International Journal of Advanced Engineering Research and Science (IJAERS)
Peer-Reviewed Journal
ISSN: 2349-6495(P) | 2456-1908(O)
Vol-11, Issue-12; Dec, 2024
Journal Home Page Available: https://ijaers.com/
Article DOI: https://dx.doi.org/10.22161/ijaers.1112.13

Credit Rating Model Based on Deep Learning

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Received: 27 Nov 2024,
Receive in revised form: 21 Dec 2024,
Accepted: 25 Dec 2024,
Available online: 31 Dec 2024

***Keywords*— Credit Rating, Credit Risk, Gated Recurrent Units, Principal Component Analysis, Small and Medium Enterprises, Farmer Loans**

***Abstract*— Credit ratings are essential for distinguishing borrowers' risk profiles and guiding lending decisions, yet mismatches between ratings and default risks persist, particularly for high-rated borrowers. This study proposes a Gated Recurrent Unit (GRU) model to address this by modeling sequential credit metrics for accurate rating assignments. Using data from 2,157 small and medium enterprise (SME) loans and 2,044 farmer loans (2018–2022), the GRU processes time-series indicators like payment history and debt ratios to classify borrowers into five rating tiers (AAA to B). Principal component analysis (PCA) reduces input dimensionality, enhancing efficiency. The model achieves 86.7% accuracy, outperforming support vector machines (80.4%) and logistic regression (78.9%). It effectively aligns ratings with credit risk, reducing misclassifications in high-rating tiers. Applications include improved bank risk management and policy support for inclusive finance. Limitations involve data granularity and computational costs. This approach offers a dynamic framework for credit rating, advancing financial risk evaluation in China's lending markets.*

I. INTRODUCTION

1.1 Research Background and Significance

Credit ratings shape lending decisions by quantifying borrowers' ability to repay, a critical function in China's financial system, where small and medium enterprises (SMEs) and farmers face persistent financing hurdles[1]. SMEs contribute over 50% of China's GDP, yet their default rates spiked during the 2020–2021 economic recovery, exposing flaws in traditional rating systems[2]. High-rated borrowers (e.g., AAA, AA) occasionally default, signaling a mismatch between ratings and actual risk. This undermines banks' loan portfolios and restricts credit access for underserved groups, like rural farmers, who rely on microfinance[3-5]. China's inclusive finance policies, emphasized in the 14th Five-Year Plan, demand precise risk models to balance growth and stability.

Static rating methods, reliant on snapshot metrics like credit scores, fail to capture evolving risk patterns, such as payment delays or debt surges[6]. Sequential models, leveraging time-series data, offer a solution by tracking borrower behavior over time[7]. This study employs Gated Recurrent Units (GRUs), a neural network tailored for sequences, to predict credit ratings dynamically[8-10]. By modeling metrics like quarterly cash flows, the approach aims to align ratings with creditworthiness, benefiting banks and policymakers. For SMEs and farmers, accurate ratings could unlock fairer credit access, supporting China's dual-circulation economy.

1.2 Literature Review

Credit rating research spans three domains. First, statistical models, like logistic regression, use financial ratios (e.g., debt-to-income) to estimate default probability[11]. These are simple but struggle with non-linear patterns. Second, machine learning methods, such as support vector machines (SVMs) and Random Forests, handle complex features but treat data cross-sectionally, missing temporal trends[12]. Third, deep learning, including recurrent neural networks (RNNs) and GRUs, excels in sequential modeling, applied in stock forecasting but less in credit rating due to data constraints.

Recent studies highlight gaps. Bolton et al. (2012) noted rating inflation in corporate bonds, skewing risk perceptions. Goldstein and Huang (2020) linked inflated ratings to overinvestment, a concern for SMEs[13]. Shi et al. (2019) used LGD to assess microfinance, finding static models misaligned with defaults. Chen et al. (2020) explored social media data for ratings, but scalability remains limited. Le et al. (2021) applied sequence clustering to credit risk, suggesting temporal models' potential[14-17]. However, GRU applications in SME and farmer loan ratings are scarce, despite their fit for time-series like payment records[18].

This study bridges these gaps by using GRUs to model sequential credit metrics, integrating PCA for feature efficiency. Unlike static min-max or tree-based methods, GRUs capture dynamic risk shifts, offering precision in China's volatile SME and rural credit markets.

II. METHODOLOGY

2.1 GRU Model Framework

Gated Recurrent Units (GRUs) are recurrent neural networks designed for sequential data, balancing memory retention and computational efficiency[19]. For credit rating, GRUs process time-series metrics (e.g., quarterly debt ratios) to predict rating tiers, capturing patterns like deteriorating cash flows that static models miss.

2.1.1 GRU Architecture

The model is structured as follows:

- **Input Layer**: Sequences of T=8 quarters, each with m PCA-derived features (e.g., liquidity, solvency). Eight quarters balance historical depth with model stability.
- **GRU Layers**: Two layers, each with 64 units:
  - **Update Gate**:
    $$z_t = \sigma(W_z * [h_{t-1}, x_t] + b_z)$$
  - **Reset Gate**:
    $$r_t = \sigma(W_r * [h_{t-1}, x_t] + b_r)$$
  - **Candidate Hidden State**:
    $$\widehat{h_t} = tanh(W_h * [r_t * h_{t-1}, x_t] + b_h)$$
  - **Hidden State Update**:
    $$h_t = (1 - z_t) * h_{t-1} + z_t * \widehat{h_t}$$
- **Dense Layer**: Outputs probabilities for $k=5$ rating tiers (AAA, AA, A, BBB, B):
  $$\mathrm{p}(\mathrm{y_t}) = \mathrm{softmax}(\mathrm{W_d} * \mathrm{h_t} + \mathrm{b_d})$$
- **Regularization**: Dropout (rate 0.25) mitigates overfitting, vital for noisy SME data.

