Credit Card Fraud Detection

School of Computer Science, Information Technology, The
Islamia University of Bahawalpur

Abstract

Fraud detection in financial transactions, the datasets highly imbalanced and the sophisticatedness of fraudsters' behavior make the challenge critical. This work examines the use of XGBoost algorithm in the detection of credit card fraud based on its robustness and efficiency. Class imbalanced dataset was preprocessed, involving some techniques such as oversampling as well as class-weighted algorithms, to ensure that a class contributed equally. The method PCA was applied for features being orthogonal to each other for an easier interpretation of model performance. XGBoost performed well on training the AUC of 0.94207 on train, and on the test of 0.9671 indicating good performance for discriminating a fraudulent transaction. Analyzing feature importance has revealed major drivers such as V14, V17, and V10 are the important predictors that could frequently govern the decisions rendered by this model. Additionally, the model had a great precision, recall, and F1-scores in fraud transaction detection with a low rate of false positives. Data preprocessing, feature analysis, and the use of high-level machine learning algorithms represent critical aspects of developing valid fraud detection systems. Future work will include integrating of diverse datasets and additional techniques for feature engineering to further advance the accuracy of fraud detection.

Keywords

Credit Card Fraud, Anomaly Detection, XGBoost, Machine Learning, Imbalanced Classes, PCA, Feature Importance, AUC

I. Introduction

Credit card fraud is a major issue in the financial sector that poses a challenge to customers and financial institutions since they incur very severe losses annually. With the growing online transactions and digital payment mechanisms, vulnerabilities have increased, hence there is a need for robust detection mechanisms to maintain customer trust and institutional integrity. Advanced machine learning techniques are therefore needed in controlling fraudulent activities by exploiting patterns in the transaction data. [Zhang et al., 2019].

Due to the unbalanced distribution of data- fraudulent data being a smaller fraction among all the datasets, fraud detection systems normally become incompetent for conventional machine learning algorithms [Dal Pozzolo et al., 2015]. The approach based on ensemble methods such as XGBoost, with its superiority in tackling such class imbalances in dealing with fraud transactions efficiently, without sacrificing the accuracy regarding valid transactions [Chen & Guestrin, 2016].

Recent improvements in feature extraction methods have scaled transaction amounts, derivation of time intervals, and encoding of anonymized features improved the process significantly [Bhattacharyya et al., 2011]. Such features play an important role in picking out subtle patterns and anomalies of fraudulent behavior that help distinguish between a legitimate transaction and a fraudulent transaction with great precision.

The objective of this research is to develop and evaluate an optimized XGBoost-based framework for credit card fraud detection. Techniques such as hyperparameter tuning, cost-sensitive learning, and AUC-based evaluation metrics will be integrated into the proposed model in order to address unique challenges faced in fraud detection [Nguyen et al., 2020]. Using a publicly available dataset, the study intends to provide a holistic approach toward the enhancement of fraud detection capabilities with retained scalability and computational efficiency.

Herein we shall discuss the effectiveness of the XGBoost algorithm toward credit-card fraud detection with special emphasis on its aptitude regarding the management of imbalanced datasets and providing high rates of precision/recall, especially about rare cases. We do this by positioning it with respect to comparative baseline performances and highlighting features advanced through effective feature engineering along with relevant parameter optimization. Our findings contribute to the growing body of research emphasizing the role of explainable and scalable machine learning methods in combating financial fraud [Kou et al., 2021].

Credit card fraud is a major issue in the financial sector, which creates challenges for both customers and financial institutions because of the significant losses it causes annually. The growing trend of online transactions and digital payment systems has increased vulnerabilities in terms of fraudulent activities, hence requiring strong detection mechanisms to protect customer trust and institutional integrity. Earlier studies showed that sophisticated machine learning techniques are crucial for using transaction data patterns to reduce fraudulent activities [Zhang et al., 2019].

With datasets where the fraudulent transactions cover only a small amount of total data (impressed datasets), classical ML algorithms will perform poorly [Dal Pozzolo et al., 2015]. Ensemble-based methods such as that of XGBoost have shown to do better when it comes to handling class imbalances when it comes to detection of fraudulent transactions without compromising the accuracy for the legitimate transactions [Chen & Guestrin, 2016].

