Bust-out fraud

Knowing what to look for can safeguard the bottom line

Experian℠
Decision Analytics

An Experian white paper

Executive summary

Bust-out is a growing area of fraud for the financial services industry. For organizations across the globe, bust-out fraud is not a new problem. However, despite continuous efforts to fight this crime, the losses incurred continue to increase.

Identification of bust-out fraud is difficult for many organizations, as traditional fraud tools in the market are primarily designed to detect third-party fraud, which is associated with stolen identities. Sophisticated credit grantors typically rely on "homegrown" systems that use internal data, such as customers' current account behaviors, transaction patterns and payment patterns, to detect bust-out. Even though credit reporting agency data is used when manually reviewing suspicious bust-out accounts, it generally is not used as the leading method of detection. However, Experian's research shows that credit reporting agency trend data is a strong predictor of bust-out fraud and should be incorporated as a predictive tool to detect and prevent this high-loss activity.

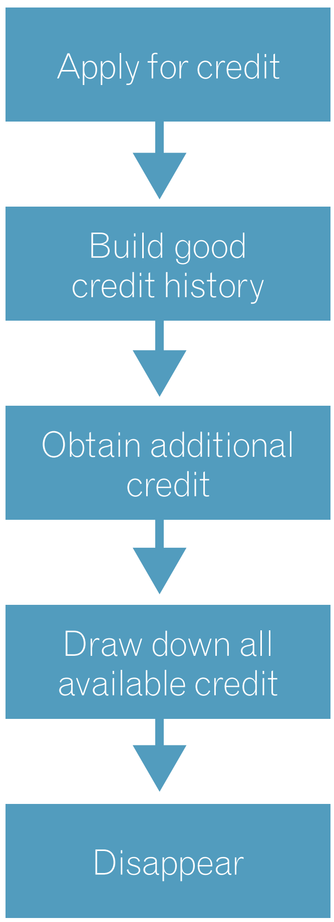
This white paper focuses on how bust-out is perpetrated, its characteristics and how it can be detected by using credit data.

Bust-out fraud

1. Introduction: Bust-out

Bust-out fraud, also known as sleeper fraud, is primarily a first-party fraud scheme. It occurs when a consumer applies for and uses credit under his or her own name, or uses a synthetic identity, to make transactions. The fraudster makes on-time payments to maintain a good account standing, with the intent of bouncing a final payment and abandoning the account.

