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The Evolution of Bank Regulatory Modeling: Integrating Artificial Intelligence with Traditional Statistical Frameworks

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Abstract

The integration of artificial intelligence and machine learning techniques into bank regulatory modeling represents a fundamental shift in how financial institutions approach risk assessment, stress testing, and capital planning. This article examines the evolving landscape where traditional statistical methods such as ordinary least squares regression, logistic regression, and time series models—long valued for their transparency and regulatory acceptance—are being enhanced and complemented by advanced AI techniques, including gradient boosting algorithms, neural networks, and ensemble methods. While machine learning approaches demonstrate superior predictive performance in capturing nonlinear relationships, interaction effects, and regime-dependent behavior that conventional models often miss, their adoption faces significant regulatory hurdles centered on interpretability, auditability, and model governance requirements. The article explores how financial institutions are navigating this tension through hybrid modeling architectures that strategically combine AI capabilities for feature engineering and pattern recognition with interpretable final-stage models that satisfy regulatory transparency demands. Explainable AI frameworks, particularly SHAP and LIME methodologies, are emerging as critical bridges between predictive accuracy and regulatory acceptability, enabling institutions to decompose complex model predictions into understandable feature contributions. The article documents empirical evidence from credit risk modeling, systemic crisis prediction, and stress testing applications, revealing that two-stage hybrid approaches and challenger model frameworks offer pragmatic pathways for integrating machine learning innovations while maintaining compliance with stringent supervisory standards imposed by regulatory authorities, including the Federal Reserve, European Central Bank, and Prudential Regulation Authority.

Keywords: Artificial Intelligence, Bank Regulatory Modeling, Hybrid Architectures, Explainable AI, Credit Risk Assessment

Introduction

The environment of bank regulatory reporting and stress testing has been thoroughly overhauled in the last few decades, spearheaded by more complicated financial markets, regulatory requirements, and technological development. Conventional statistical techniques such as Ordinary Least Squares (OLS) regression, logistic regression, and time series models have been the backbone for key regulatory activities like the Comprehensive Capital Analysis and Review (CCAR), Internal Ratings-Based (IRB) methods, and Interest Rate Risk in the Banking Book (IRRBB) evaluations. These traditional methods provide transparency, interpretability, and regulatory approval, attributes that are still of utmost importance within a setting where model governance and auditability are absolute necessities.

But the 2008 financial crisis and related market dysfunctions, such as the COVID-19 pandemic and unprecedented monetary policy actions, have underscored the shortfalls of conventional linear model methodologies. These shocks exposed that financial relations are frequently nonlinear, regime-dependent, and defined by intricate interactions difficult to model using static regression techniques. The inadequacies of conventional approaches became particularly evident during stress testing exercises

10.48047/jocaaa.2025.34.11.28

where banks struggled to accurately forecast portfolio losses under extreme scenarios. Research by Bhat et al. demonstrated that traditional regression-based models exhibited significant forecasting errors during periods of market dislocation, prompting the exploration of more sophisticated neural network architectures specifically designed for CCAR applications [1]. Their interpretable neural network model framework addresses the critical challenge of maintaining predictive accuracy while satisfying regulatory demands for model transparency, achieving substantial improvements in portfolio loss forecasting compared to standard econometric approaches without sacrificing the explainability that supervisory authorities require [1].

Concurrently, advances in artificial intelligence (AI) and machine learning (ML) have demonstrated remarkable capabilities in pattern recognition, nonlinear modeling, and handling high-dimensional data—capabilities that could significantly enhance predictive accuracy in credit risk, market risk, and pre-provision net revenue (PPNR) forecasting. The emergence of financial technology has fundamentally altered the competitive landscape, forcing traditional banks to reconsider their technological infrastructure and analytical methodologies. As documented in comprehensive analyses of fintech implications, the integration of machine learning techniques into banking operations extends beyond mere efficiency improvements to encompass transformative changes in risk assessment, customer analytics, and regulatory compliance frameworks [2]. Traditional banks face mounting pressure to adopt these technologies not only to maintain competitive parity with fintech startups but also to meet evolving regulatory expectations for more sophisticated risk modeling capabilities [2]. The digital transformation of financial services has created both opportunities and challenges, as institutions must balance the adoption of advanced AI techniques with the maintenance of robust governance frameworks and regulatory compliance standards that have historically relied on more transparent statistical methods [2].

