A Collaborative Approach to Customer Risk Assessment

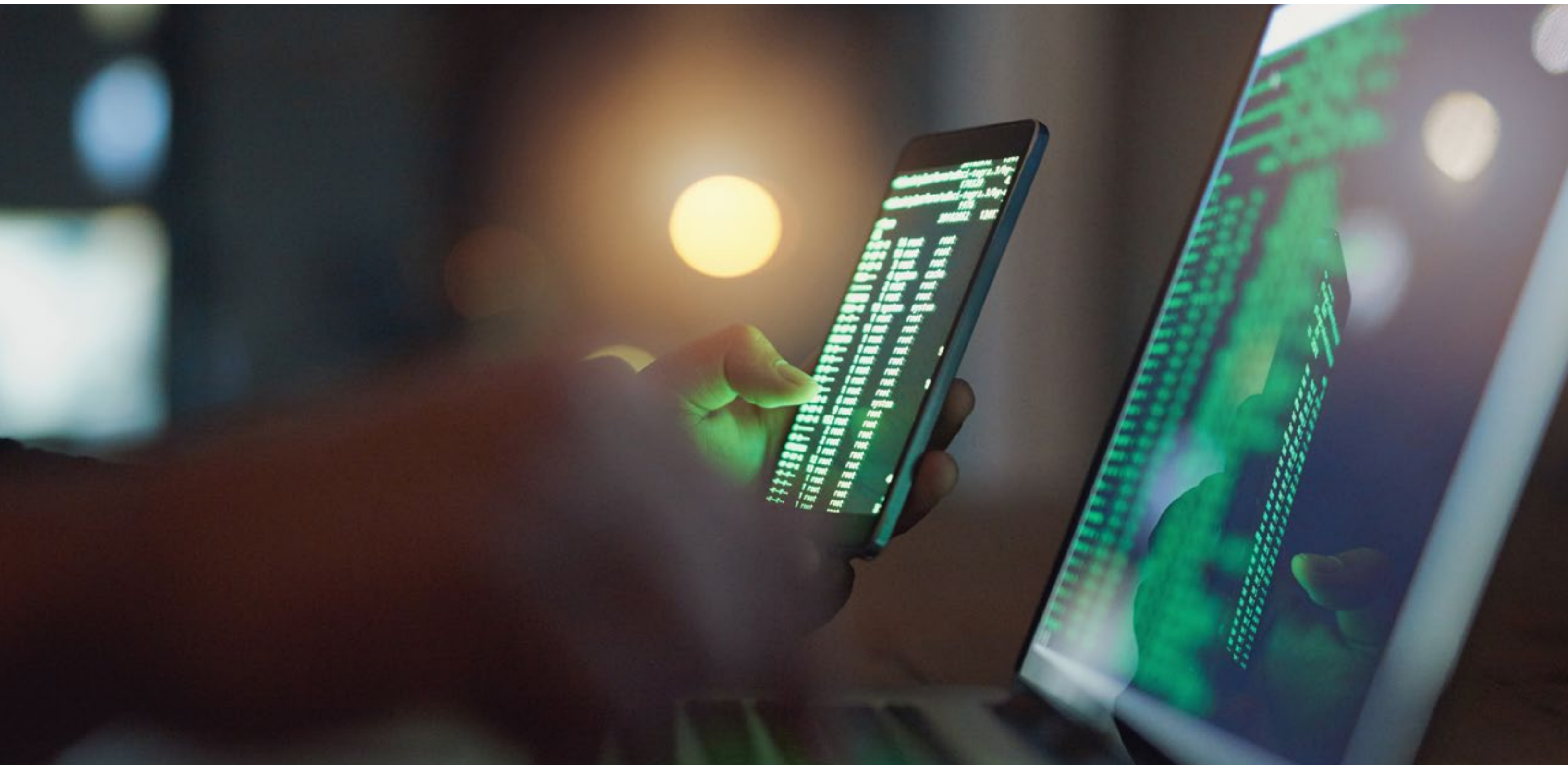
AUTHORS:

Richard Hills
K2 Integrity

Ajit Tharaken
Consilient

Executive Summary

Traditional customer risk rating (CRR) methodologies in financial institutions rely heavily on subjective judgments and static KYC data, leading to inconsistencies, bias, and regulatory challenges. This paper explores a paradigm shift toward objective, data-driven CRR by adopting machine learning models offering greater transparency, consistency, and regulatory alignment. It further examines how federated machine learning enables secure, privacy-preserving collaboration across financial institutions, enhancing model accuracy without compromising sensitive data. Combining behavioral analytics with decentralized intelligence addresses longstanding weaknesses in CRR and sets the foundation for a scalable, future-proof risk management framework.