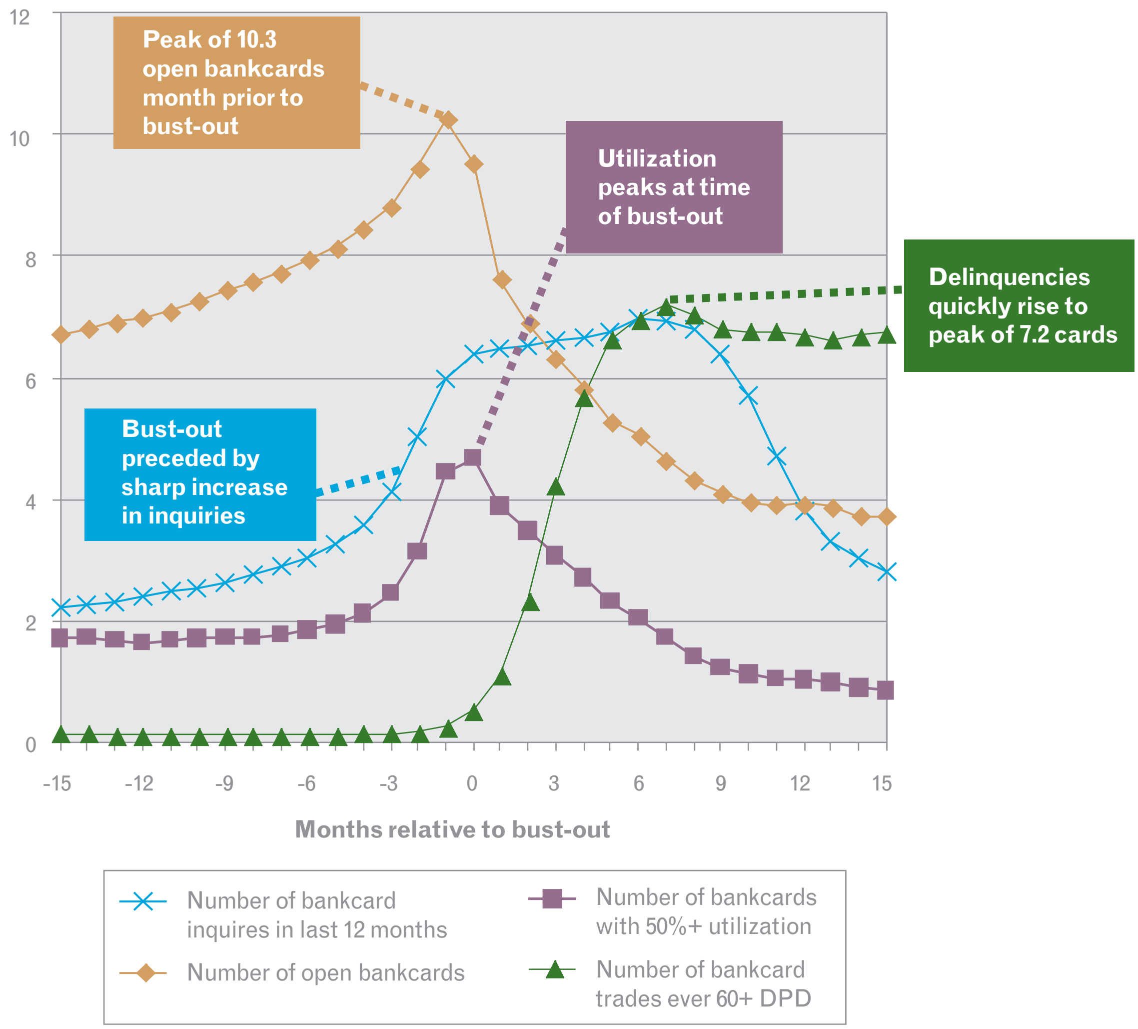
During the process, the fraudster builds up a history of good behavior with timely payments and low utilization. Over time, he or she obtains additional lines of credit and requests higher credit limits. Eventually, the fraudster uses all available credit and stops making payments. Overpayments with bad checks are often made in the final stage of the bust-out, temporarily inflating the credit limit and causing losses greater than the account credit limit.



Bankcards are bust-out fraudsters' favorite medium. However, some fraudsters also utilize retail cards, home-equity lines of credit, and other secured and unsecured loans. Perpetrators typically apply for credit four to 24 months before busting out. The typical bust-out life cycle has a period of "clean/fictitious" behavior preceding a period of "bad" behavior.

The chart below shows how bust-out occurs over time and some of the attributes associated with this behavior.

Bust-out life cycle



All four attributes change significantly right before the bust-out behavior occurs.

1. Bankcard inquiries increase steadily over time, starting at an average of two inquiries approximately 15 months before the bust-out. About three months before bust-out, inquiries increase, peaking at about seven.
2. Bankcard accounts increase steadily over time. Fifteen months prior to bust-out, the fraudster holds an average of seven cards. Three months before bust-out, that number increases to an average of 10 bankcards.
3. Credit utilization remains steady until three months prior to the fraud, at which time it increases significantly.
4. No delinquencies occur until the point of bust-out, and then, like credit utilization, they increase dramatically.

The inquiries and bankcard behavior demonstrate that the fraudsters are gaining access to as much credit as possible prior to committing the bust-out fraud. They maintain the credit accounts in good standing in order to maximize the amount of credit available at the time of bust-out.

After the bust-out and delinquencies occur, the fraudsters often attempt to obtain more bankcards, as evidenced by continuing inquiries. However, this effort is to no avail. Reports show a declining number of open accounts.

2. The cost of bust-out fraud

Losses incurred from bust-out fraud are significant. U.S. card issuers estimate their losses from this type of fraud to be more than $1.5 billion annually. (Source: *Credit Risk International*, September 2004)

The above-stated loss represents only 1 percent of the industry's annual revenue. As such, detection and prevention efforts have yet to increase to a level that would deter fraudsters. However, some fraudsters are being caught. In April 2004, the FBI estimated that an organized bust-out crew had accrued $6.8 million in profit from 1995 to 2003.

