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White Paper

Recognizing First-Party Fraud

Why It's More Expensive Than You May Think.

By Dale Daley and Rod Powers

EXECUTIVE SUMMARY

First-party fraud (FPF) — fraud committed by individuals, typically a financial institution's own customers who have no intent to pay — is not a new issue, but it is extremely costly and more expensive than you may think. The reason: It is so difficult to detect and address that it is most often misclassified as bad credit debt by the affected organizations, and therefore placed into collections. Industry analysts suggest that higher than average unemployment rates and lack of access to credit are key factors contributing to an upward trend of FPF. According to the Federal Reserve,[1] charge-off rates have spiked to 9.95 percent, nearly double the average rate of five percent over the past 18 years. This translates to approximately $85 billion of the $850 billion outstanding in revolving consumer credit being written off each year. Of this amount deemed uncollectible, roughly five to 20 percent, or $4 to $17 billion, is misclassified as bad debt when it should be categorized as FPF.[2]

Fraud doesn't discriminate — identification, reduction and on-going prevention should be priorities for FIs, whether they are small community banks or well-recognized multi-nationals. As FIs seek efficiency and greater overall financial health, FPF siphons from an institution's bottom line growth. Understanding the characteristics of FPF, identifying it sooner, and writing it off differently (as an operational loss rather than a credit loss), can positively impact a bank's operations.

The objective of this paper is to shed light on the hidden costs of FPF and help executives recognize the importance of distinguishing FPF from credit losses. Additionally, it will explore the operational advantages of an enterprise-wide approach to identifying FPF earlier in the customer lifecycle, thereby generating substantial savings for an organization. Further, such an approach can also help to protect an organization's reputation and appealing brand.

MARKET OVERVIEW:
What Exactly Is First-Party Fraud?

First-party fraud is different from third-party fraud in which an existing identity is stolen and then fraudulently used to make purchases. With FPF, the primary victim is the financial institution whereas with third-party fraud, often orchestrated by an organized crime ring, typically victims are innocent individuals who are left to spend countless hours to resolve the fraudulent charges and restore their identities. Analytics experts at Experian claim that FPF can occur at three times the rate of traditional third-party fraud.[3]

First-Party Fraud[2]

> Top three behaviors

- Opening accounts with no intention of paying on them with real or synthetic identification. The information — social security number, name and date of birth — associated with a synthetic ID is either completely or partially fabricated.
- Boosting credit limits — artificially and through manipulation of behavior score
- Making false claims of fraud

> How it manifests

- Defaulting on the first payments or very early defaults
- Excessively over an account limit
- Poor recovery rate
- Unable to collect on the debt

Although recognition of first-party fraud is growing, no single industry definition exists, nor are there standard working policies or processes for addressing it. For the purposes of this report, FPF is defined as: "when a consumer applies for and uses credit under his or her own name, or uses a synthetic identity — not to be mistaken with a stolen identity — to make transactions."[3] This definition refers to just one of the four FPF variants known as bust-out or sleeper fraud. The other types of FPF based on "intent not to pay" include organized crime, true and synthetic identification (ID), and change in motivation.

Stereotypical Fraud Profiles

> Bust-out Fraud: Credit Card
A male, typically aged 20 to 40 years old, opens an account without a co-applicant. Many of his banking patterns are similar to a trusted customer. The fraudster makes on-time payments and maintains good account standing for months or years — with the intent of bouncing the final payment and abandoning the account."[3] He appears to be a solid customer with on-time payments, all the while securing and utilizing higher credit limits until abandoning the account. Experian explains that, "Perpetrators typically apply for credit four to 24 months before busting out."[3]

> Change In Motivation: Loan
A female, over the age of 30, is an active and good standing customer. She consistently deposits into her checking account, including her directly deposited paycheck. With her husband losing his job, which isn't, nor would be, communicated to the bank; she applies for and receives a loan for $15,000 to help cover household expenses. She pays her loan on time for a period of 2 years. She then misses a payment, yet the bank assumes there is a reasonable explanation. Eventually, after a series of professional and personal hurdles, she decides she isn't responsible for repaying the loan and stops paying it.

> Organized Fraud: Credit and Retail Banking
A group of individuals hold credit cards and linked bank accounts. They exchange funds and payments with one another, which, from the bank's perspective, appear to be regular account transactions. Similar to the other fraudsters, the credit cards are paid on time and the credit isn't maxed out — yet — creating the appearance of respectable customers. Over time, they each obtain additional lines of credit, including loans. Simultaneously, they withdraw available funds, plus some from overdraft; write checks knowing they will bounce, and max out their credit cards through "high velocity spending."[4]

The Problems Fraud Presents

The Tower Group does an excellent job of outlining the handful of key challenges an institution faces with FPF.[5] First, since FPF is so difficult to recognize, it is often not reported as fraud, but rather classified and handled as a collections case. Second, institutions are not taking strong enough measures to prevent or detect fraud, therefore increasing their risk exposure at an enterprise-wide level. Third, even though FPF is a larger problem than third-party fraud, few to no organizational resources are allocated to it. Fourth, since FPF is often misclassified as collections, the expense, write-off amounts, and reserve requirements are artificially high, tying up valuable resources that could be allocated to other strategic initiatives, such as fraud prevention or detection, earlier in the customer credit lifecycle.