This paper examines the emerging paradigm of hybrid modeling in bank regulatory frameworks, where AI-enhanced techniques complement rather than replace traditional statistical methods. It explore how institutions are navigating the tension between predictive performance and regulatory acceptability, developing architectures that leverage the strengths of both approaches while satisfying stringent governance requirements imposed by regulatory authorities, including the Federal Reserve, European Central Bank (ECB), and Prudential Regulation Authority (PRA).

Traditional Statistical Techniques in Regulatory Modeling

The foundation of contemporary bank regulatory modeling rests upon a well-established suite of statistical techniques, each selected for specific applications based on their methodological properties and interpretability. OLS regression remains the workhorse for PPNR projections, expected loss calculations, and net interest income (NII) forecasting due to its computational simplicity, closed-form solutions, and straightforward coefficient interpretation. When modeling binary outcomes such as borrower default, logistic and probit regression provide maximum likelihood estimation frameworks that yield probability estimates with clear decision boundaries. Empirical investigations into credit risk prediction have demonstrated the enduring relevance of traditional statistical approaches, where logistic regression models incorporating financial variables such as leverage ratios, profitability metrics, and liquidity indicators achieve classification accuracy rates between seventy and seventy-five percent in discriminating between defaulting and non-defaulting borrowers [3]. The study by Khemakhem and Boujelbene examining Tunisian banking data revealed that traditional regression-based approaches, when properly calibrated with relevant financial predictors including return on assets, debt-to-equity ratios, and working capital measures, provide robust baseline models that satisfy regulatory requirements for

10.48047/jocaaa.2025.34.11.28

interpretability while maintaining acceptable predictive performance across different economic environments [3]. These conventional methodologies benefit from decades of validation and regulatory acceptance, establishing them as the foundational layer upon which more sophisticated techniques can be built.

Time series methodologies, including Autoregressive Integrated Moving Average (ARIMA), Vector Autoregression (VAR), and Vector Error Correction Models (VECM), serve critical functions in linking macroeconomic variables to bank-specific outcomes and forecasting interest rate movements. These techniques explicitly model temporal dependencies and cointegration relationships, making them indispensable for projecting how macroeconomic stress scenarios translate into balance sheet impacts. Panel data regression extends these capabilities by incorporating both time-series and cross-sectional dimensions, enabling institutions to capture bank-specific or segment-specific heterogeneity in loan growth patterns and exposure at default (EAD) estimates.

For variable selection and multicollinearity management, regularization techniques such as LASSO, Ridge, and Elastic Net provide disciplined frameworks that prevent overfitting while maintaining model parsimony. Survival and hazard models address time-to-event phenomena inherent in default timing and prepayment behavior, while Monte Carlo simulation generates scenario distributions essential for IRRBB and market risk quantification. Principal Component Analysis (PCA) reduces dimensionality in yield curve modeling and compresses correlated macroeconomic variables, facilitating more stable parameter estimation. Comprehensive evaluations of early warning systems for banking crises have systematically compared traditional statistical models against emerging machine learning alternatives, revealing important insights about the strengths and limitations of conventional approaches. Beutel, List, and von Schweinitz conducted extensive analysis using historical crisis data spanning multiple decades and jurisdictions, finding that traditional logistic regression models incorporating macroeconomic indicators achieved area under the receiver operating characteristic curve values of approximately 0.80 when predicting systemic banking crises one to three years in advance [4]. Their research demonstrated that while regularization techniques improved model stability and reduced overfitting in out-of-sample testing, the fundamental challenge for traditional approaches remained their inability to capture nonlinear threshold effects and complex interaction terms without explicit specification by modelers [4]. These traditional techniques share common attributes: mathematical tractability, well-understood statistical properties, and crucially, the transparency that regulatory validation demands, though their performance limitations in capturing regime changes and tail risk events have motivated the exploration of hybrid approaches incorporating machine learning enhancements.

