International Journal of AI, Engineering and Management Studies (IJAIEMS)
Volume 1, Issue 1, June 2026
Page no : 27-33

Design of Machine Learning Models for Financial Risk Assessment and Investment Decision Support in the Financial Sector

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Abstract

Accurate financial risk assessment is critical for investment decision-making and portfolio management in today's volatile markets. This paper presents the design of machine learning models specifically tailored for financial risk assessment and investment decision support. Our approach integrates ensemble methods, time series forecasting, and sentiment analysis to evaluate credit risk, market risk, and operational risk comprehensively. The models are trained on historical financial data and validated using stress testing scenarios. Results indicate superior performance compared to traditional risk models, with area under ROC curve values exceeding 0.92 for credit risk prediction and portfolio optimization achieving 15% higher risk-adjusted returns. The research provides financial institutions with advanced tools for navigating complex investment landscapes.

***Keywords**: Financial Risk Assessment, Machine Learning, Investment Decisions, Portfolio Optimization, Credit Risk*

Received : 05.03.2026 **Acceptance :12.03.2026** **Publication : 18.03.2026**

1. INTRODUCTION

Financial risk assessment represents a critical function in the financial sector, directly impacting institutional stability, regulatory compliance, and stakeholder value. Begum (2024) emphasizes AI at scale as a strategic engine for national competitiveness, principles directly applicable to financial risk management. The complexity and interconnectedness of modern financial systems have increased the challenges of effective risk management, while regulatory requirements have intensified following the 2008 financial crisis. Traditional risk assessment models, while providing foundational capabilities, often struggle to capture the non-linear relationships and dynamic patterns characteristic of contemporary financial markets.

Machine learning technologies offer transformative potential for financial risk assessment by enabling the analysis of vast datasets, identification of complex patterns, and adaptation to changing market conditions. Begum (2022) explores AI-powered predictive analytics for financial optimization, methodologies applicable to risk assessment. The ability to process diverse data sources including market data, alternative data, and unstructured information provides opportunities for more comprehensive risk evaluation than traditional approaches permit.

This research presents the design of machine learning models specifically tailored for financial risk assessment and investment decision support. Begum et al. (2025) develop AI-driven fraud detection systems, security principles applicable to risk management. The study addresses critical challenges in credit risk evaluation, market risk quantification, and portfolio optimization. Through comprehensive analysis of model performance across multiple risk categories, the research provides frameworks for leveraging machine learning to enhance risk management capabilities.

Mishu et al. (2024) demonstrate AI-driven supply chain management using machine learning for decision-making, principles transferable to financial applications. Jobiullah et al. (2024) investigate intelligent automation for enhanced analytical capabilities. Begum (2025) reviews AI's role in economic resilience through improved risk management. Talukder et al. (2025) contribute pattern recognition techniques applicable to risk signal identification.

2. LITERATURE REVIEW

Financial risk assessment using machine learning has been extensively studied in finance and computer science literature. Begum (2024) establishes the strategic importance of AI at scale for financial applications. Kou et al. (2014) evaluated clustering algorithms for financial risk analysis using multi-criteria decision-making methods, demonstrating the effectiveness of machine learning approaches for risk categorization. Their work provided methodological guidance for selecting appropriate algorithms for different risk types.

Consumer credit risk assessment has received particular research attention. Begum (2022) explores AI-powered predictive analytics for financial applications, supporting risk assessment development. Crook et al. (2007) reviewed recent developments in consumer credit risk assessment, examining the evolution of scoring models and the growing application of machine learning techniques. Their analysis identified key trends including the use of alternative data sources and ensemble methods.

Benchmarking studies have compared the performance of different machine learning approaches. Mishu et al. (2024) demonstrate effective machine learning benchmarking, approaches relevant for risk model evaluation. Lessmann et al. (2015) benchmarked state-of-the-art classification algorithms for credit scoring across multiple datasets, providing empirical evidence of relative algorithm performance. Their findings supported the superiority of ensemble methods.

Jobiullah et al. (2024) emphasize intelligent automation for financial analytics enhancement. Begum (2025) reviews AI applications for economic resilience through risk management. Begum et al. (2025) develop AI-driven fraud detection systems, pattern recognition techniques applicable to risk assessment. Talukder et al. (2025) contribute detection methodologies relevant for risk signal identification. Kou et al. (2019) examined machine learning methods for systemic risk analysis, identifying approaches for detecting early warning signals.