Major banks have reported an increase in credit loss reserves in the last several years. Even though some of it can be blamed on rising indebtedness and a global economic slowdown, the increase in fraud is also a major factor. Anecdotal evidence suggests that several banks consider bust-out fraud a rising problem that contributes to the increase of bad debts.

Experian's research indicates that there are 100 to 200 bust-out accounts per year for every million accounts. That means for a large bank with 10 million customers, there are approximately 1,000 to 2,000 cases of bust-out annually.

The losses associated with bust-out are more than those that associated with nonfraudulent write-offs. The bad check with overpayment submitted at the last stage of bust-out temporarily inflates the credit limit, causing the damage to reach more than 100 percent of the original credit limit. In contrast, defaults and losses due to consumer financial distress rarely include inflated bad payments.

3. Bust-out defined

Defining factors

Bust-out fraud is not a new problem in the credit industry. It has been reported to Experian that the number of confirmed bust-outs for an issuer has increased twofold from 2005 to 2007. However, despite this issue's significance, there is no industry-standard definition of what constitutes bust-out fraud. This is largely due to the varying behavior patterns displayed by fraudsters. Some credit grantors have a very restrictive definition, such as the account must exceed its credit limit or display an unusual purchase pattern at particular high-risk merchant locations. Conversely, some credit issuers do not have a bust-out definition. The danger of defining bust-out too narrowly is that lenders will exclude the accounts that do not strictly follow the typical pattern, thus leading the true bust-out account to be treated inappropriately. Conversely, having too broad of a definition will include regular credit losses in the bust-out cycle. For the purpose of Experian's analysis and development, bust-out has the following characteristics:

- Account is 90 days or more delinquent
- Balance is close to or over the credit limit (70 percent or above)
- Payment has been returned, i.e., a bad or nonsufficient-fund check was submitted
- The account holder cannot be reached using the address or phone number provided
- The same condition exists in more than one account either at one or multiple institutions

The first three criteria are similar to those of regular credit losses. Consumers in financial distress with no intention to defraud often have delinquent accounts and high credit utilization. Also, a bounced payment or two is not uncommon. Consequently, the last two criteria are added to imply intention of bust-out. Incorrect phone numbers and addresses provided by account holders could indicate intention to commit fraud or abandon the account. Also, the likelihood of a true bust-out is high if the account holder has the same condition across multiple organizations.

Bust-out fraud characteristics

Even though bust-out fraudsters do not always follow a distinct behavior pattern, it is still important to understand their behaviors collectively. In Experian's analysis, we looked for common characteristics of bust-out fraud. There are two groups of bust-outs in this category. The first group includes accounts that were actively shut down due to bust-out activities. The second group includes accounts that were never flagged but were then categorized as bust-out at the time of charge-off. These bust-out attributes are calculated three months prior to shutting down or charging off.

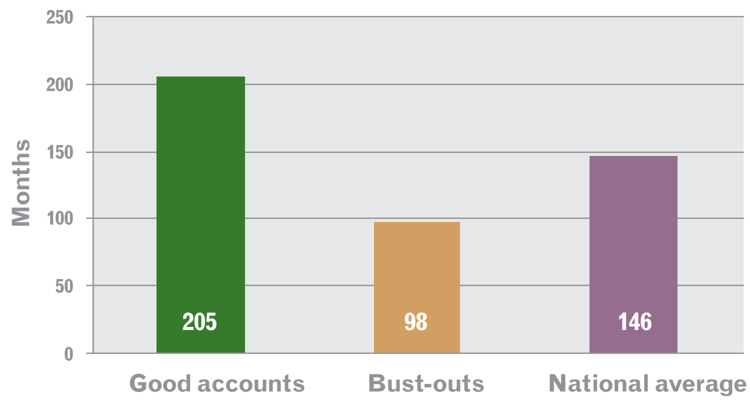
To understand the figures, we dug deep into the individual characteristics of the bust-out accounts compared with those of non-bust-out profiles with clean credit histories, as well as the national average for the U.S. population.

