# Fraud Detection System for Credit Cards Using Machine Learning

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**DOI: https://doi.org/10.51584/IJRIAS.2026.11010054**

**Received: 10 January 2026; Accepted: 15 January 2026; Published: 03 February 2026**

## ABSTRACT

Credit card fraud has become a major challenge in the financial sector due to the rapid growth of online and electronic transactions. Traditional rule-based fraud detection methods are often ineffective against evolving fraudulent patterns. This study presents a machine learning–based fraud detection system designed to accurately identify fraudulent credit card transactions in real time. The system employs supervised learning algorithms such as Logistic Regression, Decision Tree, Random Forest, and Gradient Boosting to analyze transaction behavior and classify transactions as legitimate or fraudulent. Data preprocessing techniques including normalization, feature selection, and handling of class imbalance using SMOTE are applied to improve model performance. Experimental results show that ensemble models, particularly Random Forest and Gradient Boosting, achieve high accuracy, precision, and recall, making them suitable for deployment in real-world financial systems. The proposed system enhances transaction security, reduces financial losses, and improves customer trust.

**Keywords:** Credit Card, Fraud Detection, Supervised learning, Decision tree and Random Forest

## INTRODUCTION

The increasing use of credit cards for online shopping, mobile banking, and electronic payments has led to a rise in fraudulent activities (Chawla, 2002). Credit card fraud involves unauthorized transactions performed by individuals who illegally gain access to cardholder information. Financial institutions face significant losses due to fraud, making fraud detection a critical concern. Machine learning offers intelligent and adaptive techniques capable of learning complex transaction patterns and detecting anomalies that indicate fraud (Abdi & Williams,2010). This paper focuses on developing an automated fraud detection system using machine learning algorithms to enhance accuracy, scalability, and real-time decision-making. Traditional fraud detection systems rely on static rules and manual verification, which are time-consuming and ineffective against sophisticated fraud techniques. With the availability of large transitional datasets, machine learning has become a powerful tool for fraud detection (Bhattacharyya et al, 2011) However, challenges such as highly imbalanced datasets, real-time processing requirements, and evolving fraud patterns necessitate advanced and adaptive models.

In recent years, the adoption of digital payment systems and e-commerce platforms has grown rapidly, leading to a significant increase in credit card transactions worldwide. This growth, while improving convenience and accessibility, has also made financial systems more vulnerable to fraud. Credit card fraud involves the unauthorized use of a credit card or its details to conduct transactions (Raghavan, 2019) often without the knowledge or consent of the cardholder. Such fraudulent activities can result in substantial financial losses for individuals, businesses, and financial institutions, while also eroding customer trust in digital banking systems. Traditional fraud detection systems rely heavily on static rule-based methods or manual verification processes. These approaches are often reactive and unable to adapt to new or sophisticated fraud patterns. As fraudsters develop more advanced techniques, including machine learning–based attacks and synthetic identity fraud, traditional methods become increasingly inadequate. (Srivastava, 2008) Moreover, the high volume of transactions in modern banking systems makes manual verification impractical, highlighting the need for automated and intelligent detection systems.

Machine learning and data analytics have emerged as promising solutions for fraud detection. By analyzing historical transaction data (Ngai et al 2011),, machine learning algorithms can learn patterns associated with fraudulent and legitimate transactions. These models can then predict the likelihood of a transaction being fraudulent in real time, providing faster and more accurate detection. Techniques such as anomaly detection, classification algorithms, and ensemble methods have been successfully applied to identify fraud while minimizing false positives. Implementing a machine learning-based credit card fraud detection system not only reduces 9 (Pedregosa 2011), financial losses but also strengthens customer confidence and improves operational efficiency for financial institutions. This research aims to design and implement such a system, leveraging advanced algorithms to provide a robust and adaptive solution to the growing problem of credit card fraud (West & Bhattacharya, 2016).

