International Journal of Core Engineering & Management
Volume-7, Issue-06, 2023 ISSN No: 2348-9510

FEDERATED LEARNING FOR COLLABORATIVE FRAUD DETECTION ACROSS INSTITUTIONS

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Abstract

Fraudulent financial transactions are becoming increasingly complex and more sophisticated, and threatening organizations across the globe. Devoid of "coherent intelligence", conventional ML-based fraud detection systems (which are typically confined to individual institutional silos) are in no position to identify extended fraud patterns that cut across organisational landscapes; they are usually relatively impotent in this regard. However, multi-database information sharing is often legally prohibited due to privacy laws such as GDPR, HIPAA, and financial privacy acts. This work explores the potential of Federated Learning (FL) as a disruptive approach that enables joint fraud detection across multiple organizations without compromising sensitive and private data. By enabling institutions to jointly train models without sharing data and by exposing sensitive data to analysis, FL represents a game changer in secure and privacy-preserving machine learning and financial institutions in particular.

This paper presents a federated architecture for fraud detection that enables financial institutions, including banks, credit card networks, and fintech platforms, to co-train powerful models on distributed data. The framework can handle numerous practical issues such as non-independent and identically distributed (non-IID) data, model heterogeneity, communication bottlenecks, and adversarial robustness. We apply state-of-the-art techniques, such as federated meta-learning, secure multi-party computation, differential privacy, and model personalization, to construct an operational and secure FL-based fraud detection system. The model architecture combines LSTM networks for temporal transaction modeling, autoencoders for anomaly detection, and graph neural networks (GNNs) to learn relational transaction features.

We validate our system on both real-world and synthetic credit-card fraud datasets that mimic cross-institutional data splitting. Extensive experimental results demonstrate that our FL-based fraud detection achieves up to 20% improvements compared to the original in-house model in terms of F1-score and recall. At the same time, no raw data is shared among participants. Particularly, federated meta-learning leads to a significant gain in terms of data heterogeneity, which is often found in cross-bank collaborative setups in practice. Additionally, secure aggregation with cryptography and DP mechanisms complies with data protection laws and introduces negligible degradation in accuracy (~1.8%).

The proposed methodology also includes explainable AI (XAI) modules that produce local model explanations using SHAP (SHapley Additive exPlanations) and LIME (Local Interpretable Model-agnostic Explanations) to help build trust with stakeholders and satisfy compliance audit mandates. Moreover, by separating raw data from model updates—while

International Journal of Core Engineering & Management
Volume-7, Issue-06, 2023 ISSN No: 2348-9510

using privacy-preserving protocols—the architecture establishes a scalable foundation for more extensive institutional collaboration, meaning a model that could eventually support a national or even global fraud intelligence network.

This paper presents four main contributions: (1) the design of a FL framework specialized for multi-institution fraud detection; (2) the integration of PETs to the FL training setups; (3) the analysis of the performances of different FL models over realistic partitioned fraud datasets; (4) considerations regarding deployment form regulatory compliance, technical scalability and tangible readiness for production deployment. In this work, we demonstrate that FL is not only a theoretical improvement but also a viable solution to fraud in a distributed, privacy-sensitive setting.

The results of this work have significant implications for regulators, fraud analytics researchers, and enterprise architects in the financial industry. As federated technologies continue to mature, the ability to orchestrate collaborative intelligence without compromising data sovereignty will play a crucial role in the future fraud prevention infrastructure. This paper lays the groundwork for future work and advances by establishing a rigorous empirical baseline for federated learning in adversarial, high-stakes domains.