Model Type	Application	Accuracy/Performance Metric
Logistic Regression	Credit Risk (Default Prediction)	70-75%
Logistic Regression with Financial Variables	Credit Risk (Tunisian Banks)	70-75%
Logistic Regression with Macro Indicators	Systemic Banking Crisis Prediction (1-3 years)	AUC = 0.80
Regularized Logistic Regression	Early Warning Systems	Improved Stability (AUC ~0.80)

Table 1: Predictive Performance of Traditional Statistical Models in Regulatory Banking Applications [3, 4]

AI Enhancement of Classical Modeling Frameworks

10.48047/jocaaa.2025.34.11.28

Artificial intelligence and machine learning techniques offer transformative enhancements to traditional statistical models by addressing their fundamental limitations in capturing nonlinearity, interaction effects, and regime-dependent behavior. Gradient boosting algorithms, including XGBoost and LightGBM, along with neural networks, can approximate arbitrarily complex nonlinear relationships that linear regression cannot represent, potentially improving forecast accuracy in PPNR and credit risk models. Advanced research into gradient tree-boosted Tobit models has demonstrated the substantial advantages of machine learning approaches in credit default prediction, particularly when dealing with censored data structures inherent in loss given default estimation. Sigrist and Hirnschall developed the Grabit framework, which combines gradient boosting with Tobit regression to handle the dual challenges of nonlinearity and censored dependent variables, achieving predictive performance improvements of fifteen to twenty percent over conventional parametric approaches measured by mean squared error reduction [5]. Their empirical analysis using real-world mortgage default data revealed that gradient boosting trees captured complex interactions between loan-to-value ratios, borrower credit scores, and macroeconomic conditions that traditional linear models failed to identify, with out-of-sample prediction accuracy improving by approximately eighteen percent when measured by concordance statistics [5]. The Grabit methodology proved particularly effective in identifying high-risk segments within seemingly homogeneous borrower pools, detecting nonlinear threshold effects where default probability accelerated sharply once certain combinations of risk factors exceeded critical levels [5]. In probability of default (PD) estimation, deep neural networks and ensemble methods have demonstrated superior classification performance compared to logistic regression, particularly in capturing subtle patterns across high-dimensional feature spaces.

The advent of Long Short-Term Memory (LSTM) and Gated Recurrent Unit (GRU) networks has revolutionized time series forecasting by learning long-range temporal dependencies and adapting to structural breaks that confound traditional ARIMA and VAR models. These architectures have shown particular promise in modeling interest rate dynamics and behavioral assumptions under stress, where relationships between variables shift across different economic regimes. Similarly, transformer-based architectures, originally developed for natural language processing, are being adapted for multivariate time series prediction, offering attention mechanisms that dynamically weigh the relevance of historical observations. Comprehensive investigations into systemic financial crisis prediction have yielded compelling evidence for machine learning superiority in macroprudential surveillance applications. Oyewole examined artificial intelligence applications for predicting systemic financial crises in the United States context, employing an extensive macroprudential dataset spanning multiple economic cycles and incorporating over one hundred potential indicators, including credit aggregates, asset price dynamics, liquidity measures, and interconnectedness metrics [6]. The analysis demonstrated that ensemble machine learning methods, particularly random forests and gradient boosting machines, achieved classification accuracy rates exceeding eighty-eight percent in identifying crisis conditions six to twelve quarters in advance, substantially outperforming traditional logit models that achieved approximately seventy-five to seventy-eight percent accuracy over comparable forecasting horizons [6]. Critically, the research revealed that AI models automatically identified leading indicators that traditional econometric approaches had overlooked, including nonlinear interactions between household debt service ratios and housing price momentum, corporate leverage cycles coupled with market volatility measures, and banking sector interconnectedness metrics that exhibited threshold effects during periods of financial stress [6].

10.48047/jocaaa.2025.34.11.28

DeepSurv and neural Cox models generalize traditional proportional hazards models in survival analysis to model nonlinear hazard functions and interactions between complex covariates. Graph Neural Networks (GNNs) are a new frontier for panel data that address network effects and institutional connections that fixed-effects models cannot. Generative AI methods, such as Generative Adversarial Networks (GANs) and Variational Autoencoders (VAEs), allow for the artificial creation of realistic stress environments, opening up the scenario universe beyond the fixed set generally dictated by regulators. These AI advancements yield concrete advantages: enhanced predictive power from auto-management of nonlinearities and interaction, machine-learning-driven feature discovery without prior manual specification of hidden drivers, adaptive learning of regime changes, and unencumbered fusion of disparate data modalities.

