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Verifraud Study Challenges Credit Fraud Perceptions

Though finance professionals are certainly not surprised to hear that credit fraud is an increasing problem, new research by Verifraud shows that the degree of sophistication present with many of today's fraud attempts is quite surprising. The Verifraud study analyzed nearly 700 fraud attempts over a five year period in order to quantify underlying characteristics such as legal structure, location type, bank balance and phone type. The results of this study were then compared with a survey of credit analysts with respect to these same characteristics to determine how closely perception mirrored reality. The overall findings confirm that credit fraud has become very sophisticated, while many finance professionals underestimate this sophistication; certainly a dangerous combination.

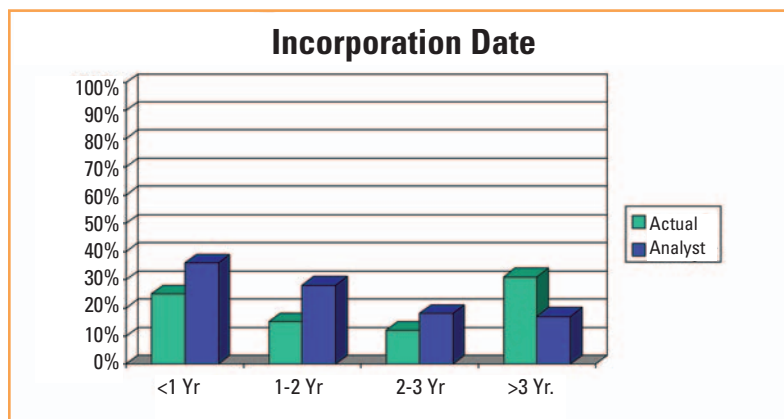
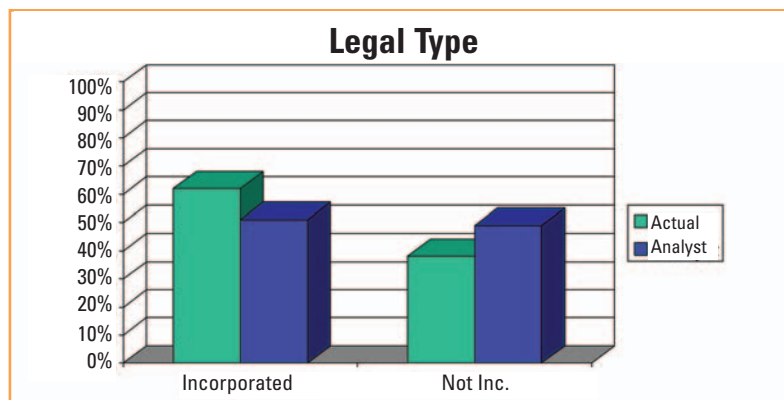
The motivation for the Verifraud study was twofold. In addition to recognizing the need to continually learn from the data and incorporate this into solution development, we also wanted to better understand the industry dynamics. Specifically, we became interested in understanding why fraud loss rates remain high despite the fact that effective prevention is possible. We sensed that misperception and misclassification were driving the losses and wanted to quantify these factors.

With those objectives in mind, we analyzed the fraudulent companies with respect to legal structure, location

type, banking information, and phone type. For those fraud attempts that were incorporated and/or supplied valid banking information, we also looked at the respective age of each. In summary, the results of the study confirmed that these frauds are often extremely sophisticated and have evolved to bypass many of the basic prevention measures companies have in place. What we also found with respect to the survey is that credit professionals tend to underestimate the sophistication of the perpetrators. In fact, some of the largest perception gaps had to do with very basic elements such as cell phone vs. landline, commercial location vs. mail receiving/residential location etc.

Consistent with this, several of the professionals we spoke with stated they were not concerned with fraud risk if a company had been incorporated for years, had a substantial bank balance, and was operating from a commercial location. Our research findings show just how costly such beliefs can be.

The first element we looked at in the study was Legal Structure. Specifically, we wanted to determine the percentage of frauds that were actually incorporated. By analyzing Secretary of State records, we found that nearly 62 percent of fraudulent companies had been incorporated. Though we knew that a very large percentage would be incorporated, the results were still somewhat surprising. The next area of focus was the



Age of Incorporation at the time of the fraud. Again, the results were somewhat surprising, especially with respect to the number of companies incorporated more than three years. One other interesting piece of information that emerged in this section was that the average age of incorporation increased during the last two years of the study period. We believe this was partly due to an increase in shell-company and takeover bust-outs during the period, but was also partly fueled by an increase in internal bust-outs during the economic downturn which was more pronounced during those years.

