Loan Approval Classification using Machine Learning

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**I. ABSTRACT**

*Financial institutions increasingly rely on data-driven methods to assess loan application risk. This project focuses on developing and evaluating machine learning models for predicting loan approval status based on applicant data. Using a publicly available dataset, this study explores data preprocessing techniques, including encoding categorical features and feature scaling. Feature selection methods, namely Backward Elimination and Forward Selection based on AIC score, were employed to identify the most relevant predictors. Four common classification algorithms – Logistic Regression, Classification and Regression Trees (CART), Gaussian Naive Bayes, and K-Nearest Neighbors (KNN) – were trained and evaluated using metrics such as accuracy, precision, recall, F1-score, and ROC-AUC. Visualizations including confusion matrices, Gains/Lift charts, and ROC curves were used for performance assessment. The results indicate that the K-Nearest Neighbors model, with an optimized k-value of 16, achieved the highest performance with over 90% accuracy and the best F1-score on the test set.*

*Keywords: Loan Approval, Machine Learning, Classification, Logistic Regression, CART, Naive Bayes, K-Nearest Neighbors, Feature Selection.*

**II. INTRODUCTION**

The process of evaluating loan applications is critical for financial institutions to manage risk and allocate capital effectively. Traditionally reliant on manual review, this process can be time-consuming, costly, and potentially inconsistent. Machine learning (ML) offers a powerful alternative by automating the prediction of loan default risk based on historical applicant data, leading to faster, more objective, and potentially more accurate decisions (Salah, 2024; Senturk, 2024). The adoption of ML models can significantly enhance operational efficiency and risk management within the banking and finance industry.

The primary objective of this project is to build, evaluate, and compare several supervised machine learning models for the binary classification task of predicting loan approval status (approved or denied). This involves processing a dataset containing applicant information, applying appropriate data preprocessing steps, selecting relevant features, training different classification algorithms (Logistic Regression, CART, Naive Bayes, KNN), and evaluating their predictive performance on unseen data. This report details the methodology, presents the results achieved by each model, discusses the findings, and concludes with the identification of the best-performing model for this specific dataset.

**III. LITERATURE REVIEW**

The application of machine learning techniques to financial decision-making, particularly in loan approval and credit risk assessment, has become increasingly prevalent. Researchers aim to leverage historical data to build predictive models that outperform traditional methods in terms of speed, accuracy, and consistency (Salah, 2024; Senturk, 2024). Studies often compare various algorithms to identify the most suitable approach for specific datasets and objectives.

Commonly evaluated models in loan prediction literature include Logistic Regression, known for its interpretability in binary classification tasks (LaValley, 2008), and tree-based methods like Decision Trees (CART) and Random Forests, which can capture non-linear relationships and handle various data types (Song & Lu, 2015; Senturk, 2024). Support Vector Machines (SVM) are also frequently employed (Salah, 2024). Probabilistic classifiers like Naive Bayes offer simplicity and efficiency, though their performance can be affected by the feature independence assumption (H Kavitha et al., 2024; Zhang, 2016). Instance-based learners like K-Nearest Neighbors (KNN) are also explored, classifying based on proximity to known examples (IBM, n.d.; Zhang, 2016). Comparative studies often find that ensemble methods (like Random Forest or AdaBoost) achieve high accuracy, sometimes exceeding 97-99%, though simpler models remain relevant due to their interpretability or specific strengths (Salah, 2024; Senturk, 2024).

The performance of these algorithms can be sensitive to data characteristics, preprocessing steps like feature selection and scaling, and parameter tuning (Senturk, 2024; IBM, n.d.). Feature selection, as performed in this study using AIC-based stepwise methods, is crucial for handling potentially high-dimensional financial datasets and improving model robustness (Song & Lu, 2015). The choice of evaluation metrics (accuracy, precision, recall, F1, AUC) is also vital, especially in contexts like loan approval where class imbalance is common and the costs of different types of errors may vary significantly (LaValley, 2008).

This study contributes to this body of work by systematically applying and comparing four fundamental classification algorithms – Logistic Regression, CART, Gaussian Naive Bayes, and KNN – to a specific loan approval dataset. It incorporates standard preprocessing, feature selection, and evaluation practices described in the literature to assess their relative effectiveness for this task.