Bust-out fraud

Length of credit history

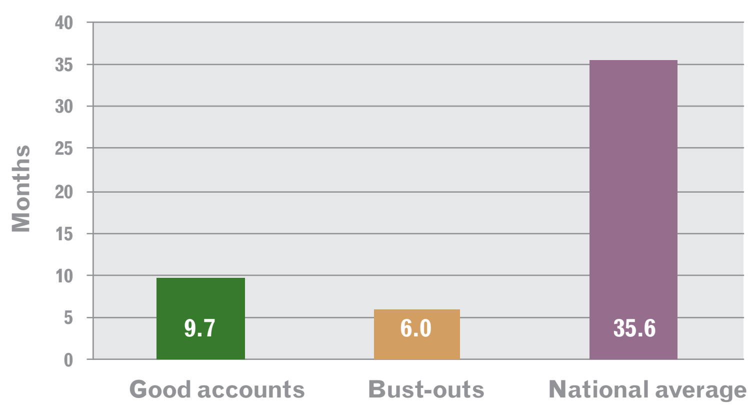
The expectation may be that bust-out fraudsters have limited credit experience, i.e., thin-file consumers. However, the study indicates that the average age of the oldest trade in a bust-out profile is 98 months (8.2 years), with a median of 79 months (6.6 years). In other words, bust-out accounts do not necessarily have thin files. While bust-out profiles are not as robust in length as the average accounts, they are not primarily thin-file consumers nor do they have limited consumer histories.

Age of oldest trade



Viewed from a different angle, these accounts do have the youngest trades. On average, the youngest trade bust-out fraudsters have is just 6 months old, compared with 9.7 months for the good account holders. For the rest of the population, the youngest trade is 35.6 months (2.9 years) old, indicating that both good account holders and bust-out fraudsters are more active in obtaining new financial obligations.

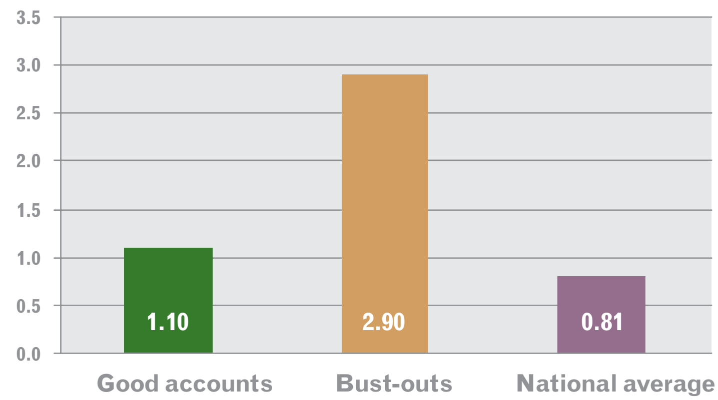
Age of most recently opened trade



Credit activity

It's not surprising that bust-out fraudsters are more credit-active than the average consumer. Over a period of 12 months, bust-out fraudsters are almost three times more credit-active than good account holders, with an average of 2.9 trades opened versus only 1.1 trades in the good account population. At three months prior to bust-out, the fraudsters have obtained as many credit lines as possible. In contrast, the national average actually has fewer trades than both the bust-outs and the good accounts.

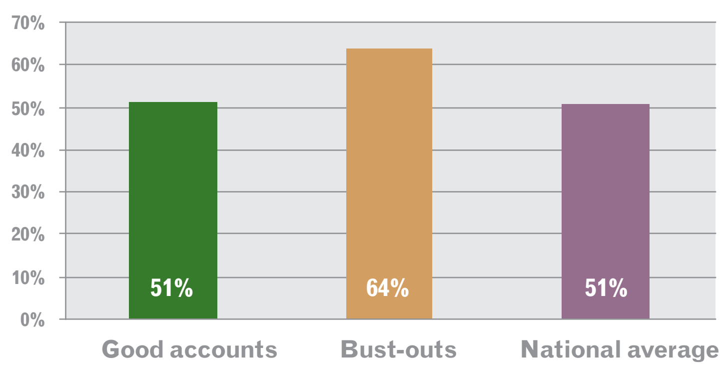
Number of trades opened in last 12 months



