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COURSE #: FM9528

BANKING ANALYTICS: CONSUMER CREDIT RISK

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1. **Introduction**

This report develops a Basel-III-compliant credit risk assessment framework for a portfolio of residential mortgages originated in the United States. The data, sourced from Freddie Mac’s Single-Family Loan Dataset, includes both origination details and subsequent performance records. The primary objectives of this assignment are to construct a behavioural scorecard to estimate one-year-ahead default probabilities, build and interpret a Loss Given Default (LGD) model using machine learning techniques, and perform an Expected Loss simulation under varying economic assumptions. The methodology integrates logistic regression, XGBoost, and Monte Carlo simulation to generate risk metrics consistent with regulatory capital estimation and internal provisioning.

The dataset contains two key components: an application file with borrower and loan characteristics at origination, and a performance file documenting quarterly mortgage status over time. A subset of these datasets is used to construct training, test, and out-of-time samples. The out-of-time sample, consisting of loans active as of June 2024, serves as the basis for applying the final models and estimating expected portfolio-level provisions.

This report is structured in four main parts: the methodology details the theoretical and practical approach to model development; the results section presents empirical findings from the models; the conclusion summarizes insights and policy implications.

1. **Methodology**

This section provides a detailed account of the data preprocessing steps, scorecard modeling techniques, segmentation strategies, macroeconomic modeling, LGD estimation, and provisioning simulation, aligned with the Basel III regulatory framework.

**2.1 Data Preprocessing**

The raw application and performance data were merged using the unique loan sequence identifier. Only active loans (those not paid off or foreclosed) as of June 2024 were retained for the out-of-time sample. Variables indicating repayment status were cleaned and recoded. Specifically, loans marked as “RA” were converted to zero to reflect a non-delinquent status, and the target variable was constructed as a binary flag where loans with delinquency of three or more months were marked as defaulted.

Behavioral variables such as most recent delinquency status, last month’s status, and delinquency frequency over the past year were engineered to enrich the logistic regression model. Data cleaning steps included removing duplicates, handling missing values and ensuring the consistency of numerical data types across features. The cleaned data was split using a group-based sampling technique, ensuring loans with the same sequence number remained within the same partition. The final train-test split followed an 80–20 structure. A fixed random seed was applied to ensure reproducibility.

**2.2 Behavioral Variable Construction**

Behavioral variables were engineered to capture temporal dynamics in borrower and loan performance over a rolling window of the four quarters preceding each prediction point. Features include:

**2.2.1 Delinquency**

A binary **delinquency flag** was first created to track whether a loan was in any state of delinquency:

To construct a robust behavioral feature, the number of months in delinquency over the past 12 months was computed using a rolling sum:

The last month’s delinquency status was also lagged by one period to prevent information leakage:

**2.2.2 Default history**

To monitor the cumulative default history, a cumulative sum of historical default flags was calculated for each loan:

This was used to remove all loan records following a default event, ensuring the predictive model only learns from periods prior to the first default. Specifically, only rows where were retained.

**2.2.3 Feature Engineering**

**Weight of Evidence**

These features were further binned and transformed using Weight of Evidence (WoE) to create monotonic relationships between independent variables and the log odds of default. WoE for a feature category k is defined as:

Information Value (IV) was computed to assess predictive strength:

Only variables with IV > 0.02 were retained for modeling.

**XGBoost**

In the modeling stage targeting XGBoost, a more refined pipeline is applied. First, columns with a high percentage of missing values, such as *'PRODUCT GROUP'*, are removed. Remaining missing values in numerical features are imputed using the median of each column to ensure completeness.

Categorical variables are transformed using one-hot encoding, producing binary indicator columns suitable for gradient boosting algorithms. The dataset is then split into training and testing sets using a group-aware strategy. Specifically, the train\_test\_split\_by\_group function ensures that all records associated with the same loan remain within the same partition, preserving the temporal and relational structure of the data.

**2.3 Logistic Regression and Scorecard Scaling**

The behavioral scorecard was estimated using logistic regression:

Where is the probability that loan will default, given the set of features , is the intercept term of the logistic regression model, is the vector of coefficients associated with each feature in the vector

Model estimation was performed via maximum likelihood. The final model was transformed into a points-based scorecard using a linear scaling function:

Where the factor and offset are determined based on two reference points: score at odds = 1:50, and points-to-double-odds (PDO) = 20. The transformation constants are:

This allows the continuous logistic output to be converted into interpretable scores.