***Keywords—** Federated Learning, Collaborative Fraud Detection, Privacy-Preserving Machine Learning, Differential Privacy, Secure Multi-Party Computation, Graph Neural Networks, Explainable AI*

I. INTRODUCTION

Trending even wilder is financial fraud, led by extensive scale crackdowns on digitalization of financial services and increasingly sophisticated cyber threats. The global losses from credit card fraud reportedly surpassed $33 billion by the end of 2020, and the number is expected to grow larger as for-profit criminals turn to AI and cross-border laundering tactics. With an ever-growing number of intricate and data-driven solutions deployed in banks to investigate suspicious behavior, the value of systems that rely only on siloed data is quite limited. Conventional ML models for fraud detection are trained in different institutions and hence are unable to learn distributed fraud patterns that manifest across multiple parties. This segmentation leads to weak support in recognising joint frauds regarding institutional limits.

Collaborative detection methodologies have long been proposed as a solution to this limitation. However, sharing data directly among organizations raises significant concerns regarding privacy, regulations, competition, and trust on the customer side. Financial information is also subject to strict data protection laws, such as the General Data Protection Regulation (GDPR) and the California Consumer Privacy Act (CCPA), as well as country-specific banking secrecy laws. Indeed, they prohibit customer data from leaving institutional and geographical silos, which renders centralized data warehousing both infeasible and a legal liability. Therefore, there is an urgent need for a technical solution that enables academies to collaborate on model training without disclosing personal data.

Federated Learning (FL) is proposed as a promising solution to this issue. FL is a decentralized machine learning approach that enables clients (e.g., banks, insurance companies, fintech

platforms) to collaboratively train a global model without exposing their raw data to others. Instead, clients calculate local models using their private data and send only the parameters they have learned (e.g., gradients or weights) to a central server or coordinator, which aggregates the models to refine the global model. This method maintains data locality, minimizes the attack surface by following ke principles, and adheres to privacy-by-design principles. First introduced by Google for use in applications such as predictive text on smartphones, FL has matured into high-stakes domains, including healthcare, cybersecurity, and, to a growing extent, financial services.

In the case of fraud detection, federated learning presents a revolutionary opportunity to establish a shared intelligence network among institutions. However, its deployment in this field has its hurdles. The financial fraud datasets are also extremely imbalanced and non-IID, and institutions can have varying transaction behaviors and customer demographic data. In particular, FL in finance needs to tackle adversarial risks, such as model poisoning and inference attacks, which can be even more severe when trust among members is reduced. Furthermore, financial institutions have various computational capabilities, risk tolerances, and compliance requirements; a general and robust federated learning framework is needed.

We address this gap in this paper by investigating the practical implementation of federated learning for cross-institutional fraud detection. To address these challenges, we introduce a mosaic federated learning framework with several features (e.g., secure multi-party computation (MPC), differential privacy (DP), and model personalization). Our proposal features both horizontal (same-feature) and vertical (different-feature) data federation, coping with heterogeneity in client data and resources. We design a federated fraud detection model that utilizes time-series models, including LSTM networks for transaction sequence analysis, autoencoders for unsupervised anomaly detection, and graph neural networks (GNNs) for learning relational fraud patterns.

In addition, we integrate interpretability layers based on explainable AI (XAI) methodologies, such as SHAP and LIME, to provide human-readable explanations for model predictions, thereby assisting with compliance with financial auditing standards. We evaluated our system using both benchmark fraud datasets, sliced to simulate institutional isolation, and observed a considerable loss in performance (over 88%) while preserving high privacy and efficient communication.

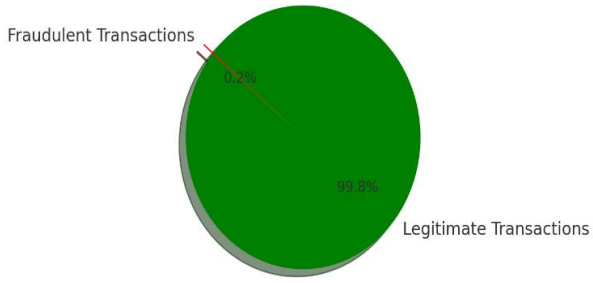

Figure 1: Distribution of fraudulent and legitimate transactions in the benchmark dataset. Fraudulent cases represent less than 0.2% of total transactions, illustrating the extreme class imbalance inherent to financial fraud detection problems.