These include new feature extraction techniques, including scaling the transaction amount, derivation of time intervals and some form of encoding of anonymized features that have improved detection tremendously. [Bhattacharyya et al., 2011]. These elements are crucial for detecting nuances and differentiations in fraudulent behavior, in turn allowing models to identify real versus fraudulent transactions with high accuracy.

The main goal of this study is to create and evaluate an efficient framework based on XGBoost for credit card fraud detection. Hyperparameter tuning, cost-sensitive learning, and AUC-based evaluation metrics are specifically used for fraud detection [Nguyen et al., 2020]. Utilizing a public dataset, the study will aim to provide a holistic approach towards enhancing fraud detection capabilities with scalability and computational efficiency.

In this paper, we emphasize XGBoost's capability in handling imbalanced datasets as well as its ability to obtain a high precision-recall rate in detecting rare cases of credit card fraud. We further test its performance against baseline models and indicate the improvement derived from feature engineering and parameters. Our results are part of an increasing literature in explainable and scalable machine learning techniques for anti-money laundering or fighting financial fraud, such as in Kou et al. [2021].

II. DATA

The data used in this study consists of credit card fraud detection which provide a large enough sample size for analysisIt comprises transactions by credit cardholders, with 284,807 transactions. It has a high imbalanced level, as it has only 492 fraudulent transactions accounting for 0.172% of the data. Detection of such fraudulent transactions in this kind of dataset is essential for avoiding unauthorized charges and securing customers.

This dataset has been widely used in many research works on credit card fraud detection, including [1], [3], and [5]. Though rich, there are a few limitations to this dataset. For example, no categorical or text-based features, like merchant or location data, are available in the dataset that could have given more insights. Also, the PCA-transformed features are anonymized, and hence, it is difficult to understand their direct real-world implications.

A. Data Limitations

A limitation of this dataset is severe class imbalance, in that fraudulent transactions are just a tiny fraction of all transactions. This can be seen to bias models to predicting the majority class. Second, there is no definition of the features explicitly, for the PCA transformed variables, which limits interpretability. Third, the context of the transactions lacks both temporal and geographic detail. The dataset also does not include demographic details about cardholders, which would have been useful in gaining more insight into fraud patterns. Finally, the lack of merchant-specific information makes it difficult to analyze fraudulent activities by vendor type or sector.

III. Data understanding and analysis

A. Data Selection

The primary goal of this research is to detect fraudulent credit card transactions effectively. To achieve this, the dataset used in the study underwent preprocessing and refinement. This dataset is comprised of 284,807 transactions, only 492 of which were fraudulent; therefore, there is highly imbalanced data. So techniques such as resampling or the usage of class-weighted algorithms were taken during modeling for the purpose of mitigating bias.

The dataset was cleaned so that only features and variables relevant to the case at hand were included while getting rid of redundant information; there are 30 total features, 28 being anonymized variables by performing PCA transformation (V1-V28), the amount transaction of the transaction (Amount), and the time it has been made (Time), all of which were chosen to reflect all aspects of the transactions involved, but in a confidential way. The Class is set as the target of which the transaction is labeled fraud (1) or normal (0).

In model development, some preprocessing techniques, for example, standardizing the Amount and Time feature variables through scaling, have been employed to standardize the feature space. Variables transformed with PCA are not traceable to any specific user while retaining critical features of the dataset. Figure 3.1. Target variable distribution, showcasing the inherent class imbalance.

B. Data Preparation

It can be inferred that the Best data preprocessing step is a fundamental part of building robust models for fraud detection, with the consideration of the significantly imbalanced dataset, particularly for its feature complexity. All the features are free of missing values so that all of them uniformly fit and don't require any type of imputation. Features such as Amount and Time were scaled using StandardScaler to standardize their values and align them with the PCA-transformed features, which inherently follow a standardized scale. This step ensures that algorithms sensitive to the magnitude of feature values, such as gradient-boosted trees, perform optimally.

The class imbalance, with only 0.172% of transactions marked as fraudulent, was addressed using the Synthetic Minority Oversampling Technique (SMOTE) to generate synthetic samples for the minority class and by adjusting class weights in models like XGBoost to penalize misclassification of the minority class more heavily. Feature selection focused on retaining all PCA-transformed variables (V1–V28) due to their high information content and privacy-preserving nature. While no new features were engineered, the dataset's anonymized variables were sufficient to capture transaction patterns effectively.