Bankcard as a bust-out medium

A bankcard is one of the easiest loans to obtain. Requiring no collateral, issuers make the application process quick and convenient. Presenting themselves as typical consumers, bust-out fraudsters acquire as many bankcards as possible. In our study, we looked at the number of bankcards as a percentage of total open trades. On average, 64 percent of bust-out fraudsters' profiles are made up of bankcards, compared with only 51 percent in the typical population. This is not only because cards are bust-out fraudsters' favorite medium, but also because they usually have fewer other financial relationships, such as real estate and auto tradelines.

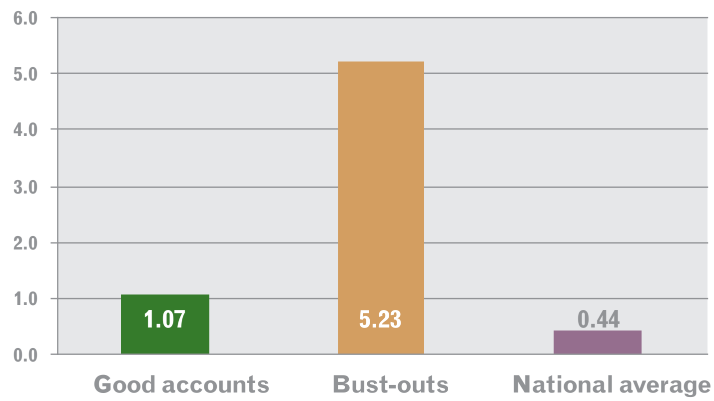
Percentage of bankcard to total open trades



Bust-out fraud

From another angle, we also see that bust-out fraudsters have almost five times as many inquiries as the good accounts, with 5.23 bankcard inquiries compared with only 1.07 in good accounts. This information shows that the bust-out fraudsters actively apply for credit cards.

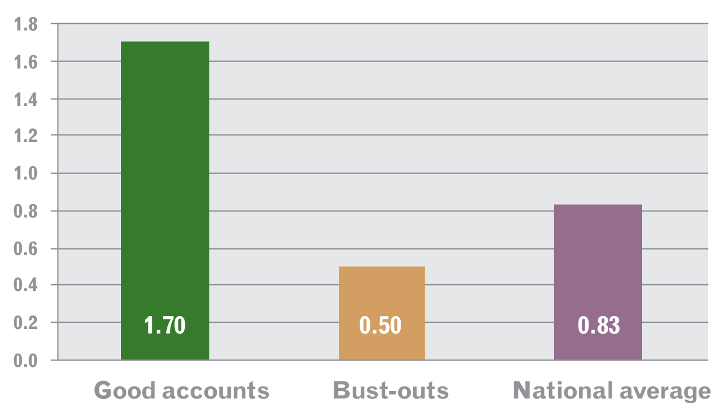
Number of bankcard inquiries



Other financial obligations

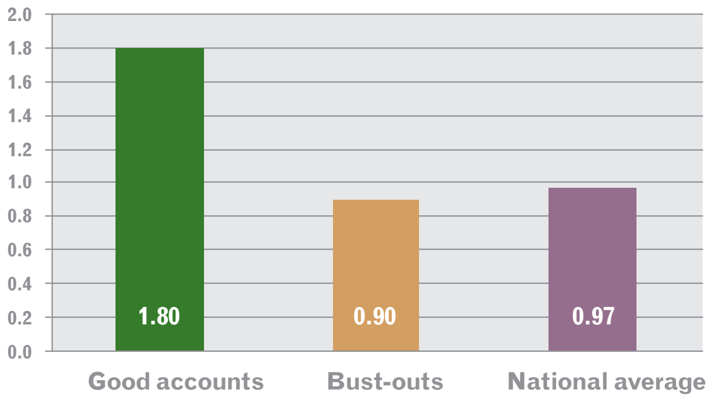
As we mentioned, bust-out fraudsters tend to have fewer nonbankcard financial relationships. For example, they have, on average, 0.5 real property trades (mortgages, home improvement, mobile homes and second mortgages) compared with 1.7 and 0.83 trades observed in good accounts and in the national average, respectively. This finding is in line with the common belief that bust-out fraudsters do not typically own properties. At the same time, however, this figure also implies that we should not expect them to have absolutely no property loans.