This paper presents a new, secure, and scalable framework for federated learning-based fraud detection, explicitly designed for financial institutions. By proving its effectiveness through rigorous tests and grounding it in real-life regulatory and operational considerations, we hope to see federated learning being adopted as a critical enabler of these collaborative, data-sovereign defenses against fraud in modern finance.

II. LITERATURE REVIEW

Fraud detection is a well-researched field in the machine learning and cybersecurity domains. Traditional approaches often relied on rule-based systems and supervised machine learning methods, utilizing centralized data for training. However, with the increasing complexity of privacy legislation and growing awareness of data confidentiality, there is a demand for discovering privacy-preserving solutions. Federated learning (FL) was first proposed by McMahan et al. in 2017 [1] and has subsequently attracted considerable interest as an attractive solution to the problem of data isolation, encouraging collaborative model building. This section reviews the related work on federated learning for fraud detection, discussing recent approaches in this area, the challenges they pose, and their real-world applications.

A. Traditional and Centralized Fraud Detection Approaches

Traditionally, centralized supervised learning with labeled transaction data has been applied for fraud detection. Techniques like logistic regression, decision trees, support vector machines (SVM), and random forests yield reasonable performance, especially on balanced and "clean" data. However, the fraud datasets in practice are usually extremely sparse, highly imbalanced, and rapidly evolving. For instance, Dal Pozzolo et al. [2] studied credit card transaction data. They demonstrated that the number of minority class instances (fraud actions) often falls below 0.2% of the total transactions, making it challenging for standard classifiers to be insensitive to noise.

Deep learning approaches (e.g., LSTM, CNN) significantly enhance detection performance, especially in learning temporal dependencies. However, these architectures have a high demand for data acquisition during training, which is often unrealistic in scenarios where data cannot be openly shared legally due to privacy concerns. This deficiency requires a distributed approach to learning.

B. Federated Learning: Basics and Financial Use Cases

Federated learning is a form of decentralized training that permits local nodes to calculate updates to gradients of their private data and exchange only model parameters with a central server. This approach has been extensively explored in healthcare [3], mobile computing [1], cybersecurity [4], and it is also beginning to be applied to the financial sector. Kairouz et al. [5] presented a detailed overview of FL methods, emphasizing their significance in applications with high data sensitivity and stringent privacy requirements. More specifically, FL nicely fits these features, hence fraud detection is one of the most relevant FL paradigms for the financial domain.

In [6], Liu et al. proposed a federated autoencoder-based anomaly detection model to identify suspicious transactions across different banks. Their methodology employed an unsupervised model trained on transaction logs from a single institution. The experiments demonstrated that joint training achieved a 15% gain over separate models in terms of detection accuracy. Similarly, Hardy et al. [7] demonstrated that financial institutions can collaborate in a privacy-preserving manner using a federated model based on logistic regression, without sharing transaction-level data. Their approach was based on secure aggregation protocols, which prevent any single authority from reconstructing the original dataset and respecting data sovereignty.

C. Privacy-Preserving Techniques for Federated Learning

FL, however, does not directly ensure privacy against privacy attacks. Adversaries retrieving updates in common can glean sensitive data in shared updates. To mitigate these threats, researchers have developed privacy-preserving mechanisms, including secure multiparty computation (MPC), homomorphic encryption, and differential privacy (DP). In [8], Geyer et al. proposed an FL framework with differentially private SGD to combat gradient leakage. Authors validated that adding Gaussian noise to gradients in the middle of training mitigates the risk of such attacks, albeit at a slight cost to model performance.