Introduction

This paper explores how machine learning models can address the significant challenges of Customer Risk Rating by providing objective, data-driven risk assessments, improving regulatory compliance and overall risk oversight.

Regulators have expressed growing concern over the inconsistent and subjective methods used by financial institutions (FIs) to assign Customer Risk Ratings (CRRs) an essential component of the Risk-Based Approach (RBA) to AML/CFT. When flawed, these can lead to compliance failures, misclassifications of risk, and regulatory breaches.

CRR is critical for identifying potential risks from customers, such as money laundering and fraud. When implemented effectively, it allows institutions to apply appropriate mitigation measures and uphold regulatory standards. Accurate CRRs enhance efficiency by directing resources to higher-risk customers, streamlining operations, reducing false positives, and allowing compliance teams to focus on real threats.

However, traditional CRR methodologies rely on expert human judgment and static KYC inputs, making them vulnerable to bias and inconsistency. Regulatory examples—from the FCA's critique of oversimplified risk models in 2021 to FinCEN's 2023 enforcement actions—highlight the consequences of these outdated approaches. A transformation is needed to bring objectivity, clarity, and objectivity to risk assessments.

Limitations of Traditional Risk Rating Methods

The main challenge with legacy CRR models lies in their reliance on subjective weightings and qualitative assessments. These may differ across analysts or committees and often lack standardized criteria. Heuristics, informal feedback, and personal intuition introduce variability that undermines the credibility and auditability of risk assessments. Moreover, traditional models fail to incorporate customer behavior or dynamic data patterns, leading to potentially inaccurate ratings.

Without transparency in methodology, institutions struggle to justify CRRs to regulators and internal stakeholders. A lack of industry collaboration further compounds the problem, as banks often operate in silos, missing opportunities to standardize and improve practices. This fragmented landscape creates inconsistent risk evaluations, increased compliance costs, and poor customer experiences.

Modernizing CRR Through Machine Learning

Machine learning (ML) models address many of the weaknesses of traditional CRR. They apply behavioral analysis to large datasets, ensuring decisions are grounded in data rather than opinion. Once trained, ML models assess all customers using consistent parameters, minimizing variation and ensuring fair, reproducible results.

- **Empirical Risk Assessment:** Machine learning models analyse vast amounts of transactional, geographic, and behavioural data to identify subtle patterns that may indicate potential financial crime. Unlike traditional approaches that rely on static or surface-level information, these models detect anomalies and trends over time, enabling more accurate, evidence-based customer risk assessments. This data-driven approach enhances the detection of emerging risks and reduces reliance on manual assumptions.
- **Consistency:** By applying algorithmic machine learning models across all customer profiles, machine learning ensures that each risk assessment follows the same objective criteria. This eliminates the variability and subjectivity that often come with human judgment, especially when multiple analysts interpret risk differently. As a result, institutions gain uniformity in how customers are rated, supporting fairer treatment and more dependable compliance practices.
- **Bias Reduction:** With appropriate model governance and design, machine learning systems can be configured to ignore irrelevant or potentially discriminatory inputs—such as race, gender, or physical

appearance. Instead, they focus exclusively on data directly correlating with financial risk, such as kyc data, transaction behaviour or network connections. This reduces the chance of unconscious human bias influencing risk scores and helps institutions uphold ethical standards and regulatory fairness.

- **Transparency:** Modern machine learning systems can generate detailed, auditable documentation that outlines how each customer risk rating was derived. This includes the data sources, decision paths, and key influencing variables. Such transparency is critical for regulatory compliance, allowing institutions to explain and justify their risk assessments clearly to auditors and supervisors and demonstrate their models' integrity.

Federated Learning: A New Era of Secure Collaboration

A significant innovation in advancing CRR accuracy lies in federated machine learning (FML).