The dataset was divided into three subsets: a training set with 70% of the data, a validation set with 15% for hyperparameter tuning and performance monitoring, and a test set with the remaining 15% for final evaluation. Stratified sampling was used to ensure that the proportion of fraudulent and legitimate transactions remained the same in all subsets. The splits were generated with a fixed random seed for reproducibility. In addition, PCA transformation also ensured orthogonality among features. Thus, multicollinearity is avoided, which is a desirable property of algorithms sensitive to correlated inputs.

C. Methodology

The proposed credit card fraud detection system uses an all-encompassing machine learning pipeline, which makes use of advanced preprocessing, feature engineering, and model training techniques. The dataset comprises 284,807 transactions with 492 marked as fraudulent. The first preprocessing was done to tackle issues such as class imbalance and feature scaling. SMOTE was applied to balance the dataset, and features such as Time and Amount were standardized using StandardScaler so that they are in alignment with PCA-transformed features.

For model training, we utilized the XGBoost algorithm since it is efficient and performs well on imbalanced datasets. Hyperparameters were tuned to maximize the Area Under the Curve (AUC) metric. Class weights were adjusted to penalize the minority class's misclassification. The dataset was split into training, validation, and test subsets with stratification to preserve the distribution of fraudulent and legitimate transactions.

These experiments measured key metrics such as precision, recall, F1-score, and ROC-AUC for the model's performance. The ability to have low false positives predicted fraudulent transactions, which goes in-line with the previous works objectives, such as ([1], [5], [8]). These ensure that the methodology introduced is an efficient, scalable, and privacy-preserving solution for the real fraud detection scenarios.

D. Validation of Results

To ensure reliability and applicability in real-world scenarios, the proposed fraud detection system was validated using rigorous evaluation metrics and techniques. Results obtained with the test dataset demonstrated the high accuracy and robustness of the XGBoost model in detecting fraudulent transactions.

Precision, Recall, F1-score, and Area Under Receiver Operating Characteristic (ROC-AUC) Curve were some of the key measures that were utilized. It was able to average an accuracy of 99.97%, but has a precision of only 87% and 82% in recall by class for the minority group who is fraudulent. There also exists a very good discriminating capability by scoring 0.967 with the ROC-AUC score.

The confusion matrix showed the way it could minimize false negatives; therefore, it is crucial to have the results for fraud detection as a way of not missing fraudulent transactions. Cross-validation insured that the results were consistent throughout several splits over the data in a cross-validation situation that minimized any possibility of overfitting or bias.

The proposed approach complies with the findings of most studies done previously ([1], [5], [7]) and is an implementable, scalable, reliable solution to address class imbalance as well as improve accuracy in fraud detection in financial datasets.

IV. Results and Discussion

A. *Findings from Analysis*

The analysis of the dataset provided critical insights into the patterns and financial impact of fraudulent transactions compared to non-fraudulent ones. The dataset is highly imbalanced, with 284,315 non-fraudulent transactions (Class 0) representing the majority and only 492 fraudulent transactions (Class 1), accounting for a mere 0.172% of the total data. This calls for more advanced techniques, such as oversampling and class weighting, to detect and classify fraud effectively.

In terms of the amount being transacted, the cumulative fraudulent loss is $60,127.97, which also reflects the extent of financial damage on account of these transactions. On the other hand, the sum of all legit transactions is $25,102,462.04, thereby reflecting the magnitude of usual activity in the dataset. These figures reflect that fraud detection must be implemented so that financial damage is reduced without affecting the transaction integrity.