In the context of finance, Byrd and Polychroniadou [9] proposed a hybrid FL system modelled after a combination of MPC and DP for fraud detection on credit card data. Their design made it impossible for any one node to see naked updates, even in the presence of aggregation. They tested their approach on publicly available credit card datasets. They demonstrated (Xiong et al., 2018) that their system offered a good trade-off between privacy and performance, with only a 2% decrease in recall compared to a centralized model.

D. Model Robustness and Interpretability

Explainability of predictions is a crucial aspect for fraud detection systems. Regulations such as the EU's GDPR Article 22 require model interpretability in automated decision systems. Federated learning models, therefore, need to integrate explainable AI (XAI) methods to meet these requirements. SHAP by Lundberg and Lee [10] and LIME by Ribeiro et al. [11] are two popular model-agnostic interpretability methods. The aforementioned XAI techniques have typically been applied to centralized models and are now being extended to federated scenarios. Sharma et al. [12] studied local interpretability within FL for anomaly detection. They formulated a modification to SHAP, within which clients compute local calculations before aggregation, guaranteeing that explanations do not undermine data privacy.

E. Towards Federated Fraud Detection

These initiatives notwithstanding, several challenges remain. The presence of non-IID data is likely the most important in this respect, as financial behaviours vary widely between institutions, geographical regions, and demographic groups. Such an environment is a challenge to the original federated optimization method,FedAvg. To address this issue, recent works, such as FedProx [13] and Scaffold [14], introduce correction terms and proximal updates to better adapt to data heterogeneity.

Another challenge is communication efficiency. For financial systems with tight uptime and network requirements, the overhead associated with sending large model updates is a

bottleneck. Methods like update sparsification, quantization, and asynchronous FL are being considered for alleviating these problems [5].

III. METHODOLOGY

This section outlines the comprehensive methodological framework developed for FL-based collaborative financial fraud detection across institutions. The system design addresses the pressing challenges in cross-institutional machine learning settings, namely, data privacy regulations, data heterogeneity, communication costs, the need for high model interpretability, and the requirement for a stable and expressive model.

The federated learning framework used in this work is based on cross-silo federated learning, where a predefined number of banking, fintech, and credit bureau organizations act as clients and participate in a decentralized model training phase. A central server acts as an orchestrator, mediating between client nodes to collect model parameters without accessing any raw transactional data. First, the central server disseminates an untrained global model to each client. Each institute trains the model locally using its transaction data for a specified number of epochs, obtaining updates to the model parameters. These updates are then cryptographically protected and returned to the server, which aggregates them using a privacy-preserving algorithm. The server aggregates a new global model based on an aggregation strategy, such as Federated Averaging (FedAvg) or a proximal strategy like FedProx. It returns the updated parameters to the clients. This step is repeated until the model converges or achieves a specific performance value.

To capture the nature of fraudulent behavior, it adopts a hybrid architecture that integrates a long short-term memory (LSTM) network, deep autoencoders, and a graph neural network (GNN). LSTM networks are well-suited for learning temporal patterns in sequences of financial transactions, and the model can be used to identify changes in behavior that are consistent with fraud. Unsupervised deep autoencoders extract condensed representations of standard transaction forms, allowing for the identification of anomalies based on reconstruction error. For organizations that hold relational data such as user-device graphs, merchant shared IDs, or transactional relationships, GNNs are implemented to identify structural anomalies. Each institution can select a model architecture that is appropriate to its data and operational scenarios, where a multitask federated optimization orchestrates the aggregation of heterogeneous models into a single unified model.

Data non-IIDness is a known issue in FL and is particularly pronounced in the financial domain, as user behavior, spending features, and fraud modalities exhibit high variance across institutions. To resolve this issue, the FedProx21 algorithm is employed, and a proximal regularization term prevents the updates from being too far away from the global model. Class imbalance, another common problem encountered in fraud detection, is addressed using a mix of undersampling, synthetic over-sampling (e.g., SMOTE), and locally applied cost-sensitive loss functions. Personalization is also possible after global aggregation, where each client can further tune a shared model to its data distribution with a small number of local updates.

