White Paper

The Tide is Changing

How to Prepare for the Next Wave of Fraud and Risk Challenges

Brian O'Malley, Max Blumenfeld, Mike Marcus, and Matthew Barton

November 2021

The last 18 months have been surprisingly positive in the credit, fraud, and collections world, with loan volumes and charge-offs at all-time lows. However, there has also been an unprecedented level of fraud during this time. One particular target was the US government, with an estimated over $85 billion stolen from Unemployment Insurance benefits alone. Those managing risk at financial institutions must prepare for a changing tide as stimulus benefits wane, eviction moratoriums expire, and it becomes harder to collect on unpaid debts—all happening in an accelerating digital environment with new consumer behaviors and expectations.

These changes impact the entire loan issuance lifecycle, from onboarding and identity verification to credit underwriting and collections. With new tactics and types of fraud emerging, traditional tools may be insufficient to solve the same problems as before.

To help financial institutions prepare, here are four recommended action steps to shore up risk vulnerabilities, create efficiencies, and fuel growth in anticipation of this new wave of change.

1. Screen for synthetic identity fraud at account opening. While the typical ID theft case doesn't make a single payment once approved for a loan, synthetic identities may perform for a while, but the probability of default for a credit card issued to a synthetic identity is three times higher than one issued to a non-synthetic identity according to SentiLink, a leading provider of identity verification solutions.

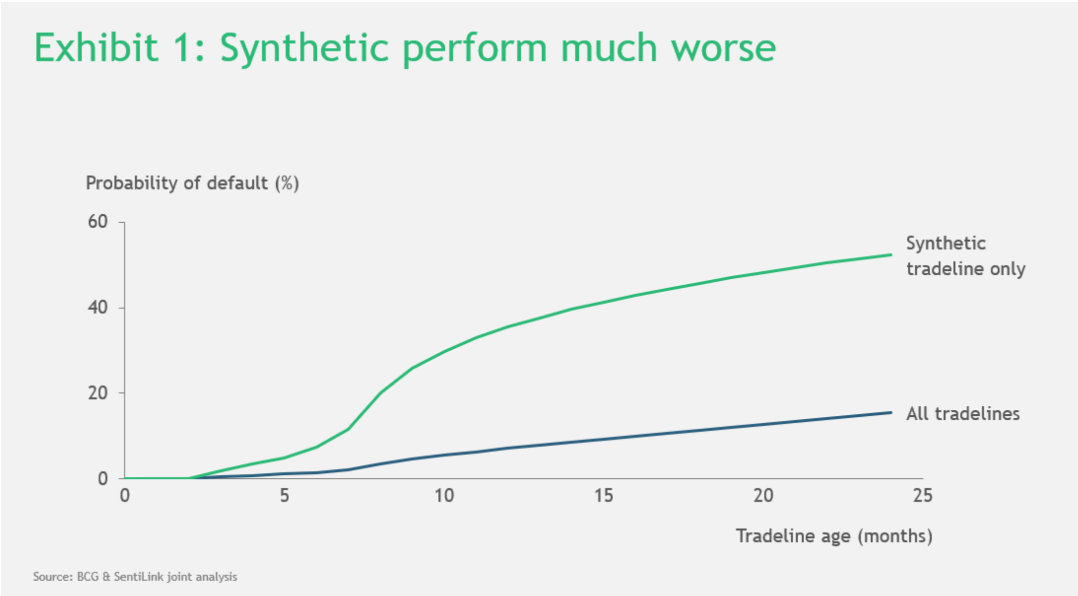


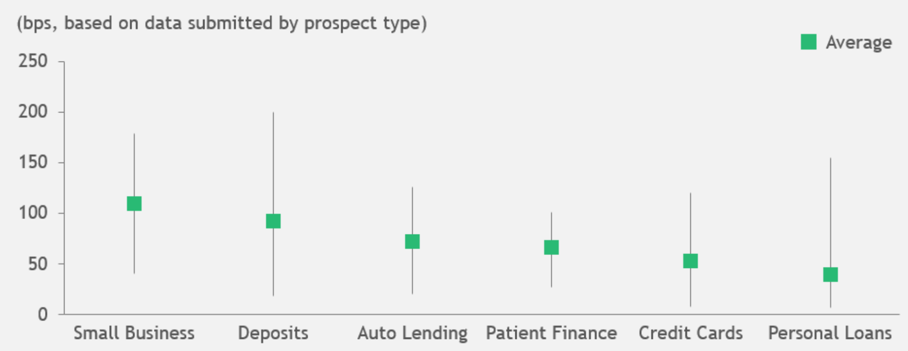
Exhibit 1: Synthetic perform much worse

Source: BCG & SentiLink joint analysis

Without a solution to flag synthetic fraud at onboarding, losses from this type of fraud are miscategorized as credit losses. This unnecessarily increases loan loss reserves, and collections teams end up wasting effort trying to collect on "fake" consumers.

Benefits: Lower charge-offs materially. The rate of synthetic fraud varies by financial institution and vertical from 10 to 200 basis points (bps) of apps, with an average of 40 bps according to SentiLink. If synthetic identities go undetected at onboarding, synthetic fraud can represent 5% or more of your charge-offs. Lowering charge-offs translates into lower loan loss provisioning, which can improve overall profitability.

Exhibit 2: Incidence of Synthetic Fraud Data



Source: BCG & SentiLink joint analysis

2. Incorporate a tradeline-level approach to credit underwriting. While everyone depends on credit bureau data to make risk decisions, the data contains some meaningful anomalies. Fewer credit card issuers report payment information. New credit products like buy now pay later (BNPL) are categorized with installment lenders. New credit-boost products are designed to furnish a wide range of consumer behavior outside of traditional credit repayment. As a result of these changes, legacy underwriting models are less able to accurately assess consumers. Adjusting your credit model to reflect these credit-reporting anomalies can create significant lift.