GRUs were chosen over LSTMs for lower computational cost, as SME and farmer datasets (~4,000 loans) are moderate[20-21]. The dual-layer design captures both short-term fluctuations (e.g., missed payments) and long-term trends (e.g., debt growth).

2.1.2 Loss Function

The model minimizes categorical cross-entropy:

$$\mathrm{L} = -\frac{1}{\mathrm{N}}\sum_{\mathrm{i}=1}^{\mathrm{N}}\sum_{\mathrm{j}=1}^{\mathrm{k}} \mathrm{y_{ij}}\log(\widehat{y_{ij}})$$

where N is the sample size, $\mathrm{y_{ij}}$ is the true label, and $\widehat{y_{ij}}$ is the predicted probability. Training uses Adam optimizer (learning rate 0.001) for fast convergence, with early stopping after 12 stagnant epochs[22]. This handles imbalanced ratings (e.g., ~10% AAA, ~30% B).

2.2 Model Validation

A synthetic dataset of 500 borrowers, with metrics like revenue and defaults over 10 quarters, tested GRU performance, yielding 88.2% accuracy vs. 82.6% for SVM. A public credit dataset (simplified for SMEs) gave 87.4% accuracy, confirming robustness[23]. Sensitivity tests varied sequence lengths (T=6, 10), with T=8 optimal (86.7% accuracy, ~20-minute training on a GPU). Dropout rates (0.2–0.4) were tuned to prevent overfitting[24]. These validations ensure the GRU's reliability for real loan data, addressing noise and class skew.

III. EMPIRICAL ANALYSIS

3.1 Data Sources

The study uses data from a major Chinese state-owned bank, covering 2,157 SME loans and 2,044 farmer loans

(2018–2022) across 29 provinces[25]. Metrics include quarterly payment history, debt-to-asset ratio, cash flow, revenue, and credit scores (derived via logistic regression by Shi et al., 2019). The period captures China's post-2020 recovery, reflecting SME and farmer resilience[26]. Missing values (<5%) were imputed using median substitution, and outliers were capped at 3 standard deviations to preserve sequential trends.

3.2 Indicator Selection

Fifteen initial indicators were selected: net profit margin, ROA, current ratio, debt-to-asset, interest coverage, cash flow, revenue growth, payment delays, loan size, repayment rate, credit score, employee count, years in business, market share, and collateral value[27-28]. PCA reduced these to six components (explaining 82.3% variance):

1. **Profitability**: Net margin, ROA, cash flow.
2. **Liquidity**: Current ratio, repayment rate.
3. **Solvency**: Debt-to-asset, interest coverage.
4. **Growth**: Revenue growth, market share.
5. **Stability**: Employee count, years in business.
6. **Credit History**: Payment delays, credit score.

KMO (0.72) and Bartlett's test ($p<0.01$) confirmed PCA suitability. These components streamline GRU inputs, reducing noise.

3.3 Data Processing

Indicators were normalized:

$$x'_{id} = \frac{x_{id} - \mu_d}{\sigma_d}$$

forming sequences of T=8 quarters. Labels (AAA to B) were based on default records and score thresholds. The dataset split was 80% training, 20% testing, with 20% of training for validation[29]. Sequences were padded for consistency, and class weights addressed imbalance (e.g., fewer AAA cases).

3.4 Empirical Results

The GRU was trained with:

- Epochs: 80, batch size 32.
- Optimizer: Adam, learning rate 0.001.
- Dropout: 0.25.

Results as below:

Table 1 results of model

Metric	Details
Accuracy	Overall: 86.7% (SMEs: 87.1%, Farmers: 86.2%) Comparisons: SVM (80.4%), Logistic Regression (78.9%)
Precision	AAA: 89%, AA: 87%, A: 85%, BBB: 84%, B: 81% (limited by sparse B-rated cases)
F1-Score	AAA: 0.88, AA: 0.86, A: 0.84, BBB: 0.83, B: 0.80
Loss	Converged to 0.27 by epoch 65

The GRU excelled at detecting sequential risks, e.g., payment delays preceding defaults, unlike static benchmarks missing gradual shifts. For SMEs, it identified high-risk BBB firms with rising debt; for farmers, it flagged seasonal repayment issues. Robustness tests with 15% noise reduced accuracy to 83.9%, underscoring data quality needs. The model's distribution of ratings (e.g., 25% A, 30% BBB) approximates a bell curve, aligning with credit market norms.

IV. CONCLUSIONS

The GRU model accurately assigns credit ratings, achieving 86.7% accuracy by modeling sequential credit metrics. PCA ensures efficient inputs, while GRUs capture dynamic risk patterns, outperforming static methods. For banks, it reduces misclassifications, especially for high-rated borrowers, enhancing loan decisions. For policymakers, it supports inclusive finance by identifying creditworthy SMEs and farmers. Limitations include data availability and GPU demands. Future work could integrate macroeconomic indicators or explore LSTM variants. This approach refines credit risk evaluation, supporting China's financial stability goals.

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