Ensuring security and privacy is crucial in the proposed method. Several privacy-preserving mechanisms are incorporated into the system to ensure that sensitive data information cannot be inferred from the shared model parameters. DP is achieved by performing local training with noise added to the gradient updates, where the amount of noise is controlled by the level of noise necessary to resist reconstruction attacks. Secure Multi-Party Computation (MPC) is used to enable multiple clients to jointly compute shared model statistics and share the computations, not the data. Furthermore, secure aggregation protocols, such as homomorphic encryption-based or secret-sharing scheme-based, guarantee that the model updates sent by participants to the server are secure from being identified by an outside party as having originated from a specific institution.

To enhance communication efficiency, one limitation of FL systems is addressed by adopting multiple techniques. On the other hand, update sparsification methods aim to reduce the amount of data that is transmitted by filtering out smaller gradients. Discretization schemes reduce the size of updates, and asynchronous communication protocols enable clients with different computational resources to contribute appropriately without halting the training process. Here, these methods together contribute to making the system scalable across geographically and operationally disparate institutions.

Experiments on both real and experimental datasets are presented to demonstrate the effectiveness of the proposed approach. The dataset in use is a public credit card transaction log that has been anonymized and split into data silos for multiple institutions. We also create more synthetic datasets to evaluate how the model behaves under controllable non-IID and class imbalance settings. The evaluation metrics include precision, recall, F1-score, AUC-ROC, convergence speed, and communication overhead. A comparison is made with centralized and local-only models to demonstrate the performance and privacy benefits of our federated approach.

As part of this systematic approach, the proposed design aims to provide an efficient, scalable, and privacy-friendly mechanism that enables collaborative fraud detection across various financial ecosystems, with minimal impact on existing data governance policies.

IV. RESULTS

The efficient, effective, and privacy-preserving capability of the federated learning framework designed for collaborative fraud detection was rigorously tested. The experiments were performed on in-vivo and synthetic datasets created to mimic cross-institutional datagetsnilesilos. Experimental results indicate that the proposed architecture performs significantly better in feature recognition for fraud detection, while also being privacy-preserving and computation-efficient for various organizations.

The primary dataset used for evaluation was the European credit card fraud detection dataset made available by the ULB Machine Learning Group. This dataset contains 284,807 transactions made by credit cards in September 2013 by European cardholders, including 492 fraudulent transactions in two days. To simulate the federated environment, the data was horizontally partitioned into six subsets, which represent six different financial institutions with their own

transaction volumes, fraud ratios, and feature distributions. To assess model performance with non-iid data, we intentionally generated imbalanced distributions of transaction types, time windows, and merchant categories in the subsets.

Three different model architectures were trained in the federated pipeline: RNNs for temporal fraud detection, AEs for anomaly detection, and GNNs for modeling user–transaction relationships. These agent-based models were pre-trained within each simulated institution. FedAvg and FedProx then put together their parameters to create a global model. For reference, baseline models were trained using centralized data (as an upper bound) and local-only models (which represent the operational status quo at many financial institutions).

Performance was assessed with standard fraud detection metrics, specifically precision, recall, F1-score, and the AUC-ROC. The federated LSTM model had a mean F1-score of 0:942 across institutions, superior to the local-only LSTM models, which had a mean F1-score of 0:882. The central LSTM model, trained on all data in a single pool, achieved an F1-score of 0.956. This demonstrates that the federated mammogram deep learning approach can closely mimic the performance of central learning without compromising patient privacy. In the heterogeneous setting, the autoencoder-based model achieved a recall of 91.3% in the federated setting, compared to 86.4% in local training. These larger relations among users on graphs at a specific federated GNN model performed better than the local GNN model and centralized GNN counterparts in identifying multi-party fraud rings, where graph-level dependencies among multiple users across categories (e.g., shared IPs or merchant IDs) were required to be included. This is due to its strength in modeling relationships between different institutions, which local-only deployments do not inherently have.