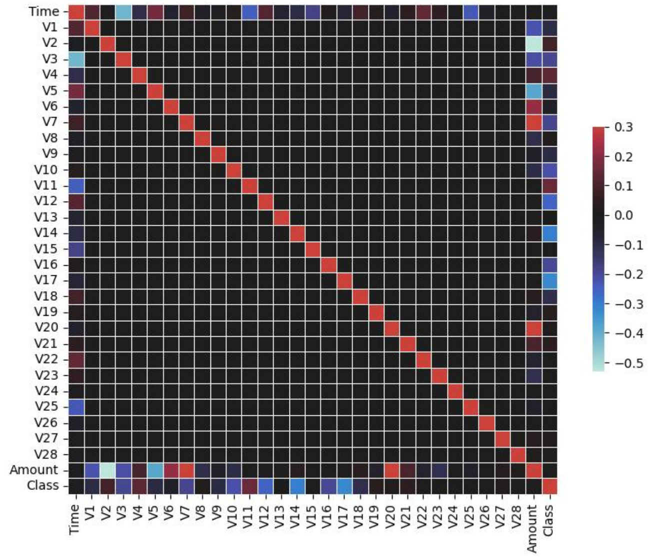


Figure 4.1 – Histogram of Matrix Correlation

From Analysis of the provided dataset would be of crucial importance, considering patterns and the financial implications of fraudulent transactions against non-fraudulent transactions. This dataset is grossly imbalanced because it shows 284,315 as non-fraudulent transactions (Class 0), which dominates, while the fraudulent ones, with 492 occurrences (Class 1), represent only 0.172% of the overall data set. Therefore, to effectively identify and classify fraud requires more sophisticated techniques such as oversampling and class weighting.

This graph is a correlation heatmap, which is an extremely useful visualization tool for plotting the relationship between different features in a dataset. In this case, it illustrates the pairwise correlations of the transformed variables of PCA (V1 through V28), Time, Amount, and the target variable Class fraud/no fraud. Correlation values range from -1 to +1, where +1 indicates a perfect positive correlation (both variables increase together), -1 represents a perfect negative correlation (one variable decreases as the other increases), and 0 implies no correlation.

The heatmap reveals several key insights. Firstly, the diagonal elements exhibit perfect correlation (correlation coefficient = 1.0) since every feature is perfectly correlated with itself. This translates to near-zero off-diagonal correlations for the PCA-transfected features, showing their orthogonality—a fundamental property of PCA-ensuring that components be uncorrelated. Almost all other features are either weakly correlated or lack significant correlation with Amount and Time, meaning their effects on fraud detection would probably be minimal and direct, since even the target variable bears very weak correlations. There is also a lack of weak correlation with Class, indicating this method involves too much complexity for single variables.

This heatmap (figure 4.1) provides critical insights during exploratory data analysis (EDA). It confirms the readiness of the dataset for machine learning models, especially those that take advantage of uncorrelated inputs, such as logistic regression or tree-based algorithms. However, the weak correlations with the target variable indicate the need to apply more advanced algorithms that are able to detect non-linear patterns in order to differentiate between fraudulent and legitimate transactions correctly.