Credit Losses Impact on Reserve Requirements

The Federal Reserve defines reserve requirements as the amount of funds that a depository institution must hold in reserve against specified deposit liabilities.[11] This amount is three percent for liabilities in the range of $10.7 million to $55.2 million and 10 percent for liabilities of $55.2 million or more. During John C. Dugan's testimony before the Committee on Banking, Housing, and Urban Affairs, he explained that substantial levels of capital and reserves are essential for the health of the national banking system.[12] Indicative of the stressful scenarios banks faced from 2006 to 2008, the amount of capital in national banks rose by $186 billion. As fraud losses are anticipated to trend upward, reserve requirements are expected to follow suit in order to provision against the actual losses. Clearly, the greater reserves a bank has on hand, the larger the negative impact on earnings as fewer funds are available for allocation to products.

First-Party Fraud (FPF): What Is The Size Of The Problem?

Keir Breitenfeld, representing Experian's Decision Analytics team, notes that, "The lack of a uniform industry definition [for FPF] and subsequent operational treatment combined with the high probability that a large segment of FPF is currently classified as credit loss instead of fraud loss makes accurately quantifying the overall size of [the problem] challenging."[6] The U.S. Federal Reserve[1] reports charge-off rates are 9.95 percent, nearly double the average rate of five percent experienced over the past 18 years. Applying today's rate to the $850 billion in outstanding revolving consumer credit debt yields approximately $85 billion destined for charge-off. Of this amount, roughly five to 20 percent, or $4 to $17 billion, is misclassified as bad debt instead of FPF. As a result, collections departments treat fraudulent transactions as potentially recoverable debts when there is actually low or no probability of recovery. According to a report from Mercator Advisory Group, "…Credit card collections groups have had to deal with charge-offs that went from 'only' about $40 billion in 2007 to a number that will in all likelihood exceed $75 billion in 2009.[7] As many companies are stretched by the spike in delinquency rates, placing FPF cases into the collections queue places an unnecessary strain on resources.

There are many factors affecting the amount of losses, such as the size of an institution or the type of product. Separate interviews with analysts from both FICO and Experian revealed that estimates of FPF rates for prime bank cards and demand deposit accounts (DDA) portfolios fall within the 0.75 to 5 percent range while fraud rates for credit lines trend toward the other end of the spectrum at 20 percent. FPF isn't limited to the United States — Canada's rates, between five and 20 percent, are most similar to those of the U.S.[8] According to Actimize, The British Bankers Association estimates that 10 to 20 percent

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of bad debt in the UK is mislabeled as collections.[9] Countries in the Asia-Pacific region are troubled by FPF as well, but for a variety of reasons analysts haven't been able to estimate its extent. Institutions within emerging markets are hit harder, specifically, with non-revolving credit, where the rate of FPF is closer to 35 percent, but can reach as high as 50 percent of bad debt.[8]

Classification Conundrum: FPF Or Credit Loss?

Understanding whether or not FPF is on the rise and quantifying its impact are not easy exercises due to inconsistent approaches in classifying losses. A survey of the top 150 retail banks and credit unions conducted by Aite Group concluded that, "Fraud is not going away. In fact, all institutions expect it to grow substantially over the next three years."[10] Without a doubt, FPF is frequently classified as bad debt and put into the collections queue, but this reality is further exacerbated by regulations prohibiting the classification of the majority of FPF — including first payment default and bust-out fraud — as anything other than credit losses. Even so, institutions could gain operational efficiency by segmenting FPF from collections, thereby eliminating allocation of collections resources to fraud cases.

THE HIDDEN COST OF FRAUD: What is it costing your organization?