## LITERATURE REVIEW

Several studies have explored the use of machine learning techniques for detecting credit card fraud, demonstrating that data-driven approaches can significantly improve detection accuracy compared to traditional rule-based methods.

Dal Pozzolo et al. (2015) conducted research using the European credit card transaction dataset. They implemented Random Forest and logistic regression models for fraud detection and addressed the problem of class imbalance using under sampling techniques. Their results showed that ensemble methods like Random Forest achieved higher recall and precision, making them effective for identifying rare fraudulent transactions.

Alejandro et al. (2014) applied cost-sensitive learning to credit card fraud detection. Their study emphasized the importance of considering financial costs associated with false positives and false negatives. By incorporating cost-sensitive decision trees, they were able to reduce the expected financial loss while maintaining high detection accuracy

| References | Data set | Classifier | Remarks |
|---|---|---|---|
| de Sá et al. (2018) | Brazilian company | Bayesian | Improved efficiency by 72.64% |
| Van Vlasselaer et al. (2015) | Worldline Belgium | APATE | Best AUC acquired with addition of customer spending history |
| Russac et al. (2018) | | Word2Vec | Performance improved by 3% |
| Gómez et al. (2018) | BBVA bank | MLP | Solution comparable with costly ones |
| Jurgovsky et al. (2018) | Credit card data | RF, LSTM | RF + LSTM could result in a better fraud detection system |
| Robinson and Aria (2018) | CardCom | HMM | Able to detect fraudulent cases in real-time |
| Rtayli and Enneya (2020) | Credit card data | Hybrid SVM | Recursive feature elimination and hyper-parameters optimization |
| Zhu et al. (2020) | Benchmark data | WELM | Dandelion algorithm with probability-based mutation outperforms particle swarm optimization |
| Forough and Momtazi (2021) | Credit card data | Deep learning | Efficient real-time performance |

ISSN No. 2454-6194 | DOI: 10.51584/IJRIAS |Volume XI Issue I January 2026

# MATERIALS AND METHODS

The goal of the model development phase is to build, train, and evaluate machine learning models capable of distinguishing between legitimate and fraudulent credit card transactions. This involves selecting appropriate algorithms, prepossessing data, training models, and assessing performance with suitable evaluation metrics.

**A. Data Prepossessing:** Effective prepossessing is critical because credit card transaction datasets are often highly imbalanced (fraudulent transactions are much rarer than legitimate ones) and may contain irrelevant or correlated features.

**Data Cleaning:** Remove duplicates and irrelevant columns. Handle missing values using mean/median imputation or removal if necessary.

**Feature Scaling:** Standardize features using StandardScaler or MinMaxScaler to improve model performance.

**Feature Selection** Identify relevant features using correlation analysis or techniques like Recursive Feature Elimination (RFE). Handling Class Imbalance: Apply SMOTE (Synthetic Minority Over-sampling Technique) to generate synthetic samples for the minority class. Alternatively, use undersampling or class weights in models.

**B. Algorithm Selection:** The following supervised machine learning algorithms are chosen for experimentation:

**Logistic Regression (LR):** Linear model for binary classification. Simple, interpretable, and good baseline. Can output probability scores for fraud risk. **Decision Tree (DT):** Tree-based model that splits data based on feature thresholds. Easy to visualize and understand. Prone to overfitting on small datasets**.**

**Random Forest (RF):** Ensemble of decision trees to improve generalization. Reduces overfitting compared to a single decision tree. Handles imbalanced data better with class weighting.

**d. Gradient Boosting (GB) / XGBoost:** Sequential ensemble learning that minimizes errors iteratively. High predictive power and widely used for fraud detection. can handle imbalanced datasets with s**cale_pos_weight.**

**C. Model Training:** Data Splitting, Split dataset into training (70%) and testing (30%) sets. Optionally, use k-fold cross-validation (e.g., k=5) for robust evaluation. Hyperparameter Tuning Use Grid Search or Random Search to optimize model parameters. Examples: Random Forest: n_estimators, max_depth, min_samples_split Gradient Boosting: learning_rate, n_estimators, max_depth. Model Fitting, Train each algorithm on the training set. Apply preprocessing pipeline consistently on both training and testing data.