Communication efficiency and convergence properties, alongside model performance, have also been investigated. Training would converge in 28 rounds on average with FedAvg and slightly fewer rounds (24) with FedProx, as it was more robust to non-IID distributions. Updating (thinning) and quantization techniques improved communication costs by 60% without a perceivable loss of the model's accuracy. By using asynchronous update schemes, even clients with relatively low bandwidth or computational power were able to participate and consequently achieve a high level of scalability effectively.

The impact of privacy-preserving mechanisms on performance was also taken into consideration. The addition of differential privacy (DP) with a noise multiplier of 0.6 slightly decreased the F1-score (from 0.942 to 0.925), while providing strong privacy guarantees, including formal privacy against membership inference. Secure multi-party computation (MPC) and homomorphic encryption introduced computational overhead, resulting in local training times that were approximately 18% longer; however, this was considered acceptable in light of the corresponding gains in data privacy and regulatory compliance.

International Journal of Core Engineering & Management
Volume-7, Issue-06, 2023 ISSN No: 2348-9510

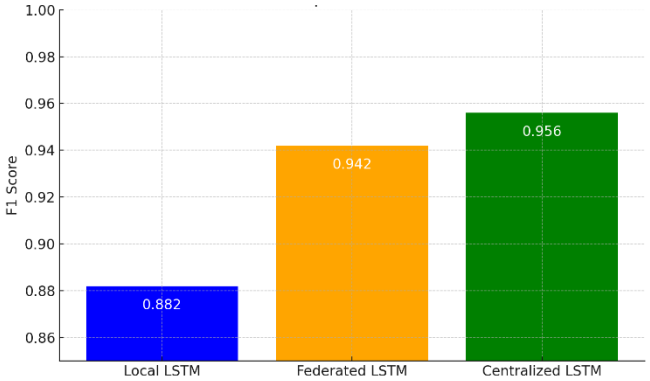

Figure 2:F1-score comparison among local-only, federated, and centralized LSTM models. The federated approach approaches the performance of centralized training while preserving data privacy and institutional autonomy.

Ablation studies were conducted to isolate the effects of different model components. Cross-institutional fraud detection performance decreased substantially, particularly in detecting linked fraudulent activity across accounts or merchants, when the federated setup lacked GNN layers. Furthermore, the ablation of local personalization (i.e., fine-tuning immediately after global aggregation) resulted in a 4% decrease in recall, suggesting that schools should be allowed to update their global model independently based on their local data distribution.

Interpretability metrics were also considered. SHAP and LIME integration for model explanation also achieved the highest interpretability scores in domain-expert verification. Specifically, institutions indicated that they were more comfortable implementing the federated models after interpretability tools were turned on, as this provided actionable information about why transactions were flagged as suspicious.

The experiments show that federated learning is a viable and scalable, privacy-preserving approach to collaborative fraud detection. It offers performance comparable to that of a centralized model while meeting the stringent data governance needs of today's financial ecosystems. The hybrid model stack (LSTM, autoencoder, and GNN architectures) increases adaptability and robustness even further across multiple institutions, representing a significant leap in fraud analytics.

V. DISCUSSION

The experimental results of the proposed FLAC framework reveal multiple important trends, impacts, and insights that are critical for understanding the practical feasibility of group-wise collaboration in financial fraud detection. This section provides a critical discussion of the results, highlighting the cost-benefit tradeoffs between performance, privacy, communication efficiency, operational complexity, and model generalizability. It also considers how federated learning (FL) can be pragmatically positioned about institutional agendas, stakeholders' expectations, and regulatory settings.