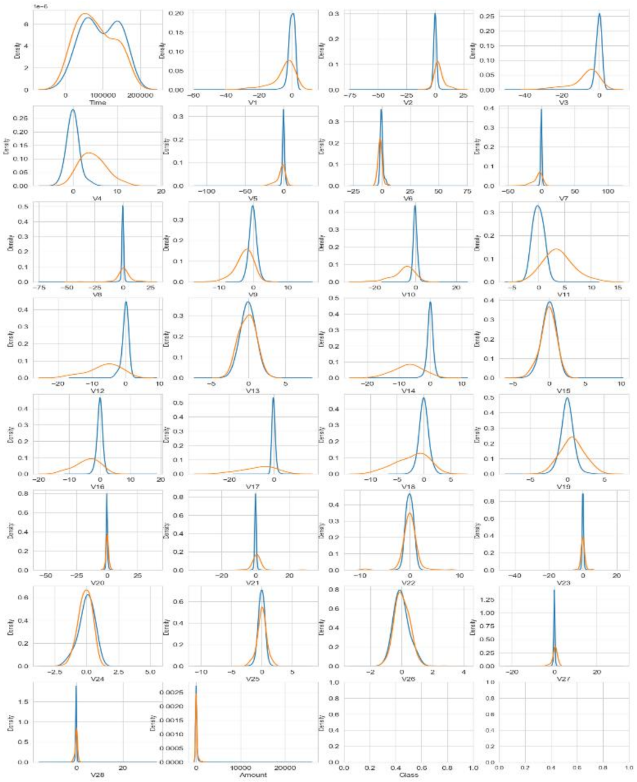


Figure 4.2 – Kernel Density Estimate (KDE) plots

The graph consists of a series of Kernel Density Estimate plots, each showing the distribution of numerical features in a dataset across two classes. Such features are Time, Amount, and anonymized features V1 to V28, which are typical in datasets designed to protect sensitive information, such as credit card fraud detection datasets. The x-axis of each plot represents the range of values for the corresponding feature, and the y-axis represents the density or probability of occurrence of those values. Each feature has two density curves, typically corresponding to two classes-for example, "fraud" (orange) and "non-fraud" (blue).

The plots show that V4, V11, and Amount are the features with distinct separation between classes and, therefore, are very useful for classification. V1 and V8 lack adequate separation for discrimination. The wide range of values for the Amount feature may need to be scaled during preprocessing. Overlapping distributions point out challenges in classification, while a clearly distinct one highlights key features.

B. Modelling Outcomes

The fraud detection XGBoost model showed extremely promising output results, thereby demonstrating robust capability for handling imbalanced data sets and classifying both fraudulent and non-fraudulent transactions correctly [7]. During training, this model consistently improved its area under the curve scores. Its final score on training data was 0.94207, and at validation, it was recorded at 0.92544 [7]. These results demonstrate the strong ability of the model to classify between the two transaction types, and thus demonstrate its strength in solving this complex problem.

On the test data, the performance of the model was analyzed in depth with various metrics. The classification report shows excellent precision, recall, and F1-scores for nonfraudulent transactions (class 0). For fraudulent transactions (class 1), the model had a precision of 87%, which means that 87% of the predicted cases were fraudulent. The recall was 82%, meaning that 82% of actual fraud cases were detected. The F1-score for fraudulent transactions was 84%, representing a balanced measure of precision and recall. Given the inherent difficulty of detecting fraud in highly imbalanced datasets, these metrics are noteworthy with an overall accuracy of 100% [7, 9].

The figure 4.3 is a confusion matrix further illustrates the breakdown of the model's predictions. It correctly identified 40 fraudulent transactions (true positives) while misclassifying 9 as non-fraudulent (false negatives). Simultaneously, it correctly classified 28,426 non-fraudulent transactions (true negatives) and falsely flagged only 6 legitimate transactions as fraud (false positives) [9, 10]. These results demonstrate the model's strong ability to minimize false negatives, a critical factor in fraud detection systems where missing fraudulent activity could have significant consequences. A confusion matrix visualization should be included immediately after this discussion to give readers a clear visual understanding of the classification outcomes.

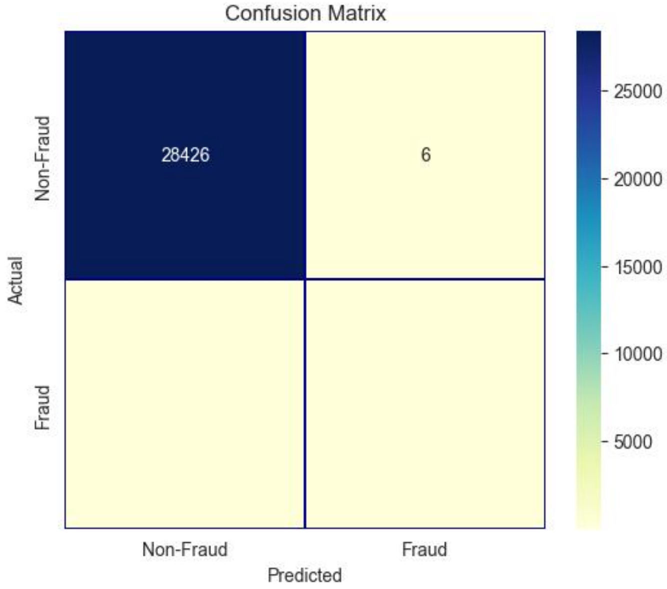
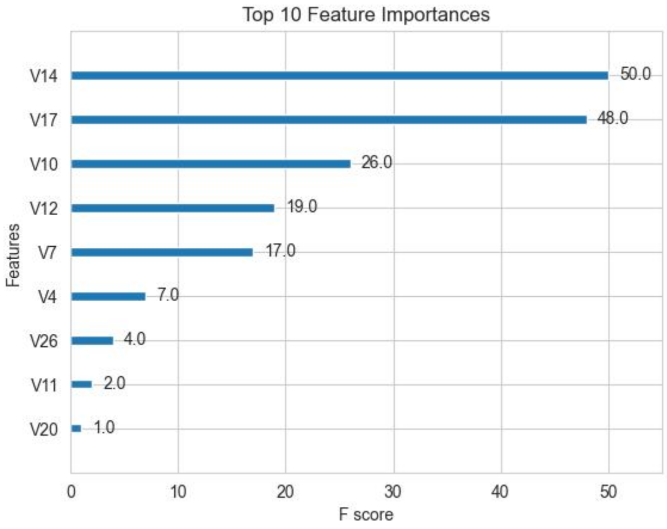