The next characteristic analyzed was Location Type. Here we wanted to determine the percent of fraud attempts using commercial locations vs. traditional high-risk addresses such as residences or mail receiving centers. The results reveal that nearly 60 percent of frauds were using commercial locations, while the percentage using residences and mail receiving locations was 27 percent and 13 percent respectively. Again, these results point to a high degree of sophistication.

Following Location Type, we analyzed banking information. The results show that nearly 72 percent of fraudulent companies providing legitimate banking information had either four- or five-figure balances. What was most surprising, however, is that the number with six-figure balances was nearly 12 percent. In fact, this was only slightly lower than those with three-figure balances (16 percent). We then looked at the age of the bank accounts and were again somewhat surprised by how many older accounts were involved. The data shows that though 39 percent had accounts open less than one year, 30 percent had accounts open at least three years. Again, the sophistication becomes evident.

One important point with respect to banking and incorporation data is that many of the frauds provided information

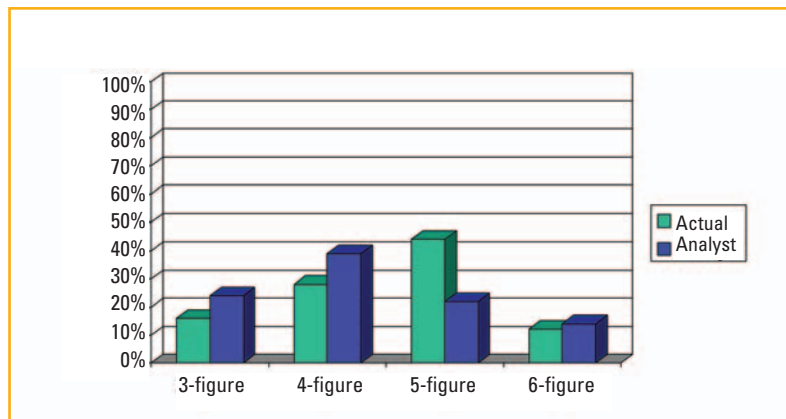
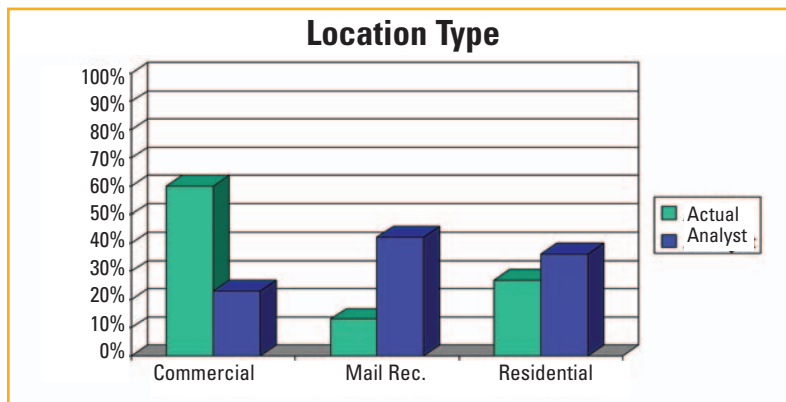
that conflicted with Secretary of State and bank records. In other words, many claimed to be incorporated but were not, while a number also provided bogus banking information. Thus, checking banking and incorporation information is really a no lose situation if used correctly. Though our data suggested that a company would be foolish to qualify an applicant based on such data, it certainly may be used to “disqualify” an applicant.

The next data element that we looked at was Phone Type. Here we see that nearly 90 percent of fraudulent companies were using land-lines as the main business phone

while only 10 percent were using cell phones. This is in sharp contrast to experience in the credit card fraud industry and again points to the fact that credit fraud tends to look very clean on the surface.

Next we looked at the responses on the analyst survey with respect to these same characteristics. The goal again was to identify gaps between perception and reality in order to determine where companies are most vulnerable. As shown on the graph of Legal Type, the average response of the analysts was actually quite close, though it is important to understand that the distribution of the responses across each of the survey categories was quite wide. What we did tend to see from the distributions, however, is that the largest gaps tended to correspond to companies that fared poorly against credit fraud attempts.

Looking next at Location Type, we see that the analysts tended to underestimate the number of frauds using normal office locations. In fact, the average response to the question about the percentage using commercial locations was 23 percent while the actual data showed a 60 percent rate. The analysts also tended to overestimate the percentage of frauds using residential addresses (36 percent vs. 27 percent) and mail receiving locations (42 percent vs. 13 percent).