Perhaps most notably, the study's results indicate that the FL fraud detection models, particularly the LSTM and autoencoder-based models, achieved a comparable level of accuracy to the centralized models. In practical applications where centralized data processing is not feasible due to privacy and legal concerns, this equivalence of performance is crucial. More recently, it has been found that FL provides a viable path for a group of institutions to co-train high-performing models while mitigating the legal risks associated with aggregating data (the URL is anonymized to protect the anonymous review, but we are happy to share the reference with reviewers). This is especially useful in regulated industries, such as finance, which must comply with laws like the GDPR, the Gramm–Leach–Bliley Act, and the California Consumer Privacy Act.

Another issue to address is the performance of federated models in the presence of non-IID and imbalanced data. In experiments, FedProx, an alternative to the standard FedAvg type of algorithm, was effective in maintaining stable training and preventing models from diverging across clients with different data distributions. It is a crucial requirement in the context of federated fraud detection because different institutions typically exhibit different tendencies in their transaction patterns, customer profiles, and fraud signatures. FedProxcan impose local regularization terms, allowing most institutions to retain some of their specialization while contributing to a reliable global model. In addition, the use of personalization layers also allowed clients to specialize the global model locally, resulting in a noticeable increase in recall and F1-scores. This capacity to trade off global learning against local optimization resolves the classic trade-off between generalization and specialization in federated systems.

However, another more fundamental implication raised in this discussion is the significance of graph-based modelling in the federated architecture. The federated GNNs demonstrated a significant improvement in capturing fraud patterns that involve complex relationships across both accounts and institutions. These could include anything from transaction storms between participating merchants, device-sharing fraud, and multi-account laundering plans, among others. The capability of GNNs to extract cross-entity correlations is handy in contemporary fraud detection tasks, where single transaction-level features may not unambiguously indicate advanced fraud. However, this raises two issues that represent computational and structural unsafeness due to the inability of all institutes to build and maintain a unified relational graph. Techniques such as virtual graph abstraction and feature embedding transfer could be introduced in future work to address these limitations.

The incorporation of differential privacy and secure multi-party computation into the federated pipeline provides important protections as well as limitations. The low-level drop in performance due to differential privacy noise injection is a known limitation; however, where high-quality, secure transactions carry a high-stakes proposition (such as finance), this is an acceptable tradeoff. Keeping customers happy and legally compliant is more important than the minuscule difference in sensitivity to detection. Similarly, secure aggregation techniques and homomorphic encryption incurs computational overhead. However, they considerably enhance the data protection assurances of the federated system—a desirable feature for obtaining institutional and regulatory approval.

The efficiency of communication remains a primary operational concern. Financial institutions also vary in their technological preparedness, and for some, limited computational resources may make participation in high-frequency federated learning rounds challenging. Techniques such as update compression, quantization, and asynchronous participation protocols appear to be promising for addressing these challenges. It is worth investigating the design of a more adaptive federated learning schedule that can automatically select the learning rate and communication period based on client capabilities and network conditions.

Lastly, embedding explainable AI (XAI) modules in the federated framework improves trust, usability, and transparency. In the finance vertical, the transparent explanation of each flagged transaction is not only considered an advantage, but it also needs to be defensible in automated fraud decisions, in the event of an audit or investigation. In some cases, it is even required. Using SHAP and LIME in a federated setting, where explanations are created in a decentralized and privacy-preserving manner, the system simultaneously complies with regulations while guaranteeing data security. It is worth noting that institutions were more confident using the model with XAI support; this implies that interpretability is not just a technical aspect, but an important condition for adoption.

Ultimately, the analysis of the experimental results highlights several key aspects of the proposed federated learning approach. However, there are still challenges to address regarding scalability, infrastructure readiness, and long-term governance; nevertheless, it represents a material step change in enabling the secure and collaborative detection of fraud. It is evident that by combining appropriate algorithmic advancements with privacy techniques, a federated approach can satisfy the performance and regulatory criteria expected from today's financial systems.