AI Technology	Key Capability	Specific Achievement
Gradient Boosting Trees	Nonlinear interaction detection	Captured LTV-credit score-macro interactions
Grabit Framework	Threshold effect identification	Detected sharp default probability acceleration at critical risk combinations
Ensemble ML (Random Forest/GBM)	Leading indicator discovery	Identified 100+ overlooked indicators, including debt-housing price interactions
Machine Learning Models	Crisis prediction accuracy	88%+ accuracy 6-12 quarters ahead
AI Models (General)	Nonlinear threshold detection	Banking sector interconnectedness metrics during stress
LSTM/GRU Networks	Regime shift adaptation	Learns structural breaks that confound traditional models

Table 2: Advanced Capabilities of AI/ML Technologies in Financial Risk Assessment and Crisis Prediction [5, 6]

Regulatory Constraints and the Interpretability Challenge

Despite their technical superiority in predictive performance, AI models face substantial obstacles to widespread adoption in regulatory contexts due to fundamental tensions between model complexity and governance requirements. Regulatory frameworks, including the Federal Reserve's SR 11-7 guidance, the ECB's Targeted Review of Internal Models (TRIM), and similar supervisory standards, emphasize model explainability, stability, and auditability—characteristics that are often inversely related to model sophistication. Regulators require institutions to articulate clear causal relationships between input variables and model outputs, justify parameter estimates with economic intuition, and demonstrate model behavior under stress conditions. Black-box neural networks, despite their predictive prowess, often fail these interpretability standards. Empirical investigations into credit scoring model enhancement have revealed the persistent tension between predictive accuracy and regulatory acceptability that characterizes modern financial risk management. Research by Derbel and Ltifi examining support vector machine applications in credit scoring demonstrated that while SVM models achieved classification accuracy rates of approximately eighty-six to eighty-nine percent compared to seventy-eight to eighty-two percent for traditional logistic regression across multiple datasets, the implementation barriers extended far beyond technical performance metrics [7]. Their analysis revealed that financial institutions faced substantial challenges in explaining SVM decision boundaries to regulatory examiners, particularly when kernel

10.48047/jocaaa.2025.34.11.28

transformations mapped original feature spaces into high-dimensional representations that lacked intuitive economic interpretation [7]. The study documented that model validation processes for machine learning approaches required extensive sensitivity analyses to demonstrate stability, with institutions needing to test model performance across hundreds of hypothetical scenarios to satisfy regulatory concerns about generalizability beyond historical training conditions [7].

The overfitting risk inherent in flexible ML algorithms presents particular concerns in regulatory applications where training data may be limited, especially for rare events such as severe stress scenarios or tail risk outcomes. Models that excel in fitting historical patterns may lack the stability and generalizability required for forward-looking stress projections, potentially producing unreliable results under conditions not well-represented in the training data. This vulnerability is exacerbated by the fact that financial stress events are inherently low-frequency phenomena, providing sparse observations for model calibration. Comprehensive research into explainable artificial intelligence frameworks for financial risk management has provided critical insights into how institutions can bridge the gap between machine learning capability and regulatory transparency requirements. Bussmann, Giudici, Marinelli, and Papenbrock conducted a systematic analysis of explainability techniques applied to fintech risk models, finding that SHAP value implementations reduced the interpretability gap substantially, enabling financial institutions to decompose individual predictions into additive feature contributions that regulators could evaluate against economic theory and domain expertise [8]. Their empirical work demonstrated that explainable AI methods achieved model transparency scores of approximately seventy to seventy-five percent on established interpretability benchmarks compared to ninety to ninety-five percent for traditional linear models and only twenty to thirty percent for unaugmented neural networks [8]. Critically, the research revealed that institutions implementing LIME and SHAP frameworks alongside machine learning models experienced approval rates from regulatory model validation processes that improved from below forty percent to approximately sixty-five percent, though this still represented a significant barrier compared to near-universal acceptance of conventional statistical approaches [8]. The authors documented specific regulatory concerns that explainable AI partially addressed, including the ability to identify potential discriminatory patterns in algorithmic decisions, verify that model predictions aligned with established credit risk principles during stressed economic conditions, and provide customer-specific explanations required under fair lending and consumer protection regulations [8].

Model governance frameworks must address heightened validation complexity when incorporating AI techniques. Traditional validation approaches must be extended to encompass hyperparameter selection justification, architecture design rationale, and algorithmic bias detection. The computational intensity of many AI models creates practical challenges for model validation teams who must replicate results, conduct independent implementation reviews, and perform ongoing monitoring. Regulatory examination processes compound these challenges, as examiners trained in traditional econometric methods may lack the technical expertise to evaluate complex ML architectures, creating practical barriers to model approval even when institutions can demonstrate superior predictive performance.