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Turning next to the analyst responses with respect to Bank Balance, we see that the tendency was to overestimate the percentage with three- and four-figure balances while significantly underestimating the number with five-figure balances. Actually, the analyst estimates for six-figure balances was quite close though again the distribution was wide.

The final survey area that we looked at was Phone Type. Here a huge gap was evident as the average response to the question about fraudulent companies using cell phones as their main number was approximately 62 percent. As we saw earlier, the actual number using cell phones was only 10 percent while the number using landlines was nearly 90 percent. Again, the analyst perceptions here more closely resembles the experience of the credit card fraud industry where fraud tends to be much cruder.

The overall results of the survey confirmed that credit fraud has become extremely sophisticated and that effective fraud risk management is more complex than ever. Furthermore, we often see very sophisticated organized crime groups behind the fraud and these parties have become very skilled at knowing where companies are vulnerable. The fact that nearly 22 percent of fraud attempts from our study could be linked to previous fraud activity illustrates the persistence of these groups as they repeatedly use the same basic model to defraud. Clearly, the perpetrators continue to learn from experience and this, along with trends in the financial value chain towards automation, have left companies more vulnerable than ever.

Implications

Sophisticated credit fraud is truly a growing threat to companies today. Many firms experience fraud loss rates equal to 15-25 percent of overall bad debt though these losses are typically

underestimated due to misclassification. With margins slimmer than ever, credit fraud is impacting the bottom line in a way that is no longer acceptable. Clearly a more aggressive approach to fraud risk management is required.

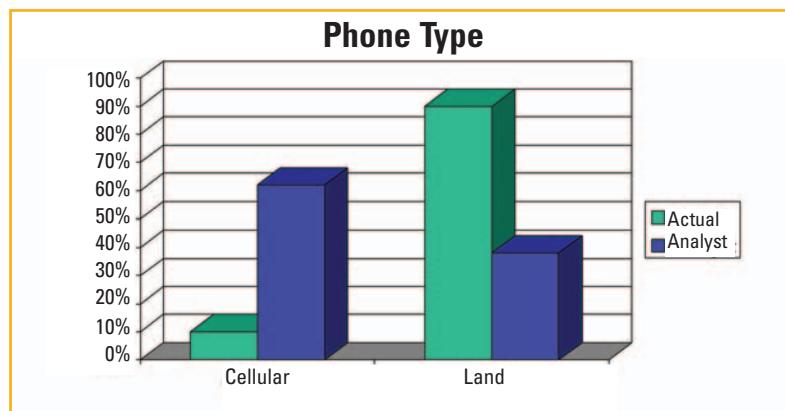
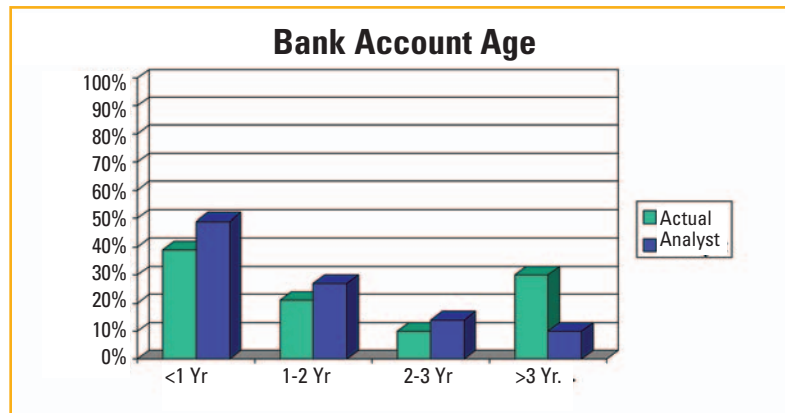
Effective Fraud Risk Management

Though credit fraud is preventable, experience shows that credit fraud risk management is really a separate functional area today. The complexity of both credit fraud and accompanying solutions dictates this. Driven by this fact, a new blueprint for effective fraud risk management has emerged

that involves trained and armed professionals, positioned centrally within credit, and connected to their peers in the industry. These professionals are able to leverage sophisticated technology in order to gain a true picture of an applicant while considering this information within the context of known fraud groups and subtle tendencies.

These findings can then be combined with information obtained from industry contacts or collaborative organizations such as the NACM Asset Protection Group in order to spot unusual velocity or activity. For companies that lack the in-house expertise to build such solutions, outsourcing can achieve similar

results. In effect, this combined approach allows a company to effectively interpret the intent of the applicant and significantly reduce fraud losses. The bottom line is that effective fraud risk management requires expertise, innovation, aggressiveness, and a sustained resource commitment. The good news is that companies that have followed such an approach have been able to dramatically reduce fraud loss rates and improve profitability.



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