	5	Average
SVM	1.00	1.00	1.00	0	0	0.60
kNN	0.52	0.56	0.53	0.54	0.53	0.54
LOGIT	0.74	0.76	0.76	0.73	0.73	0.74
RF	0.56	0.56	0.57	0.54	0.54	0.55

Table 4. Results of SVM, kNN, LOGIT and RF for five sample datasets with the measure: True Negative Rate (TNR).

Sample dataset	1	2	3	4	5	Average
SVM	0.00	0.00	0.00	1.00	1.00	0.40
kNN	0.54	0.49	0.54	0.55	0.51	0.53
LOGIT	0.47	0.49	0.50	0.48	0.51	0.49
RF	0.69	0.71	0.71	0.69	0.72	0.70

and *IB* model (11). We test these models with 20 different scenarios and 3 lenders. For each scenario, we randomly choose 10 loans from the Lending Club dataset as the loans available for investment and randomly generate the constraints for each lender.

2.1 Model-I comparison

Figure 1 shows the average portfolio return rates with three lenders obtained by solving *WMPI* model (4) and *MV* model (10). We can observe from Figure 1 that *WMPI* model has better results in 17 out of 20 scenarios. *WMPI* model achieves an average return rate of 0.17 (17%) based on 20 scenarios. Compared to the average return rate of 0.15 (15%) achieved by *MV* model (10), a difference of 0.02 (2%). On average, the proposed model's portfolio return is 2% higher than *MV* model (10).

Figure 2(a) illustrates the average portfolio risk with three lenders obtained by solving the proposed technique and *MV* model (10). We can observe from Figure 2(a) that the proposed technique has less or equal risk in all scenarios. On average, the proposed model has an average portfolio risk of 0.00022 (0.022%) based on 20 scenarios. Compare to the average portfolio risk of 0.032 (3.2%) obtained by *MV* model (10), a difference of 0.0318 (3.18%). On average, *WMPI* model's portfolio risk is about 1/145 of that achieved by solving *MV* model (10). Hence, we can conclude that the preferred portfolio achieved by applying our proposed technique will have lower risk than that achieved by applying *MV* model (10). This should be as expected, because *MV* model (10) uses covariance as risk, which is hard if not impossible to compute for

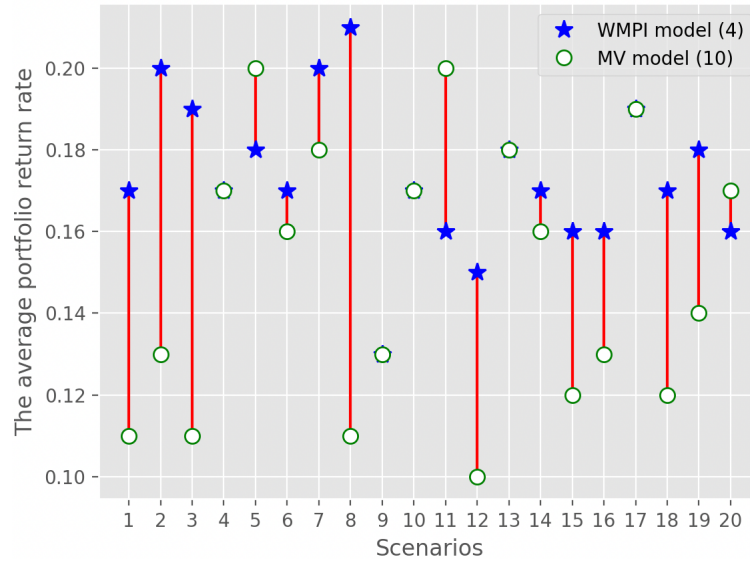
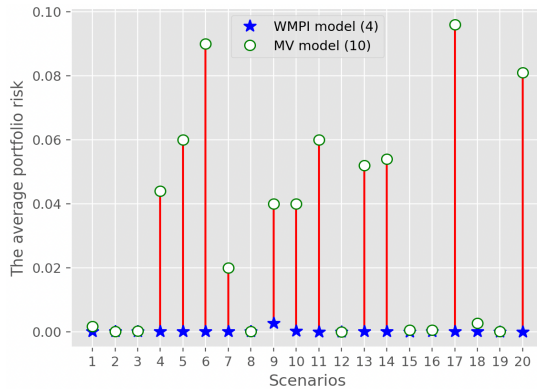
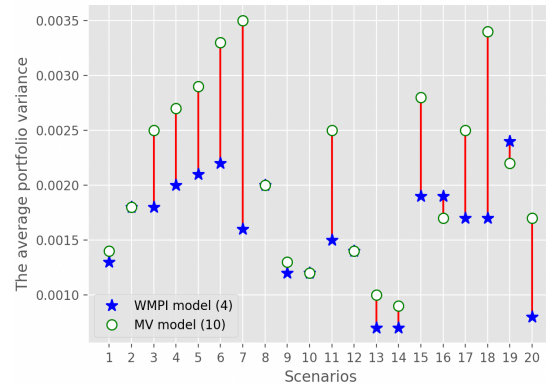