Model Type	Primary Strength	Key Limitation	Regulatory Challenge	Interpretability Level
Support Vector Machines	High prediction accuracy	Kernel transformation complexity	Explaining decision boundaries	Low to Medium

10.48047/jocaaa.2025.34.11.28

Traditional Logistic Regression	Clear coefficient interpretation	Limited nonlinearity capture	Minimal challenges	High
Neural Networks (Unaugmented)	Complex pattern recognition	Black-box nature	Unable to articulate causal relationships	Very Low
ML with SHAP Framework	Improved accuracy with explanations	Still below traditional acceptance	Partial concern resolution	Medium to High
ML with LIME Framework	Local interpretability	Validation complexity remains	Requires extensive testing	Medium to High
Traditional Linear Models	Economic intuition alignment	Performance limitations	Near-universal acceptance	Very High

Table 3: Qualitative Comparison of Model Characteristics: Strengths, Limitations, and Regulatory Positioning [7, 8]

Hybrid Architectures and Explainable AI Solutions

The financial industry is converging toward hybrid modeling architectures that strategically combine AI capabilities with traditional statistical methods to balance predictive performance against regulatory acceptability. One prevalent approach employs machine learning for feature engineering and variable selection while retaining interpretable final-stage models such as logistic regression or OLS for generating predictions. This architecture allows institutions to leverage AI's superior pattern recognition for identifying relevant predictors and transforming raw data into informative features, while maintaining the transparency and coefficient interpretability that regulators demand in the final model specification. Advanced research into two-stage hybrid modeling frameworks has demonstrated the practical viability of combining neural network pattern recognition with traditional credit assessment methodologies. Vieira, Duarte, Ribeiro, and Duarte developed a sophisticated two-stage fuzzy neural approach for credit risk assessment using real-world data from a Brazilian credit card company, where the first stage employed self-organizing maps to cluster customers into homogeneous risk groups based on behavioral patterns, followed by fuzzy neural networks that generated credit scores for each identified segment [9]. Their empirical analysis across a dataset containing thousands of credit card accounts revealed that the hybrid architecture achieved classification accuracy of approximately eighty-nine percent in distinguishing defaulting from non-defaulting customers, representing a substantial improvement over the seventy-six percent accuracy achieved by standalone logistic regression models and the eighty-two percent accuracy of single-stage neural networks applied to the same dataset [9]. The two-stage approach proved particularly effective in identifying moderate-risk customers who exhibited complex behavioral patterns that traditional linear discriminant analysis failed to capture, with the fuzzy neural component reducing Type II errors by approximately twenty-three percent compared to conventional credit scoring methods [9]. Importantly, the research demonstrated that the staged architecture facilitated regulatory explanation by providing clear customer segmentation in the first stage that credit analysts could validate against business intuition, while the second-stage fuzzy rules offered transparent if-then logic that mapped observable customer behaviors to risk classifications [9].

10.48047/jocaaa.2025.34.11.28
Challenger model frameworks represent another hybrid strategy, where AI models serve as benchmarks against traditional approaches within model risk management processes. Rather than replacing existing regulatory models, ML alternatives provide independent validation perspectives, quantify potential model risk from using simplified specifications, and inform model improvement priorities. This approach mitigates regulatory resistance by preserving established models in production while building institutional capability and regulatory comfort with advanced techniques over time. Explainable AI (XAI) methodologies are rapidly maturing to address the black-box criticism of complex models. SHapley Additive exPlanations (SHAP) decompose individual predictions into feature-level contributions, providing local interpretability that can satisfy regulatory inquiries about specific forecast drivers. Comprehensive investigations into explainable machine learning for credit scoring have provided crucial evidence that transparency frameworks can reconcile predictive performance with regulatory acceptability. Bücker, Szepannek, Gosiewska, and Biecek conducted a systematic analysis of various XAI techniques applied to credit risk models, finding that SHAP values provided the most reliable and consistent feature attributions when evaluated against established credit risk principles and expert judgment [10]. Their empirical work examining multiple machine learning architectures demonstrated that gradient boosting models enhanced with SHAP explanations achieved prediction accuracy rates exceeding eighty-five percent while simultaneously enabling credit analysts to understand individual prediction drivers with confidence levels comparable to traditional scorecard methodologies [10]. The research revealed that LIME-generated local explanations exhibited greater variability and occasionally produced counterintuitive feature importance rankings that complicated regulatory validation, whereas SHAP's game-theoretic foundation ensured consistent and additive attribution properties that aligned more reliably with domain expertise [10]. Critically, the study documented that implementing comprehensive explainability frameworks increased model development and validation timelines by approximately thirty to forty percent but substantially improved stakeholder confidence and regulatory acceptance, with institutions reporting that transparent machine learning models achieved approval rates within fifteen to twenty percentage points of traditional statistical approaches compared to rejection rates exceeding sixty percent for unexplained black-box algorithms [10].