Number of real property trades



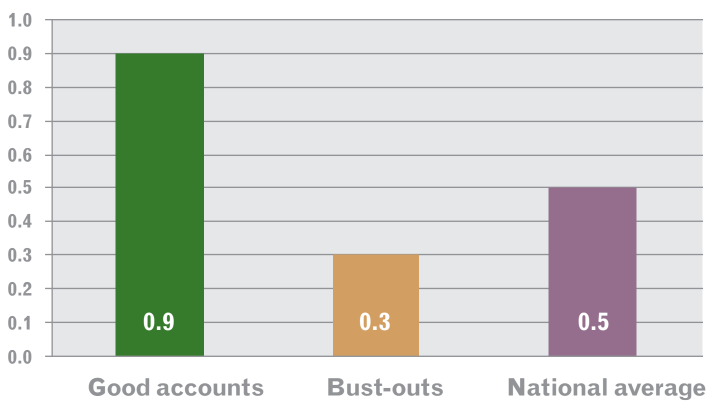
Similarly, a typical perception is that bust-out fraudsters mainly take advantage of unsecured loans and do not obtain loans that require collateral. However, mobile collateral might be an exception. As the chart below demonstrates, bust-out fraudsters have 0.9 auto trades. Even though this figure is half that of good accounts (1.8 trades), the number is only slightly lower than the national average (0.97). The difference between bust-out accounts and the national average is not very pronounced.

Total number of auto trades



Bust-out fraudsters also tend to have fewer credit union relationships, as illustrated in the chart below. With only 0.3 credit union trades, they have three times fewer than that of good accounts.

Total number of credit union trades



4. Detecting and predicting bust-out fraud

Identification of bust-out fraud

The identification of bust-out is difficult for many organizations given the uncertain timing and suddenness of the bust-out event. Traditional third-party fraud tools are not effective in tackling bust-out fraud, as these tools focus on detecting stolen or fictitious identities at the point of account origination. Because bust-out perpetrators often use their own identities, they usually obtain credit without concern.

Some lenders monitor their customers' transactions using suspicious activity triggers to review the accounts. Examples of suspicious activities are frequent convenience checks; frequent cash advances; multiple payments within one billing period from different accounts and different sources; purchases from high-risk, high-value merchants; and unusual purchase amounts (e.g., $1,000 at a dry cleaner). Some issuers use these factors in models to predict bust-outs.

Upon detecting these high-risk bust-out triggers, investigators often conduct a manual account review. In addition to evaluating transaction and payment activities, the investigators also may pull the account holders' credit reports to assess activities with other creditors. In other words, credit data typically is retrieved during investigation but is not used as the leading indicator of bust-out.

Conversely, Experian's research and analysis shows that credit data provides tremendous insight into high-risk bust-out behaviors. Using only credit data, Experian® developed its BustOut Score,℠ which demonstrates superior ability to detect and predict bust-out fraud.

Scoring development

BustOut Score was developed in collaboration with several leading U.S. card issuers using a three-month development window and a consistent definition of bust-out. For development purposes, bust-out was defined as having the following characteristics:

- A delinquent account (more than 90 days)
- A balance close to or over the limit
- A returned payment
- Failed attempts to reach the customer