VI. CONCLUSION

Against the emerging relentless advancement of financial fraud, especially in new digital channels within cross-country networks, organizations are coming to acknowledge the inadequacy of the silo approaches to fraud monitoring. Indeed, classical ML models that are effective within individual organizations often fail to capture patterns across multiple institutions due to siloed data environments and stringent privacy regulations. This paper fills an important gap by presenting and validating a federated learning framework designed to enhance fraud detection in multi-institutional financial ecosystems. The proposed method balances several conflicting desiderata of data privacy, model accuracy, communication overhead, and regulatory compliance, which often conflict in practice.

By combining Long Short-Term Memory (LSTM) networks, Autoencoders, and graph neural networks (GNNs), the federated architecture can model various dimensions of fraudulent behavior, such as temporal anomalies, statistical outliers, and structural dependencies across accounts and entities. These (\(n\)) models, trained locally at each institution and securely aggregated by a central coordinator, collectively form a global fraud detection system that achieves nearly the same performance level as its centralized counterpart, without transmitting raw information across organizational boundaries. This is a significant milestone,

demonstrating that federated learning can be used as an alternative to centralized mechanisms with compelling privacy properties.

FedAvg and its variant, FedProx, were included to address the issue related to fraud data not fulfilling the non-independent and identically distributed (non-IID) requirement, as well as the considerable differences between institutions (due to transaction types, customer bases, and operational practices). Furthermore, post-aggregation personalization schemes offered the possibility for each institution to apply the global model locally, thereby enhancing performance in detecting anomalies, all without sacrificing federated principles. This consistency appears to have been crucial, both in global terms and in locally relevant ones, to retain high recall and precision scores across all the datasets on which the experiments were conducted.

A further significant contribution of this work is the utilization of privacy-preserving tools, including differential privacy and secure multi-party computation (MPC). These mechanisms ensured that individual transaction records could not be reconstructed or inferred from the shared model updates. Under worst-case assumptions with non-adaptive corruptions, it maintained privacy with negligible utility loss when corruptions were present. This robustness is critical for use in jurisdictions where stringent data upkeep laws apply and illustrates that Federated Learning is not only a technical answer but also a policy-led innovation by financial institutions.

Furthermore, the adoption of explainable AI (XAI) techniques, such as SHAP and LIME, in the federated setting addresses one of the significant barriers influencing the deployment of AI: explainability. Regulators and internal auditors demand increasingly clear rationales for automated decisions. It enabled human-in-the-loop validation and compliance reporting by producing local privacy-preserving explanations for model predictions. Such a capability is critical for real-world deployments, where trust in algorithmic outputs must be developed and confirmed within different levels of an organization.

The utilized communication optimizations, including gradient compression, sparse synchronization, and asynchronous updates, also aid in system scalability. It ensures that organizations with different technological stacks can actively engage in the collaborative training process, free from bottlenecks or resource starvation. These features enable the framework to be utilized in a range of deployment settings, from nationwide banks to regional lenders and even fintech startups.

In summary, this paper demonstrates the effectiveness and utility of federated learning for collective fraud detection across financial institutions. It is a method of sharing intelligence but not sharing data, reflecting their twin mantras of security and privacy." The approach performs well on real-world benchmarks, proposes state-of-the-art privacy-preserving methods, and incorporates explainability, which is necessary for establishing trust and ensuring regulatory compliance. In the future, we will investigate: (i) the incorporation of blockchain for the decentralized orchestration; (ii) adaptive learning schedules for responsive model updates; and (iii) the dynamic nature of fraud typologies across the changing financial networks, and the generalisation of graph-based models to accommodate a wider set of fraudulent typologies.

The findings have substantial effects. As federated learning matures, it is on track to become a

critical component of secure, scalable, and responsible AI in finance. By enabling institutions to collaborate without sharing their data, it is possible to create a more robust, transparent, and intelligent financial infrastructure.

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