In scenario analysis and stress testing, hybrid approaches are particularly promising. Machine learning-based scenario generators can create richer, more diverse macroeconomic stress paths that capture nonlinear relationships and tail dependencies, while traditional econometric models continue to translate these scenarios into bank-specific impacts, leveraging AI's strength in multivariate distribution modeling while maintaining interpretable stress transmission mechanisms.

Model Approach	Primary Advantage	Key Innovation	Regulatory Positioning	Interpretability Method
Two-Stage Fuzzy Neural Hybrid	Superior pattern recognition	Self-organizing maps for segmentation	Facilitates regulatory explanation	Clear customer clustering with if-then rules
Standalone Logistic Regression	Direct coefficient interpretation	Traditional statistical foundation	High regulatory acceptance	Linear coefficients
Single-Stage Neural Networks	Nonlinear pattern capture	End-to-end learning	Limited regulatory acceptance	Opaque decision process

10.48047/jocaaa.2025.34.11.28

SHAP with Gradient Boosting	High accuracy with explanations	Game-theoretic feature attribution	Approaching traditional acceptance	Additive feature contributions
LIME Framework	Local model approximations	Instance-specific explanations	Moderate acceptance	Linear local approximations
Traditional Scorecard Methods	Economic intuition alignment	Established credit theory	Universal regulatory acceptance	Transparent scoring rules
Unexplained Black-Box ML	Maximum predictive power	Complex nonlinear learning	Poor regulatory acceptance	No interpretability mechanism
Challenger Model Framework	Independent validation	Benchmark without replacement	Gradual acceptance building	Comparative analysis

Table 4: Strategic Positioning of Hybrid and Explainable AI Architectures: Capabilities and Regulatory Compatibility [9, 10]

10.48047/jocaaa.2025.34.11.28

Conclusion

The evolution of bank regulatory modeling toward hybrid architectures integrating artificial intelligence with traditional statistical frameworks represents neither a wholesale replacement of established methodologies nor mere incremental enhancement, but rather a fundamental reconceptualization of how institutions balance predictive accuracy against governance imperatives and regulatory acceptability. The empirical evidence presented throughout this article demonstrates that machine learning techniques offer substantial performance improvements across credit risk assessment, systemic crisis prediction, and stress testing applications, yet their adoption remains constrained by legitimate regulatory concerns regarding interpretability, stability, and auditability that cannot be dismissed as mere institutional resistance to innovation. The consensus in the financial sector for approaching hybrid modeling is towards using AI's advantage in pattern recognition and nonlinear modeling in feature engineering and variable selection, but maintaining transparent, interpretable end-stage models that are amenable to check by regulators against economic theory and domain knowledge. Explainable AI techniques, especially SHAP-based feature attribution frameworks, have successfully bridged the interpretability gap to some extent, but significant hurdles must be crossed before machine learning models reach the same acceptance rates as conventional statistical models. The way ahead calls for ongoing development in several different directions: regulatory guidance needs to evolve to recognize AI's proper place in risk management but set definite validation criteria, model risk management functions need to acquire technical skills in machine learning testing, and financial institutions need to show responsible governance by way of thorough documentation and open model-building practices. As hybrid frameworks evolve and explainable AI techniques become increasingly advanced, the artificial distinction between conventional and AI modeling will cease to exist, creating integrated frameworks in which technique choice is a function of fitness for purpose as opposed to categorical choice, ultimately leading to financial systems that are at the same time safer, more efficient, and better equipped to manage the multifaceted uncertainties defining contemporary finance.

10.48047/jocaaa.2025.34.11.28

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