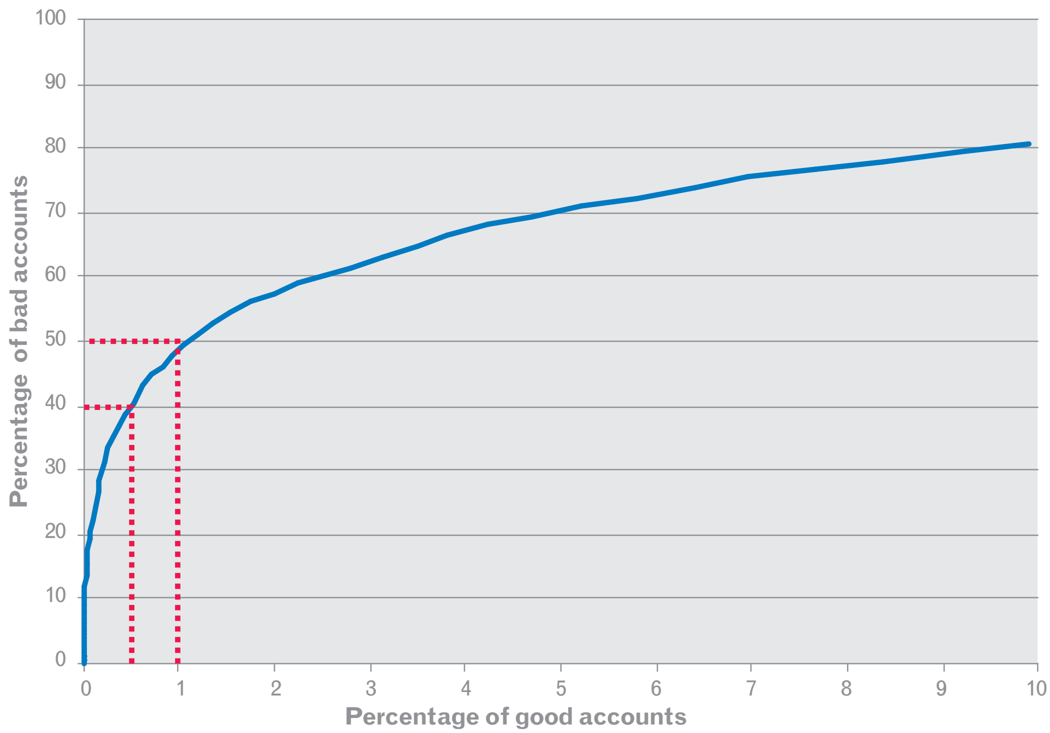
Using this definition, 27,000 bust-out cases were collected from various bankcard issuers.

The following observations were made:

- It is possible to produce bust-out models with good discrimination
- The model is predictive using only credit data

- The Kolmogorov-Smirnov (KS) value is 72 (KS measures the maximum separation in the cumulative distributions of the good and bad populations)
- For the worst-scoring 1 percent of the population, approximately 50 percent of bust-outs were identified
- For the worst-scoring 0.5 percent of the population, approximately 40 percent of bust-outs were identified