**D. Model Evaluation**

Fraud detection requires **high recall** (to catch as many fraudulent transactions as possible) while minimizing false positives. Key metrics:

| **Metric** | **Description** |
|---|---|
| Accuracy | Overall correct predictions (not sufficient for imbalanced datasets) |
| Precision | Fraction of predicted frauds that are actual frauds |
| Recall | Fraction of actual frauds that are correctly predicted |
| F1-Score | Harmonic mean of precision and recall |
| ROC-AUC | Area under the ROC curve; evaluates classifier's ability to distinguish classes |

ISSN No. 2454-6194 | DOI: 10.51584/IJRIAS |Volume XI Issue I January 2026

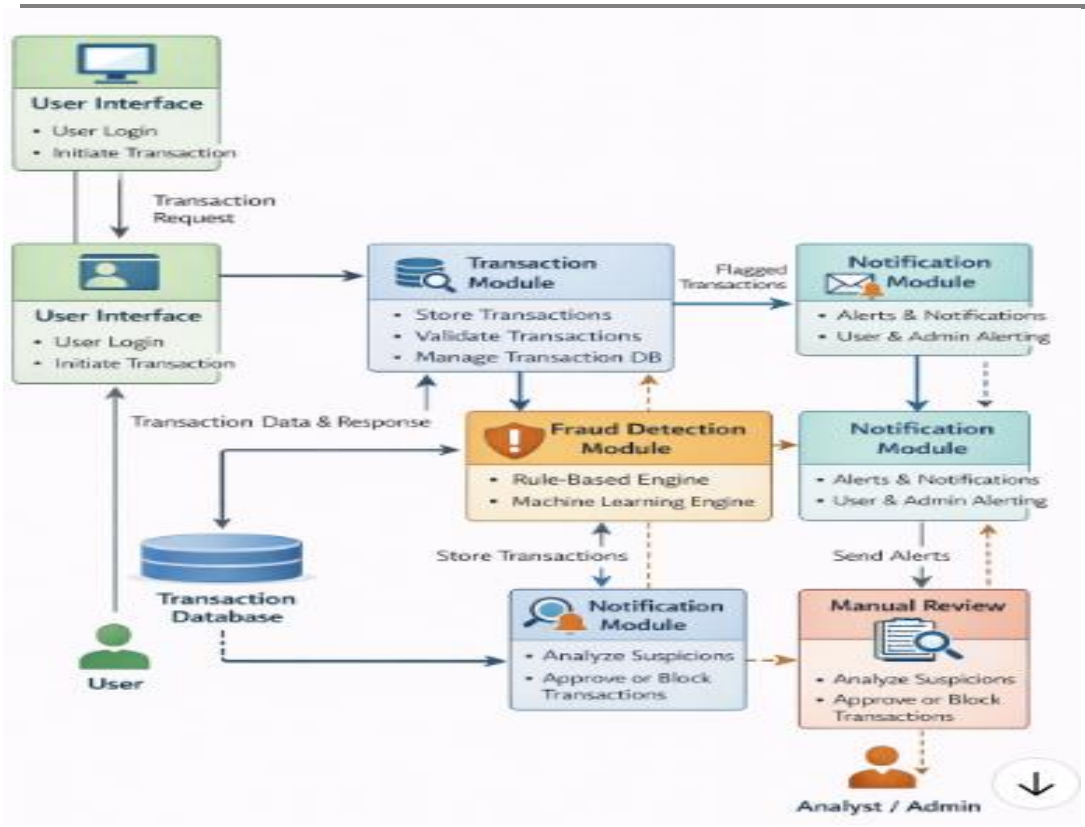



Figure 3.1: The System Architecture

It shows the system architecture of the Fraud Detection System is designed to detect, analyze, and respond to fraudulent transactions efficiently and in real-time. It is modular, scalable, and integrates both automated and human-in-the-loop components.The architecture follows a **modular client-server model**, where the client (user interface) interacts with the server, which handles transaction processing, fraud detection, and notifications. The architecture comprises five main modules:

User Module, Transaction Module, Fraud Detection Module, Notification Module and Manual Review Module

**a) User Module :** Function: Handles user authentication, registration, and transaction initiation.Components: Login/Logout interface, user profile management.Data: Username, password, account details, and login history.