Federated Machine Learning (FML) offers a secure and scalable way for financial institutions to collaborate without sharing sensitive customer data. By exchanging only model updates—not confidential raw data - FML enables the creation of a collective, high-performing "champion model" that draws on the strength of diverse datasets across institutions and jurisdictions. This approach preserves data privacy, enhances regulatory compliance, and delivers more accurate, consistent, and objective customer risk ratings—positioning institutions for more intelligent, more resilient risk management.

The Strategic Advantages of Federated Machine Learning:

- **Model Accuracy:** Diverse data inputs across institutions and jurisdictions improve model robustness and generalization.
- **Continuous Improvement and Scalability:** The system can continuously evolve as more institutions join and contribute.
- **Privacy Preservation:** KYC and Transaction data remains local and is not shared with anyone, meeting privacy and regulatory requirements.

FML also reduces duplication of effort by allowing collective intelligence to distinguish benign behavior from genuine threats.

However, to fully realize its potential, clear regulatory governance must guide FML adoption. Key considerations include model interpretability, fairness, cybersecurity, and alignment with existing compliance frameworks.

Regulatory Benefits and Industry Impact

Machine learning-driven Customer Risk Rating (CRR) represents a significant advancement in meeting—and exceeding—regulatory expectations in the financial sector. Traditional, judgment-based approaches to CRR often lack transparency, consistency, and auditability, making it difficult for institutions to justify their risk assessments and leaving them vulnerable to compliance breaches. In contrast, machine learning models introduce a structured, data-driven framework that aligns with core regulatory priorities around fairness, accountability, and governance.

By eliminating subjectivity and replacing manual heuristics with statistically grounded decision-making, machine learning enables institutions to demonstrate that their risk ratings are consistent and based on clearly defined, explainable criteria. This shift enhances credibility with regulators and improves internal governance processes across compliance teams.

Regulators are increasingly emphasizing:

- **Transparent, empirical processes:** Supervisory bodies expect financial institutions to explain how customer risk ratings are derived, including the rationale behind model inputs and outputs. Machine learning systems, when properly documented, offer detailed audit trails that clearly show how decisions are made, satisfying growing demands for model interpretability.
- **Reduction of bias and inconsistency:** Fairness and non-discrimination are critical to regulatory oversight. When built and governed responsibly, ML models can exclude irrelevant or potentially biased variables, such as race, gender, or physical characteristics, ensuring that assessments are focused solely on risk-relevant indicators.
- **Improved explainability and audit readiness:** As regulators adopt more stringent expectations around AI governance, institutions must be able to justify their model logic, outcomes, and controls. ML models - primarily when supported by federated learning—enhance audit readiness by providing detailed, replicable assessments and version-controlled documentation.

Beyond compliance, these capabilities elevate industry standards. Widespread adoption of machine learning and federated approaches can foster greater collaboration in CRR practices across institutions, reduce regulatory fragmentation, and contribute to a more resilient and trusted financial ecosystem. As financial crime risks become more sophisticated and data volumes increase, these technologies offer a scalable path forward that balances innovation with regulatory integrity.

Federated machine learning driven CRR offers significant advantages in aligning with regulatory expectations. By eliminating subjectivity and documenting clear methodologies, institutions can demonstrate their risk assessments are consistent, explainable, and fair.

Conclusion

Legacy Customer Risk Rating (CRR) methodologies—rooted in human judgment and static KYC data—present growing limitations in today's evolving financial and regulatory environment. These approaches often lack transparency, consistency, and auditability, increasing the risk of misclassification, inefficiencies, and regulatory scrutiny. Machine learning offers a transformative shift, delivering objective, data-driven risk assessments that improve accuracy, reduce bias, and streamline compliance operations.

Building on this foundation, federated learning enables financial institutions to collaborate securely while preserving customer privacy and fully complying with data protection regulations. Drawing on diverse, decentralized datasets enhances model performance and supports real-time, adaptive risk scoring.

Importantly, these innovations align closely with emerging regulatory expectations for fairness, explainability, and accountability in automated decision-making. Regulators increasingly favour models that are transparent, well-governed, and grounded in empirical evidence. Machine learning - mainly when applied through a federated architecture - positions institutions to meet these expectations, reduce compliance risk, and proactively respond to regulatory developments.

As the adoption of these technologies accelerates, the industry can redefine customer risk rating through a standardized, collaborative, and intelligence-driven lens—improving resilience, operational efficiency, and trust across the financial system.