As a result of industry regulations written to protect cardholders from abusive credit card practices, such as the Credit Card Accountability, Responsibility and Disclosure (CARD) Act, overall decreases in profitable consumer transactions and escalating credit losses have put executives from leading FIs under pressure to generate and maintain healthy balance sheets. Fraud is yet another challenge for struggling FIs, but one that can be largely mitigated. Prioritizing the reduction of losses by identifying and segmenting FPF from the generic credit loss 'bucket' by reallocating collections efforts away from uncollectible first-party fraud to actual recoverable delinquencies will pay dividends.[6]

Like it or not, fraud is here to stay and, in fact, based on the drivers discussed earlier, an indefinite upward trajectory is projected. At the same time, insights garnered from the Aite Group survey suggest that FI executives recognize the importance of fraud tools, however, a substantial gap exists between recognizing the need versus prioritizing the allocation of capabilities and resources to address fraud.[13] Even though industry executives' fraud awareness may be heightened, it isn't a near-term priority for most. This same survey revealed that, "Preventing fraud losses will be the highest priority for the fraud management team — three years from now."[13] For a large FI, taking the variance between the losses prevented and the dollar amount estimated to be attributed to FPF, see Table A. Multiplying that number by a three-year waiting period to address prevention equates to more than $37.5 million in losses. Can your organization afford to wait three years when analytics and current methodologies now enable FIs to identify and reclassify FPF, as well as reduce and deter different variants of FPF? What is fraud costing your organization? Table A provides conservative estimates for the cost of FPF by an institution's receivables size.

Reactive vs. Proactive: Enterprise-wide Strategies Will Limit Exposure

With the various bank channel transaction growth at almost 10 percent per year,[14] the risk of first-party fraud isn't limited to credit cards. The estimated annual credit losses of more than $1.5 billion among U.S. card issuers[5] represents but a mere fraction of the total size of the FPF issue. Once fraud gains a foothold within an organization, like a virus it can creep across channels and products targeting a FI's entire portfolio of products spanning the payment spectrum, including retail, credit cards, loans, mortgages and insurance.

Graph A details the percent of banks reporting losses from cross-channel fraud. Larger institutions, labeled on the graph as "Regional" and "Super regional" have a higher percentage of fraud. Alison Sullivan of FICO points out that larger financial institutions have a higher percentage of fraudulent losses — 10 to 15 percent of bad debt — compared to small banks whose losses are closer to 5 percent.[8] Even though smaller institutions may report less fraud, they are none the less still vulnerable, as fraud doesn't discriminate. It targets large and small-sized institutions, pursuing the path of least resistance.

Table A: The Hidden Cost of Fraud

	U.S. Large FI with Receivables of more than $100 Billion	**U.S. Mid-Sized FI with Receivables of $10 Billion to $99 Billion**	**U.S. Small FI with Receivables of $1.5 Billion to $10 Billion**
9.95% Total charge-off % of receivables	$ 10 Billion	$1 Billion — $ 9.95 Billion	$149 Million — $995 Million
5% — 20% Collections/losses estimated to be FPF	$500 Million — $ 2 Billion	$50 Million — $2 Billion	$7.4 Million — $200 Million
Conservative 2.5% FPF losses averted	$ 12.5 Million — $ 50 Million	$1.25 Million — $50 Million	$190,000 — $ 5 Million

Customer Credit Lifecycle Prevention & Solutions With a First-Party Fraud (FPF) Score

> Stage 1: Acquisition/ Application

The key challenges at this stage include:
- Identifying identity theft applicants and those applicants with the intent to pay versus a customer's ability to pay
- An application decision system supporting "must have" access to the decision strategy data

Detection:
- Fraud decision model
- Intention score for propensity

Solution:
- Set credit limits or deny credit at application level
- Application model integrated into cardholder profile

> Stage 2: New Account /Transactional

The key challenges at this stage include:
- Understanding the rate of balance build; yet encouraging product use while maintaining risk mitigation through monitoring.
- Accessing life event information after an account opening in relation to activity, availability and frequency.
- Recognizing that first payment default is not just a first billing month event; organizations must have functions in place to identify defaults beyond the first 60 days.

Detection:
- Identity authentication

Solution:
- Hold funds
- Monitor balance build up

> Stage 3: Credit Line Management

The key challenges at this stage include:
- The learning curve with regulatory constraints
- "Right size" lines and limit contingent liability
- Changing the perception that a customer's line size is linked to relationship and value to the issuer.

Detection:
- Transaction-based analytics
- Fraud rules
- Authorization of purchase
- Credit line increase request
- Change of contact info

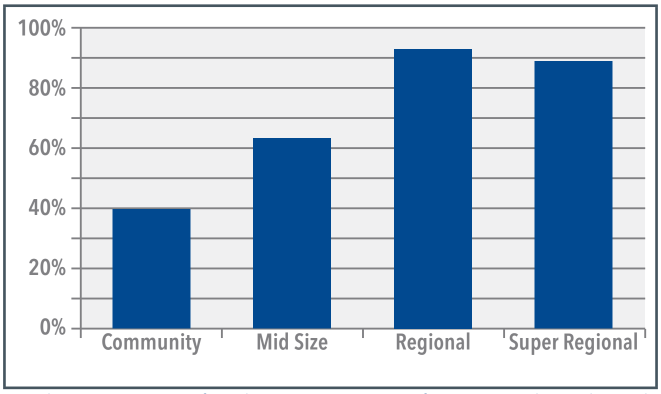
Solution:
- Over limit strategy, block accounts and mange or decrease limits
- Use adaptive control solutions and processes for line management.
- Use of external relationship data