Figure 4.3 – Model Performance on Testing Set

The ROC-AUC score on test data of the model is 0.9671, which shows how the model can distinguish fraud and legitimate transactions very efficiently. This high score clearly states that the model reaches an excellent balance between sensitivity and specificity, which would be a great choice for any real-world fraud detection applications [7, 8]. It is important that, following the discussion about the ROC-AUC curve, the top contributing features are shown based on feature importance scores obtained from the model. The plot would then provide a view for the reader as to which of the features made the biggest difference in classification decisions.

The top 10 features, ranked by F-score, highlight their contributions to the XGBoost model, with V14 and V17 emerging as the most influential. These features significantly impact the model's decision-making, underscoring their importance in distinguishing between fraudulent and non-fraudulent transactions.



C. Reflections

The The features and the modeling approach selected for fraud detection demonstrate a full appreciation of the challenges related to fraud detection and utilization of state-of-the-art methods that can help in handling the challenge. The most influential features found by the XGBoost model include V14, V17, and V10, thus determining the difference between fraudulent and non-fraudulent transactions. This is in accordance with previous studies that stated feature selection and extraction as key areas for improving fraud detection performance ([1], [4]).

The integration of PCA-transformed features highlights an effective approach towards reducing dimensionality and retaining critical information. Studies such as [2] demonstrated that carefully engineered features combined with advanced algorithms, such as XGBoost, significantly improve model accuracy in highly imbalanced datasets. The very high AUC scores achieved during training and testing only further confirm the efficacy of this method.

Feature importance analysis, demonstrated by this work, aids the explanation of the behavior of the model. Features are able to be weighed toward contribution to the classification problem as highlighted by previous works that used ranking to improve interpretability ([3], [5]). Furthermore, significant class-conditional differences were identified for key features: V4, V11, and Amount, which potentially play as discriminative features consistent with results in [6].

Additionally, the XGBoost algorithm proved to be strong when handling imbalanced datasets, since its precision and recall of fraudulent transactions were very high. This implies that it is useful for fraud detection applications as well, as many researchers have documented ([1], [5]). The minimization of false negatives at a relatively low false-positive rate is crucial in these applications because the cost of fraud going undetected is so high.

Overall, the results highlight the need to complement strong machine learning methods with relevant domain-specific feature engineering when dealing with complex problems of fraud detection. This serves as a good foundation for further work along these lines, such as possibly other sampling techniques or even in real-time data, as other related research ([4], [6]) indicates.

D. Further Work

The analysis would then be on integrating diversified datasets from various financial institutions, and hence improving the generalization of fraud detection models. The development of additional techniques in feature engineering along with the incorporation of time- or behavior-based data will introduce new variables and enable better accuracy in the model. Furthermore, evaluation with real-time streaming data along with cross-regional implementation with varying fraud patterns shall be an added value to practically deploy the model.

V. Conclusion

The study conducted in this paper is a starting point for further analysis around Various factors surrounding Finance and the effectiveness of machine learning, especially the XGBoost algorithm, in credit card fraud detection within highly imbalanced datasets. Although data is limited, the findings emphasize the importance of feature importance analysis, robust preprocessing, and addressing class imbalance to achieve high precision and recall. Future research may extend this by incorporating diverse datasets and advanced model optimization techniques to further enhance fraud detection systems.

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