Cutoff optimization was based on profit-adjusted cost analysis, incorporating assumptions: Profit margin = 30% of interest rate; while Haircut = 40% of home value.

**2.4 PD Segmentation and Macroeconomic Modeling**

To forecast long-term PDs, we segmented the scorecard into quantiles of AUC and mapped each segment to empirical default rates. We then incorporated macroeconomic variables at the state level, extracted from the FRED database, including Unemployment Rate (UR), House Price Index (HPI), Real Gross Domestic Product (GDP), Real Estate Loans at Commercial Banks (Credit) and Consumer Price Index (CPI)

A time series model, SARIMAX,was used to forecast these variables, and their impact on segment-level default rates was modeled via:

Long-run values were projected based on macroeconomic trend estimates and literature reviews, and these were used to compute the future PD distribution of the out-of-time sample.

**2.5 LGD Estimation Using XGBoost**

Loss Given Default was modeled using an XGBoost regressor trained only on defaulted loans. The target was:

Only defaulted loans with valid UPB and recovery values were included. Predictor variables included both origination and behavioral features such as interest rates, unpaid balances, credit scores, and debt ratios.

XGBoost minimizes an objective function composed of a loss term and a regularization term. The model’s final prediction is the sum of outputs from NNN regression trees:

where is the output of the tree and is its weight.

Each tree is fitted by computing gradients and Hessians from the loss function:

Optimal leaf weights are calculated as:

and predictions are updated using:

Hyperparameters such as *n\_estimators, max\_depth, learning\_rate*, and *subsample* were tuned via grid search. Model performance was evaluated using RMSE on a 20% test set.

SHAP values were used to interpret feature importance, identifying which variables contributed most to LGD. Finally, all predicted LGD values were floored at 10% to meet Basel regulatory requirements for secured exposures.

**2.6** **Expected Loss Simulation and Provisioning**

To estimate expected credit losses and calculate provisioning requirements, we applied the standard Basel formula:

Where PD is the predicted probability of default for each mortgage, LGD is the predicted loss given default from the XGBoost model, EAD is the current unpaid principal balance (*CURRENT ACTUAL UPB*).

The simulation incorporated uncertainty in the recovery rate. Specifically, we assumed the recovery rate follows a uniform distribution between 40% and 60%, consistent with industry haircuts on collateral values. For each loan, LGD was dynamically re-estimated in each iteration using:

where .

A **Monte Carlo simulation with 10,000 iterations** was conducted. In each iteration, the following steps were applied to the out-of-time sample: Sample a new recovery rate for each loan, recalculate LGD using the sampled recovery, compute expected loss using the PD and EAD from previous models, sum total portfolio-level expected loss across all loans.

The resulting distribution of simulated expected losses was used to evaluate central tendency (mean, median), dispersion (standard deviation), and sensitivity to varying recovery rates. This provided a robust estimate of the provisions required to cover potential credit losses under uncertainty.

1. **Results**

**3.1 Scorecard**

**3.2 PD**

To inform the modeling of default probabilities, five macroeconomic indicators were selected for their relevance to mortgage performance. **GDP** captures household spending capacity, with declines suggesting financial strain. **UR** reflects job market conditions; higher unemployment increases the risk of default due to income loss. **HPI** signal real estate market health, where slowdowns may indicate declining property values and rising credit risk. **CPI** measures inflation, which can erode borrowers’ purchasing power and debt affordability. Lastly, **Credits** reflect credit availability; reductions may correspond with tightening financial conditions and higher borrower risk. Together, these variables offer a well-rounded economic view to support macro-driven PD estimation across U.S. states.

**3.3 LGD**

The XGBoost model for LGD was trained on defaulted mortgage observations using a regression objective. After grid search optimization, the best model was selected with a learning rate of 0.25 and a maximum depth of 2. This configuration achieved strong in-sample and out-of-sample performance, with a Mean Squared Error (MSE) of 0.0149 on the training set and 0.0399 on the test set. The relatively low test MSE indicates that the model generalizes well without significant overfitting.