> Stage 4: Collection & Recovery

The key challenges at this stage include:
- Accessing historical data in order to identify FPF vs. skip account
- The historical classification of this scenario
- The current reserve requirements for this fraud type

Detection:
- Delinquency and bad debt
- Collections, recovery or charge-off

Solution:
- Skip trace
- Historical analysis to identify
- On-going classification of FPF as a loss



Graph A: Percentage of Banks Reporting Losses from Cross-Channel Fraud
Source: TowerGroup Consumer Banking Fraud Trends Presentation[14]

As larger institutions prioritize and activate defenses to detect and mitigate losses, small institutions with presumably fewer resources could find themselves more vulnerable. A fraud management-focused report from Aite Group expresses a similar sentiment: "With the balloon-squeezing effect of fraud, smaller institutions are increasingly likely to become targets of fraud attacks as larger institutions invest in the fraud management firepower to mitigate their losses."[15]

THE ENTERPRISE-WIDE APPROACH: Identify, Reduce And Prevent

The traditional approach to fraud, commonly siloed to a business line, is limited in comparison to an enterprise-wide strategy. Fraud isn't contained or limited to one particular line of business, so neither should the approach taken to managing it. An enterprise-wide approach is a proactive strategy for FIs of any size. It is a stronger line of defense intended to prevent fraud from creeping from one product line to another as fraudsters seek out the institution's points of weakness. Surprisingly, Aite Group reports that "Enterprise fraud case management solutions are still not widely deployed among the largest U.S. financial institutions [included in the survey]."[15] Organizations' fraud detection methods should align with the customer experience, which spans the enterprise.

The enterprise-wide approach, most efficiently undertaken with a trusted partner, includes a three-step process. The first step involves assessing and quantifying an organization's current losses. The second step entails reducing these losses. The third step is focused on prevention and detection by leveraging a FPF Score.

STEP 1: Assess, Identify And Quantify

One of the toughest challenges for organizations is distinguishing between FPF and credit losses and even something as seemingly simple as articulating the definition of it. A trusted partner adhering to a proven methodology can assess exposure across the lifecycle, quantify the losses, and identify the best framework for reduction and prevention.

Of particular value may be the use of targeted scores designed to identify unique types of FPF. Beyond use of aggregated authentication scores, implementation of policies incorporating specific bust out, third-party ID theft or first payment default models in tandem with traditional credit policies proves effective in early FPF identification and, as importantly, segmentation.

STEP 2: Reduce

Identifying and addressing fraud earlier in the lifecycle results in fewer complications due to compliance issues and expenses associated with the collection phase, thereby reducing the load on overburdened collections department resources. The reduction process includes understanding the quality of the data available and near-term immediate system enhancements, including fraud markers and account segmentation, along with overall process enhancements and training of staff.

STEP 3: Prevent

With FIs looking to attract new customers, tightening the acquisition criteria may seem counter intuitive; however, addressing FPF in the application process through the utilization of fraud intention scores or transaction-based FPF scores is a solid defense.

Prevention can limit FPF losses across the lifecycle with decisioning tools such as scores or analytics that identify suspicious patterns based on characteristics indicative of intentional fraud. Putting systems in place earlier in the credit lifecycle alerts an institution during the application process — limiting the loss or, better yet, avoiding it altogether.

The enterprise-wide approach will ensure organizational intelligence across the product lines and customer lifecycle. Plus, this approach allows integration with controls, monitoring and detection; analysis, investigation and prevention; along with reporting and measurement of fraud.

CONCLUSION

Fraud Management *will* transition from silos to an enterprise level, but it's just a matter of how many millions in losses an institution will be able to stomach before taking the steps to identify, reduce and prevent those losses.[14] While the costs of investing in methods to mitigate first-party fraud may seem high, in reality the early intervention will be repaid quickly by gaining operational efficiency with collections resources, and mitigating and averting actual losses due to FPF, potentially lowering reserve requirements and averting reputational damage.

As The TowerGroup so artfully states, "issuers must look deeply into their processes and build counter measures to protect their revenue, assets, and equity."[5] Acting now will lead to improved fraud-prevention capabilities for FIs, ultimately ensuring their institutions thrive by protecting them from losses that grow to unmanageable levels.

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ABOUT TSYS

TSYS (www.tsys.com) is one of the world's largest companies for outsourced payment services, offering a broad range of issuer- and acquirer-processing technologies that support consumer-finance, credit, debit, healthcare, debt management, loyalty and prepaid services for FIs and retail companies in the Americas, EMEA and Asia-Pacific regions.

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