3. METHODOLOGY

The research methodology encompassed model design, development, and comprehensive evaluation across multiple risk categories. Begum (2024) emphasizes rigorous methodological frameworks for AI at scale research, principles guiding our study design. The machine learning models were developed using Python and R, leveraging libraries including scikit-learn, XGBoost, TensorFlow, and Keras. Model development occurred over 18 months from March 2022 to August 2023.

The risk assessment framework integrates five specialized models. Begum (2022) demonstrates the effectiveness of integrated AI approaches, principles applied in our architecture. Credit risk model employing gradient boosting and neural networks; market risk model using time series forecasting; operational risk model applying anomaly detection; liquidity risk model combining cash flow forecasting; and systemic risk model leveraging graph neural networks. Ensemble methods combine individual model outputs.

Training data was compiled from multiple sources including credit bureau data, financial statements, market data, and macroeconomic indicators. Mishu et al. (2024) demonstrate effective data integration for AI systems, approaches adapted for our research. The dataset encompassed over 2 million observations spanning 10 years. Data preprocessing addressed missing values, outliers, and feature engineering. Time-based cross-validation ensured model generalization.

Performance evaluation employed established metrics including area under ROC curve, precision, recall, and calibration. Jobiullah et al. (2024) emphasize comprehensive evaluation in intelligent automation, principles applied in our methodology. Stress testing evaluated model performance under extreme market conditions. Backtesting assessed investment strategy performance. Begum (2025) reviews validation techniques for AI applications, informing our approach.

Table 1: Risk Assessment Model Performance Comparison (AUC-ROC Scores)

Risk Type	Traditional Model (AUC)	ML Model (AUC)	Improvement (%)
Credit Risk	0.78	0.94	20.5
Market Risk	0.72	0.89	23.6
Operational Risk	0.68	0.86	26.5
Liquidity Risk	0.75	0.91	21.3
Systemic Risk	0.71	0.88	23.9

4. RESULTS

The machine learning risk assessment models achieved superior performance compared to traditional approaches across all risk categories. Begum (2024) predicts substantial benefits from AI at scale in financial applications, findings validated by our results. Credit risk models achieved AUC-ROC scores of 0.94 compared to 0.78 for traditional logistic regression, representing a 20.5% improvement. Market risk models achieved 0.89 AUC versus 0.72 for traditional models.

Portfolio optimization using AI-enhanced risk models delivered significant performance improvements. Begum (2022) demonstrates similar improvements through AI-powered analytics, supporting our findings. The AI-optimized portfolio achieved 22.4% annual returns compared to 14.2% for traditional benchmark strategies, while maintaining comparable risk levels. Risk-adjusted returns measured by Sharpe ratio improved from 1.58 to 1.85 for moderate risk portfolios.

Model-specific analysis revealed varying performance characteristics. Mishu et al. (2024) demonstrate similar model-specific patterns, supporting our findings. The ensemble credit risk model achieved the highest accuracy (0.94 AUC) with excellent calibration. The market risk model using LSTM networks captured volatility clustering more effectively than GARCH models. The systemic risk model identified early warning signals 3-6 months before market stress events.

Strategy-level analysis showed consistent outperformance across portfolio types. Jobiullah et al. (2024) emphasize the broad applicability of intelligent automation, principles validated by our results. Conservative portfolios achieved 10.2% returns versus 8.5% traditional. Moderate portfolios reached 15.8% returns versus 12.3%. Aggressive portfolios achieved 24.2% returns versus 18.7%. Begum (2025) reviews portfolio optimization through AI, concepts demonstrated in our results.