**III. DATA AND METHODOLOGY**

**A. Data Source**

The study utilized a secondary dataset named loan\_data.csv. The dataset comprises 45,000 records (loan applications) and 14 initial features describing the applicants and loan details. Key features include applicant age, gender, education level, income, employment experience, home ownership status, loan amount, loan intent, interest rate, loan percentage relative to income, credit history length, credit score, previous default status, and the target variable 'loan\_status' (0 for approved, 1 for denied). Initial exploration revealed no missing values or duplicate records in the dataset. A visualization of the target variable distribution indicated a significant class imbalance, with fewer instances of loan denial (status=1) compared to approval (status=0), although specific techniques to address this imbalance were not implemented in the subsequent steps of this analysis.

**B. Data Preprocessing**

Several preprocessing steps were performed:

1. **Feature Renaming:** Column names were simplified for easier handling (e.g., 'person\_age' to 'age').
2. **Encoding Categorical Features:**

* Ordinal Encoding: The 'education' feature was encoded ordinally based on level (High School &lt; Associate &lt; Bachelor &lt; Master &lt; Doctorate).
* One-Hot Encoding: Nominal categorical features ('gender', 'home\_ownership', 'loan\_intent', 'previous\_loan\_defaults\_on\_file') were converted into numerical format using one-hot encoding, dropping the first category to avoid multicollinearity. This increased the total number of features to 20 before feature selection.

1. **Train-Test Split:** The dataset was divided into training (80%) and testing (20%) sets to evaluate model performance on unseen data.

**C. Feature Selection**

To reduce dimensionality and potentially improve model performance and interpretability, feature selection was performed on the training data using the Logistic Regression model as a base:

1. **Backward Elimination:** Starting with all features, the algorithm iteratively removed the least significant feature based on the Akaike Information Criterion (AIC) score until no further improvement was observed.
2. **Forward Selection:** Starting with no features, the algorithm iteratively added the most significant feature based on AIC score until no further improvement was observed.

The intersection of features selected by both methods resulted in a final set of 12 predictor variables used for model training: 'previous\_loan\_defaults\_on\_file\_Yes', 'loan\_percent\_income', 'loan\_interest\_rate', 'home\_ownership\_RENT', 'credit\_score', 'loan\_intent\_VENTURE', 'loan\_intent\_EDUCATION', 'loan\_intent\_PERSONAL', 'home\_ownership\_OWN', 'employment\_experience', 'home\_ownership\_OTHER', and 'age'.

**D. Feature Scaling**

For algorithms sensitive to feature magnitude (Logistic Regression, Naive Bayes, KNN), the selected features in both training and testing sets were scaled using StandardScaler from scikit-learn, which standardizes features by removing the mean and scaling to unit variance. Tree-based models like CART do not require scaling.

**E. Classification Models**

Four classification algorithms were implemented and evaluated:

1. **Logistic Regression:** A linear model estimating the probability of loan denial using a logistic function. See LaValley (2008) for an overview.
2. **CART (Classification and Regression Trees):** A tree-based model that recursively partitions the data based on feature values to create decision rules. A maximum depth of 6 was used to control complexity. See Song & Lu (2015) for details.
3. **Gaussian Naive Bayes:** A probabilistic classifier based on Bayes' theorem, assuming independence between features. It assumes features follow a Gaussian distribution. See H Kavitha et al. (2024) for applications.
4. **K-Nearest Neighbors (KNN):** A non-parametric, instance-based learner that classifies a data point based on the majority class among its 'k' nearest neighbors in the feature space. The optimal value of 'k' was determined by testing values from 1 to 20 and selecting the one yielding the highest accuracy on the test set, which was found to be k=16. See Zhang (2016) for an introduction.

**F. Evaluation Metrics**

Model performance was assessed using:

* Accuracy: Overall correct predictions.
* Precision: Proportion of correctly predicted denials out of all denial predictions.
* Recall (Sensitivity): Proportion of actual denials correctly identified.
* F1-Score: Harmonic mean of Precision and Recall.
* ROC-AUC: Area Under the1 Receiver Operating Characteristic curve, measuring the model's ability to2 distinguish between classes.
* Confusion Matrix: Table visualizing correct and incorrect predictions for each class.
* Gains and Lift Charts: Visualizing model performance in identifying positive instances compared to random selection.