- Credit card payment rates are a key attribute for predicting a consumer's risk, but there has been a steep decline in the number of credit-card issuers who report to the credit bureaus whether consumers pay in full or only pay a portion of their balance. In 2013, 88% of credit card tradelines included payment information, but in 2020 it was only 40%. A similar decline was found on retail revolving accounts. In 2015, 95% of retail revolving tradelines contained payment data, but declined to 71% in 2020. Since credit cards and retail revolving accounts are the two largest categories of tradelines, this reduction in payment reporting will significantly impact any underwriting models that were designed to incorporate payment information.
- BNPL products are becoming increasingly popular with consumers but aren't categorized independently by the credit bureaus. For BNPL players who furnish to the bureaus, their information is categorized under the same account type as installment

loans. However, BNPL tradelines are quite different from other loan products and should be treated differently in credit models.

- The industry has seen a surge of credit building and credit boosting products whose account types may not properly reflect the underlying risks associated with consumers who have these tradelines present. Analyzing loss rates associated with specific tradeline furnishers will enable you to adjust your models to correctly account for credit boost products, as well as other furnishers associated with disproportionate losses.

Benefits: Reduce losses due to mispricing. Issuing credit without considering tradeline history can lead to costly mispricing as these anomalies are not likely reflected in a consumer's credit score or in any measure that reflects their ability to repay.

3. Segment the tools and processes used for identity verification into distinct "swim lanes" to create greater efficiency and "friction-right" customer experiences. Banks need to create more flexibility in automation flows depending on certain factors in the application and splitting them into different risk buckets. While the bulk of applicants should experience as "frictionless" a process as possible, there are specific examples where a degree of friction and additional process steps are helpful. For example, a high fraud score can lead to an automatic KBA check followed by a bureau pull. While for customers with low stability, the data from a fraud check can inform risk decisioning, and lead to a higher risk threshold/APR to underwrite.

Mapping out these specific use cases or "swim lanes" is key to understanding if the approach is truly "risk adjusted." At the same time, there is a need for different processes and teams—such as fraud and risk—to interact and orchestrate these swim lanes. Finally, banks should keep the tradeoff between "friction-right" customer experience and "risk" in mind while mapping the swim lanes and treatments.

Benefits: Improved efficiency in verification. By deploying verification protocols in a more segmented way, a more efficient customer experience is created, and internal teams have a more structured approach to validating different risk profiles, leading to organizational efficiencies.

4. Enhance your collections segmentation strategy by using some of these tools on the back end to enhance segmentation and improve the efficiency and effectiveness of your capacity allocation and treatment strategies. In addition, apply fraud and synthetic ID screening in your collections environment to screen out wasted effort.

Benefits: Save millions in collections efforts. Improve the efficiency and effectiveness of collections and recoveries by screening out the work being done on fraudulent accounts. Banks typically spend $100 to $150* per account in early stage collections in an effort to collect debt. If synthetic accounts straight-roll into charge-offs, a book with 100,000 synthetic accounts would spend about $10 million attempting to collect on those accounts, yielding a real cost-saving opportunity.

*Assumes a standard mix of certified letters, emails, SMS messages, and manual dialing with no right-party contact.

The Bottom Line

As financial institutions gear up to lend in this post pandemic world, there are better ways to manage risk and fraud to counter emerging threat vectors. It's time to start testing these methods before the next wave of fraud and credit defaults hit.

Screening for synthetic identities at onboarding and in collections not only prevents losses but eliminates the cost of underwriting fake identities and trying to collect from them. Simply reclassifying synthetic losses as fraud losses lowers loan loss reserves and frees up the balance sheet. Incorporating tradeline level data in credit underwriting enables more effective risk identification and risk-based pricing. And segmenting identification tools and processes streamlines onboarding to create the right amount of friction for specific higher risk cases.

Executing these measures not only unlocks tremendous short-term value but positions your financial institutions for growth with an acceptable level of risk going forward.

Brian O'Malley

Max Blumenfeld

Mike Marcus

Matthew Barton

Brian O'Malley is a Managing Director & Partner in BCG's Minneapolis office, he is core member of BCG's Risk practice and global leader of Collections topic. Max Blumenfeld is Co-founder and COO of SentiLink. Prior to SentiLink, Max led Risk Operations and Fraud Data Science at Affirm. Max holds a degree in mathematics and economics from the University of Chicago and was named to Forbes' 30 Under 30 list in 2020. Mike Marcus is a Senior Advisor at BCG; he has over 30 years of experience in financial services industry and was a former C-suite leader at HSBC/Household and a BCG Managing Director & Partner. Matthew Barton is a Principal and core member of BCG's Financial Institutions and Risk practice areas and is based out BCG's Philadelphia office.

You may contact the authors by e-mail at:
OMalley.Brian@bcg.com
Max@SentiLink.com
Marcus.Mike@advisor.bcg.com
Barton.Matthew@bcg.com

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About SentiLink

SentiLink is a leader in identity verification technology. This includes solutions to prevent synthetic fraud, identity theft, and other emerging fraud vectors at the point of account origination. Our KYC Insights product is a new kind of KYC solution that satisfies regulatory obligations and uncovers insights about identity risks.

SentiLink was founded by Naftali Harris and Maxwell Blumenfeld in 2017, two former risk leaders from the online lender Affirm. SentiLink has raised $85M to date from investors and partners with over 100 financial institutions.