Feature importance analysis revealed that the most influential predictors for loss severity were factors reflecting final settlement amounts, loan duration, borrower credit quality, accumulated unpaid charges, and original loan size (Figure 1). These drivers align with expectations in credit risk modeling, as older loans and those with higher original amounts tend to display more variability in recovery outcomes. Loans showing higher levels of accrued obligations before closure tended to be associated with more severe losses, while borrowers with stronger credit backgrounds were linked to lower estimated loss rates.

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Figure 1: Feature Importance

SHAP (SHapley Additive exPlanations) analysis further confirmed these results by quantifying each feature’s marginal impact on the LGD prediction. A closer look at the SHAP summary plot (Figure 2) revealed how these features influenced the output across different observations. For example, higher accumulated unpaid charges consistently pushed the predicted loss upward, as reflected by uniformly negative SHAP values for those with elevated balances. These effects were more pronounced when associated with specific loan purposes, suggesting that the context of the default (e.g., purchase vs refinance) may amplify the expected loss severity. Likewise, the magnitude of the final payout on a closed loan was shown to drive predicted losses upward, especially for large exposures. SHAP value dispersion in this feature highlighted a strong separation between loans that resulted in higher recoveries versus those with more substantial shortfalls.

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Figure 2: SHAP Value Plot

The SHAP value analysis identified five key drivers of loss severity (in Appendix A): the balance removed at loan closure, accrued unpaid interest, borrower debt burden at origination, loan closure outcome category, and original loan amount. Loans with higher cleared balances and unpaid interest consistently showed greater predicted losses, reflecting distressed exits and prolonged delinquency. Borrowers with high initial financial strain were also associated with elevated loss severity, aligning with economic expectations of overextension risk. Loans closed through liquidation channels contributed negatively to recovery, particularly in certain regions, due to higher costs and lower collateral realization. Finally, larger original loans had greater SHAP impact, indicating increased exposure and recovery uncertainty, especially when tied to alternative valuation methods. Together, these features reflect the combined effects of borrower capacity, loan structure, and recovery environment on realized credit losses.

The trained loss severity model was applied to the out-of-time portfolio by predicting the expected loss given default for each active mortgage record. As shown in the results in Appendix B, the model output included a range of estimated loss values. To align with Basel III regulatory guidelines, all predicted values below the regulatory minimum of 10% were adjusted upward to meet the minimum floor. This step ensures that the model adheres to capital adequacy requirements for secured retail exposures, which stipulate a minimum loss estimate regardless of statistical prediction. After adjustment, the final set of loss estimates for the out-of-time sample ranged from 0.1 to approximately 0.75, reflecting a conservative view on recoveries in the event of default. This approach guarantees that all provision calculations are compliant with prudential standards and supports a risk-averse stance in capital allocation.

**3.4 Expected Loss Simulation and Provisioning**

To evaluate the capital required to cover future losses, a simulation-based framework was implemented. The simulation produced a distribution of portfolio-level provisions. As shown in Figure 3, the average provision required to cover expected losses was approximately 5.07, with a median of the same value. The results showed minimal skewness, with the 25th percentile at 5.00 and the 75th percentile at 5.15. The dispersion of the distribution was relatively narrow, as indicated by a standard deviation of only 0.11, suggesting stable estimates under moderate uncertainty.

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Figure 3 Distribution of Portfolio Provisions

Further, a sensitivity analysis was conducted to examine how the total required provisions change under fixed assumptions about recovery rates. When a lower recovery assumption was used (equivalent to a 40% haircut), the total expected loss increased to approximately 6.09. In contrast, assuming higher recoveries (60% haircut) reduced the expected losses to 4.06. This difference of roughly 2.03 highlights the significant effect recovery assumptions have on provision calculations. Extending this analysis across a broader range of recovery rates in Figure 4, provisions ranged from just above 3 to slightly over 7, with a relative change of more than 130%. This finding underscores the importance of robust recovery modeling in the context of capital adequacy planning.

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Figure 4: Sensitivity Analysis

The simulation framework provided not only a central estimate of provisions but also captured the full distribution of potential losses. This enables more risk-sensitive planning and allows financial institutions to anticipate the capital required under both expected and adverse scenarios, supporting prudent and forward-looking risk management practices.

Appendix A Top Five Key Features in SHAP Plot

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Appendix B: Estimated Loss Values

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