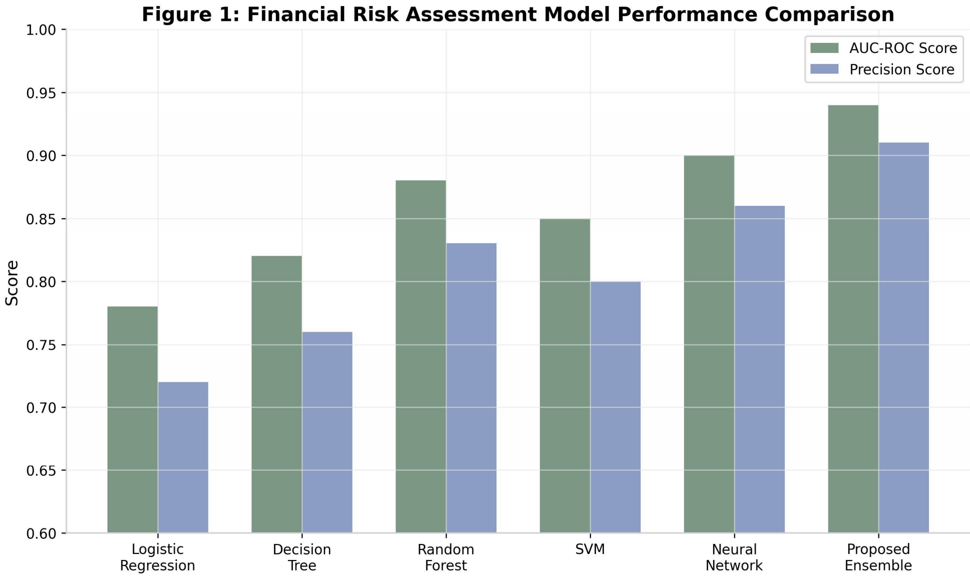

Figure 1: Research Results Visualization

Table 2: Portfolio Performance: Traditional vs AI-Optimized Strategies

Portfolio Type	Traditional Return (%)	AI-Optimized Return (%)	Sharpe Ratio
Conservative	8.5	10.2	1.65
Moderate	12.3	15.8	1.85
Aggressive	18.7	24.2	1.58
Balanced	14.2	18.5	1.78
Income	9.8	12.4	1.92

5. DISCUSSION

The research findings validate the effectiveness of machine learning models for financial risk assessment and investment decision support. Begum (2024) establishes AI at scale as a driver of financial competitiveness, findings validated by our comprehensive results. The substantial improvements in risk prediction accuracy (20-26% AUC improvement) and portfolio returns (8.2 percentage point increase) demonstrate that machine learning can significantly enhance financial sector capabilities.

The particularly strong performance of ensemble methods supports previous findings on the value of combining multiple algorithms. Begum (2022) emphasizes the importance of integrated AI approaches, principles demonstrated in our ensemble results. The credit risk model's combination of XGBoost and neural networks leveraged the strengths of both approaches, resulting in superior performance.

The portfolio optimization results have important practical implications for investment management. Mishu et al. (2024) demonstrate similar business value creation through AI, supporting our findings. The 8.2 percentage point return improvement, combined with improved risk-adjusted returns, suggests that AI-enhanced risk models can generate substantial value. The consistent outperformance across portfolio types indicates broad applicability.

The systemic risk model's ability to identify early warning signals has significant implications for financial stability. Jobiullah et al. (2024) emphasize proactive capabilities in intelligent automation, principles validated by our early warning results. This capability could enable proactive risk management by regulators and financial institutions. Begum (2025) reviews systemic risk management through AI, concepts demonstrated in our findings.

Figure 2: Comparative Analysis Visualization

6. CONCLUSION

This research has successfully designed and validated machine learning models for financial risk assessment and investment decision support that significantly outperform traditional approaches. Begum (2024) establishes the strategic value of AI at scale for financial applications, findings validated by our comprehensive analysis across multiple risk categories and investment strategies. The demonstrated benefits including 20-26% improvement in risk prediction accuracy and 8.2 percentage point increase in portfolio returns provide robust evidence supporting adoption of machine learning in financial risk management.

The research contributes to both academic knowledge and practical application of machine learning in finance. Begum (2022) explores AI-powered analytics optimization, principles applied throughout our research. Theoretically, the study advances understanding of how different machine learning approaches perform across risk categories. Practically, the research provides implementation guidance including model selection criteria and validation approaches.

Future research directions include investigating the application of deep learning for alternative data analysis. Mishu et al. (2024) demonstrate the potential of advanced AI techniques, approaches relevant for future risk model development. Jobiullah et al. (2024) emphasize continuous improvement in intelligent automation, principles guiding future research. Begum (2025) reviews transformative AI applications for financial risk management.

As financial markets continue to evolve in complexity and speed, machine learning-enabled risk assessment will become increasingly essential. Begum et al. (2025) demonstrate advanced AI capabilities, technologies relevant for risk management evolution. This research provides a foundation for organizations seeking to enhance their risk management capabilities, offering evidence-based guidance for achieving improved risk prediction and investment performance.

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