Fig. 1. The average portfolio return rates achieved by solving the proposed *WMPI* model (4) and *MV* model (10) with three lenders



(a) The average portfolio risk comparison



(b) The average portfolio variance comparison

Fig. 2. The average portfolio risk and variance obtained by solving the proposed *WMPI* model (4) and the *MV* model (10) with three lenders

unrelated borrowers. Figure 2(b) illustrates the average portfolio variance with three lenders obtained by solving the proposed technique and the *MV* model (10). We can observe from Figure 2(b) that the proposed technique has less or equal variance in 18 out of 20 scenarios. On average, the proposed model has an average portfolio variance of 0.0016 based on 20 scenarios.

Compare this to the average portfolio variance of 0.021 obtained by the *MV* model (10), a difference of 0.0005.

Table 5. T-test between the results (the average portfolio return rate, portfolio risk and portfolio variance) of 20 scenarios by applying the *WMPI* model and the *MV* model with null hypothesis that they have the same mean value

	Average portfolio return rate	Average portfolio risk	Average portfolio variance
P-value	6.6e-03	4.4e-04	4.4e-04
Decision	Reject	Reject	Reject

To validate the differences between the results (the average portfolio return rate, portfolio risk and portfolio variance) of 20 scenarios by applying the *WMPI* model (4) and the *MV* model (10) are not negligible, T-test is applied with null hypothesis, that they have the same mean value. The results are shown in Table 5. We can observe from Table 5 that all the P-values are smaller than 0.05 and we reject the null hypothesis. Hence, we can deduce that there is significant statistical difference between the average portfolio return rate, portfolio risk and portfolio variance of the investment portfolios gained by applying the *WMPI* model (4) and the *MV* model (10).

Overall, the proposed technique, *WMPI* model (4), *approaches* a better quality solution than *MV* model (10).

2.2 Model-II comparison

Figure 3 shows the average portfolio return rates for the three lenders achieved by solving the proposed technique and *IB* model (11) with 1,000 training samples. We can observe from Figure 3 that *WMPI* model has better results in all 20 scenarios. Specifically, *WMPI* model achieves an average portfolio return rate of 0.17 (17%) for these 20 scenarios. Compared to the average portfolio return rate of 0.13 (13%) achieved by solving *IB* model (11) – the difference is 0.04 (4%).

Figure 4(a) compares the average risk of the portfolios obtained from *WMPI* model (4) and *IB* model (11). Similar to the results shown in Figure 3, the proposed technique has better result in all 20 scenarios. Specifically, the proposed model obtained an average portfolio risk of 0.0016 (0.16%) for these 20 scenarios. Compared to the average portfolio risk of 0.013 (1.3%) obtained by solving *IB* model (11) – the difference is 0.011 (1.1%). On average, *WMPI* model's portfolio risk is about 1/8 of that achieved by solving *IB* model (11). Again, this is as expected, because the covariance matrix used as the risk indicator in *IB* model (11), is misleading, since borrowers usually have no relation to each other. The proposed model, fixes this problem, by directly using the total loan default rate as the risk indicator. Figure 4(b) compares the average variance of the portfolios obtained from the proposed *WMPI* model (4)