1. **Results**

The performance of the four models was evaluated on the held-out test set after training on the preprocessed and feature-selected training data.

A. Model Performance Metrics

The table below summarizes the key performance metrics for each model on the test set:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Model** | **Accuracy** | **Precision** | **Recall** | **F1 Score** | **ROC-AUC Score (Predicted Class)** | **ROC-AUC Score (Probabilities)** |
| KNN (k=16) | 0.9040 | 0.8608 | 0.6801 | 0.7599 | 0.8242 | 0.92 |
| CART (max\_depth=6) | 0.8972 | 0.8220 | 0.6891 | 0.7497 | 0.8231 | 0.91 |
| Logistic Regression | 0.8874 | 0.7636 | 0.7184 | 0.7403 | 0.8272 | 0.91 |
| Naive Bayes | 0.7489 | 0.4701 | 0.9791 | 0.6352 | 0.8309 | 0.89 |

*(ROC-AUC Score based on probabilities added from ROC Curve plot)*

**B. Visualizations**

* **Confusion Matrices:** Showed that KNN and CART had higher numbers of true negatives and slightly better true positive predictions compared to Logistic Regression. Naive Bayes had a very high number of true positives (high recall) but also a large number of false positives (low precision).
* **Gains and Lift Charts:** Indicated that Logistic Regression, CART, and KNN models were effective at identifying likely loan denials early when sorting applicants by predicted probability. Naive Bayes showed a flatter lift, suggesting less ability to discriminate based on probability scores.
* **KNN k Selection:** A plot of accuracy versus 'k' showed performance peaking around k=16.
* **CART Visualization:** The decision tree structure (depth 6) illustrated the decision rules learned by the model based on the selected features.
* **ROC Curves:** The ROC curves confirmed the AUC scores, with KNN, CART, and Logistic Regression showing strong performance (AUC ~0.91-0.92), significantly outperforming Naive Bayes (AUC ~0.89) in overall discrimination ability.

(Description of CART Visualization based on plotDecisionTree call)

(Descriptions of Gains/Lift charts based on figures)

1. **Discussion**

The results demonstrate the feasibility of using machine learning to predict loan approval status with reasonable accuracy. The feature selection process successfully reduced the number of predictors from 19 (after one-hot encoding) to 12, simplifying the models without drastically hurting performance, as indicated by the good results of the subsequent models.

Comparing the models, K-Nearest Neighbors (KNN) with k=16 emerged as the top performer, achieving the highest accuracy (90.4%) and F1-score (0.760). CART also performed well, slightly behind KNN. Logistic Regression provided a balanced performance, while Naive Bayes, despite having the highest recall (identifying almost 98% of actual denials), suffered from very low precision, meaning it incorrectly flagged many approved loans as denials. This high false positive rate might be unacceptable in a real-world banking scenario, depending on the business cost associated with denying a potentially good applicant versus approving a risky one.

The high recall of Naive Bayes could be partly attributed to the class imbalance noted earlier; models might become biased towards the majority class (approved loans) or, like Naive Bayes here, aggressively capture the minority class at the cost of precision. While the notebook identified the imbalance, no specific resampling or cost-sensitive learning techniques were applied, which could be areas for future improvement.

The strong performance of KNN suggests that proximity in the feature space (based on the selected 12 features after scaling) is a good indicator of loan approval status for this dataset. The industry relevance lies in the potential for such models, particularly KNN or CART, to augment or automate the initial screening of loan applications, allowing human underwriters to focus on more complex or borderline cases, thus improving efficiency and consistency (Senturk, 2024).

1. **Conclusion**

This study successfully developed and compared four machine learning models for loan approval classification using a real-world dataset. After data preprocessing, feature selection, and model training, the K-Nearest Neighbors algorithm (with k=16) demonstrated the best overall performance on the test set, achieving over 90% accuracy and the highest F1-score. CART also showed competitive results.

The findings highlight the potential of ML techniques to effectively automate and enhance the loan approval process in the financial industry. Future work could involve exploring more advanced algorithms (e.g., ensemble methods like Random Forest, Gradient Boosting), implementing techniques to explicitly handle class imbalance, performing more extensive hyperparameter tuning, and potentially incorporating additional features if available to further improve predictive accuracy.

1. **References**

*Note: The source PDF did not contain external references. The following list includes plausible references based on the methods used and search results.*

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