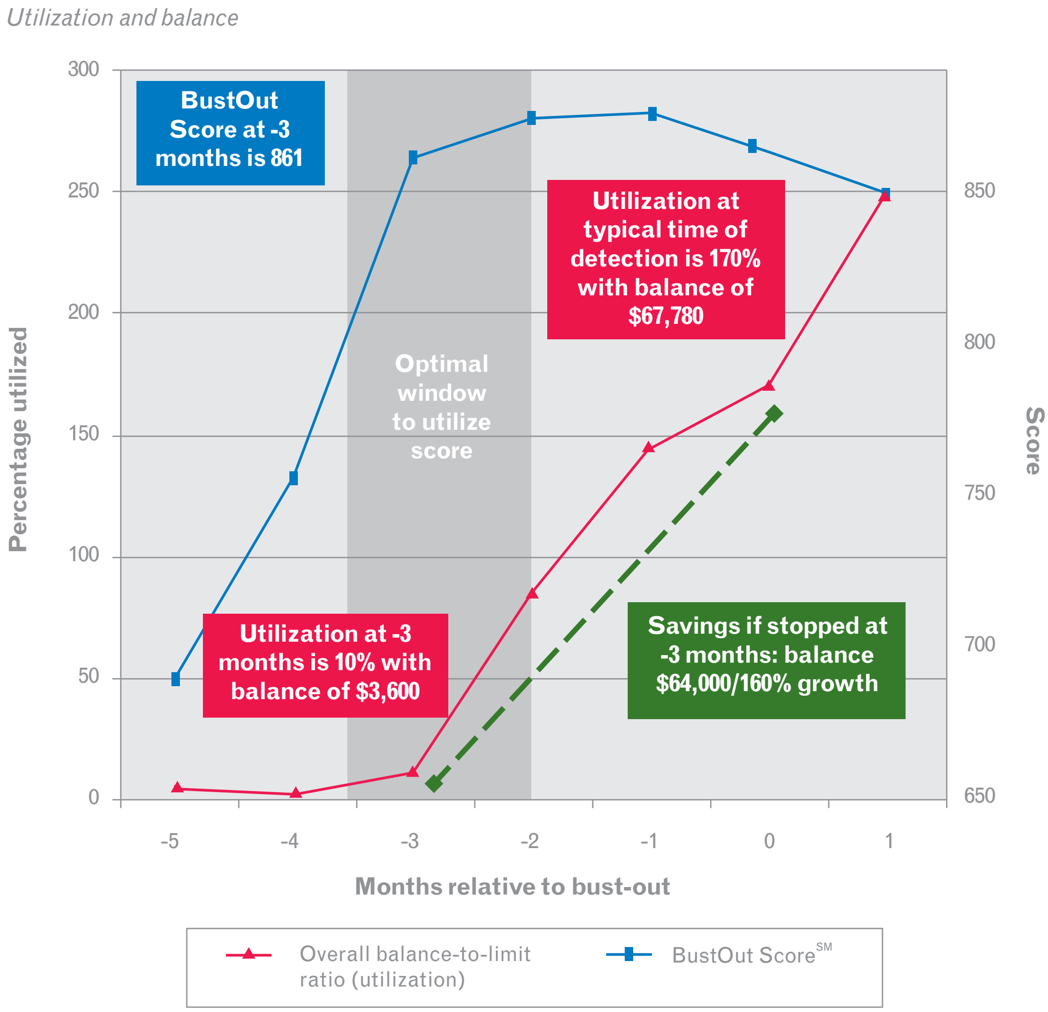
BustOut Score performance



While some false positives are expected with this score, we found that the false positives delivered by the model are accounts that are at high risk for delinquency (i.e., bad credit accounts) and still would benefit from review/action.

To understand the impact of detecting bust-outs three months before the bust-out date, we looked at the utilizations and balance trends of select customers throughout the bust-out life cycle. We also applied the BustOut Score at a monthly interval starting five months prior to the typical detection date.

Bust-out fraud



In this example, the BustOut Score rose sharply three months prior to the detection date, at which point the utilization and balance still remained relatively low at 10 percent and $3,600. A BustOut Score applied to this scenario would have alerted the issuer to the potential bust-out three months earlier — at the 10 percent utilization point — instead of at the 170 percent utilization point with a balance of $67,780.

Conclusion

Credit data brings increased predictability to the analysis of bust-out that internal data alone cannot provide. Issuers that only utilize internal transaction and payment data see only account activities in their own organization, such as suspicious purchases, cash advances, convenience checks, credit line increases and suspicious payments. With the exception of the credit line increase request, these activities usually happen close to the actual bust-out event, eliminating proactive action to prevent the bust-out scheme and, ultimately, the losses.

Credit reporting data provides a perspective on how account holders behave across the credit spectrum. Behaviors such as credit line increases, new accounts, changes in utilization and balance growth can all be captured through credit reporting data. By generating a wider perspective, the bust-out predictors can be observed months before the bust-out is executed. Including credit data in the prediction of bust-out fraud brings a 360-degree view of the consumer and relevant credit activities. Comprehensive data that identifies target behaviors in advance of the fraudulent activities allows lenders to better protect against substantial losses associated with the growing bust-out issue.

Experian's BustOut Score℠

Experian has developed a score specifically designed to assist institutions in identifying potential bust-out schemes three months before the intended bust-out date. Experian's BustOut Score℠ is easily incorporated into an existing risk-management process without significant technological investment. Utilizing the BustOut Score, either at account opening or account origination, will improve operational efficiencies by quickly clearing low-risk accounts, reducing manual review requirements and promoting positive customer experiences with a reduced false-positive rate.

For more information, please contact Experian at 1 888 414 1120.

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