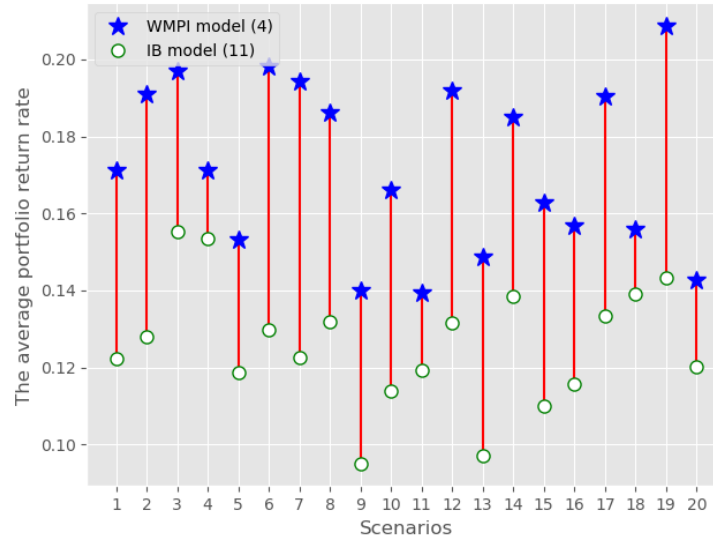
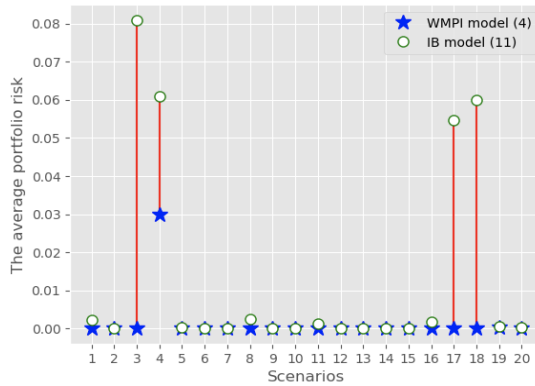
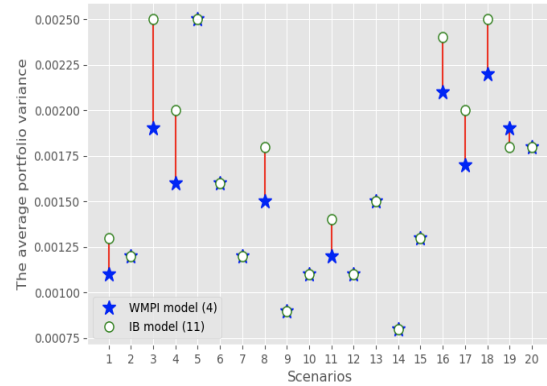


Fig. 3. The average portfolio return rates achieved by solving the proposed *WMPI* model (4) and *IB* model (11) with three lenders



(a) The average portfolio risk comparison



(b) The average portfolio variance comparison

Fig. 4. The average portfolio risk and variance obtained by solving the *WMPI* model (4) and the *IB* model (11) with three lenders

and the *IB* model (11). The proposed technique has equal or better result in 19 out of 20 scenarios. Specifically, the proposed model obtained an average portfolio variance of 0.0015

for these 20 scenarios. Compare this to the average portfolio variance of 0.0017 obtained by solving the *IB* model (11).

Table 6. T-test between the results (the average portfolio return rate, portfolio risk and portfolio variance) of 20 scenarios by applying the *WMPI* model and the *IB* model with null hypothesis that they have the same mean value

	Average portfolio return rate	Average portfolio risk	Average portfolio variance
P-value	5.0e-09	0.062	0.44
Decision	Reject	Not reject	Not reject

To validate the differences between the results (the average portfolio return rate, portfolio risk and portfolio variance) of 20 scenarios by applying the *WMPI* model (4) and the *IB* model (11) are not negligible, T-test is applied with null hypothesis, that they have the same mean value. The results are shown in Table 6. We can observe from Table 6 that the P-value of the average portfolio return rate are smaller than 0.05 and we reject the null hypothesis. Hence, we can deduce that there is significant statistical difference between the average portfolio return rate of the investment portfolios gained by applying the *WMPI* model (4) and the *IB* model (11). In addition, because the P-values of the average portfolio risk and the average portfolio variance are larger than 0.05, we do not reject the null hypothesis. In other words, there is no significant statistical difference between the average portfolio risk and the average portfolio variance of the investment portfolios gained by applying the *WMPI* model (4) and the *IB* model (11).

Overall, the proposed technique, *WMPI* model (4), *approaches* a better quality solution than *IB* model (11).

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