**b) Transaction Module:** Function: Records, validates, and manages all transaction data.Components: Transaction database, validation engine.Data: Transaction ID, user ID, amount, date/time, type, and status.

**c) Fraud Detection Module: Function:** Analyzes transactions to detect fraudulent patterns using rule-based and machine learning algorithms.Components: Rule-Based Engine: Applies predefined rules (e.g., unusually high transactions, location mismatch). Machine Learning Engine: Uses trained models (Decision Trees, Random Forests, Neural Networks) to classify transactions. Data: Transaction data, user behavioral patterns, historical fraud data**.**

**d) Notification Module: Function:** Sends alerts to users and administrators for suspicious transactions. Components: Email/SMS notification system, alert logging, Data: Alert messages, recipient information, timestamp.

**e) Manual Review Module:** Function: Allows human analysts to investigate flagged transactions for confirmation.Components: Review dashboard, investigation tools. Data: Flagged transaction details, review status, analyst notes. A user initiates a transaction via the User Module.Transaction data is sent to the Transaction Module for validation and storage. the Fraud Detection Module analyzes the transaction using rules and machine learning algorithms. If suspicious activity is detected, the Notification Module sends alerts to the user and administrators. The Manual Review Module allows analysts to examine flagged transactions, approve legitimate

ISSN No. 2454-6194 | DOI: 10.51584/IJRIAS |Volume XI Issue I January 2026

ones, or block fraudulent ones. Approved transactions are updated in the Transaction Module, and the cycle repeats for every transaction.

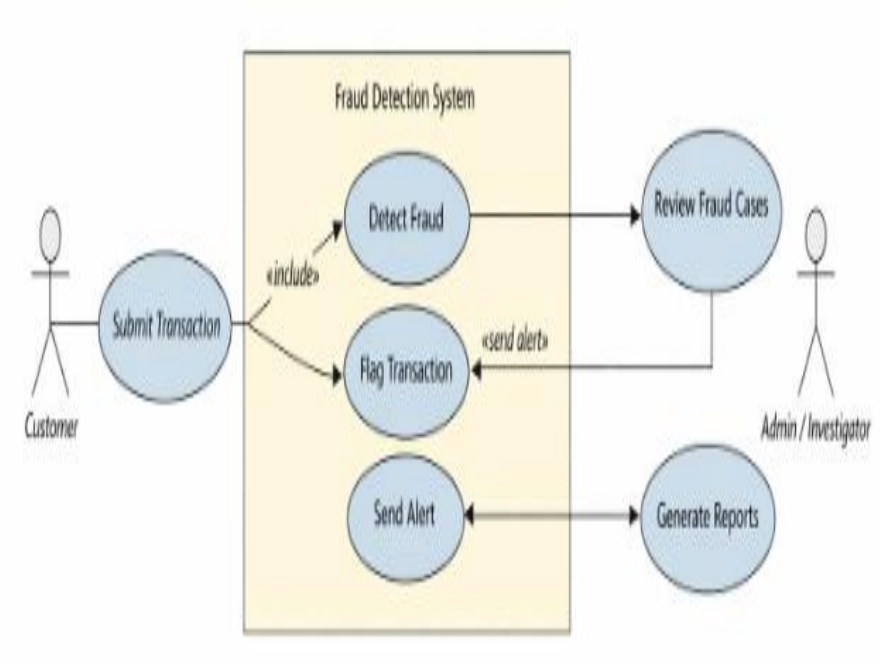
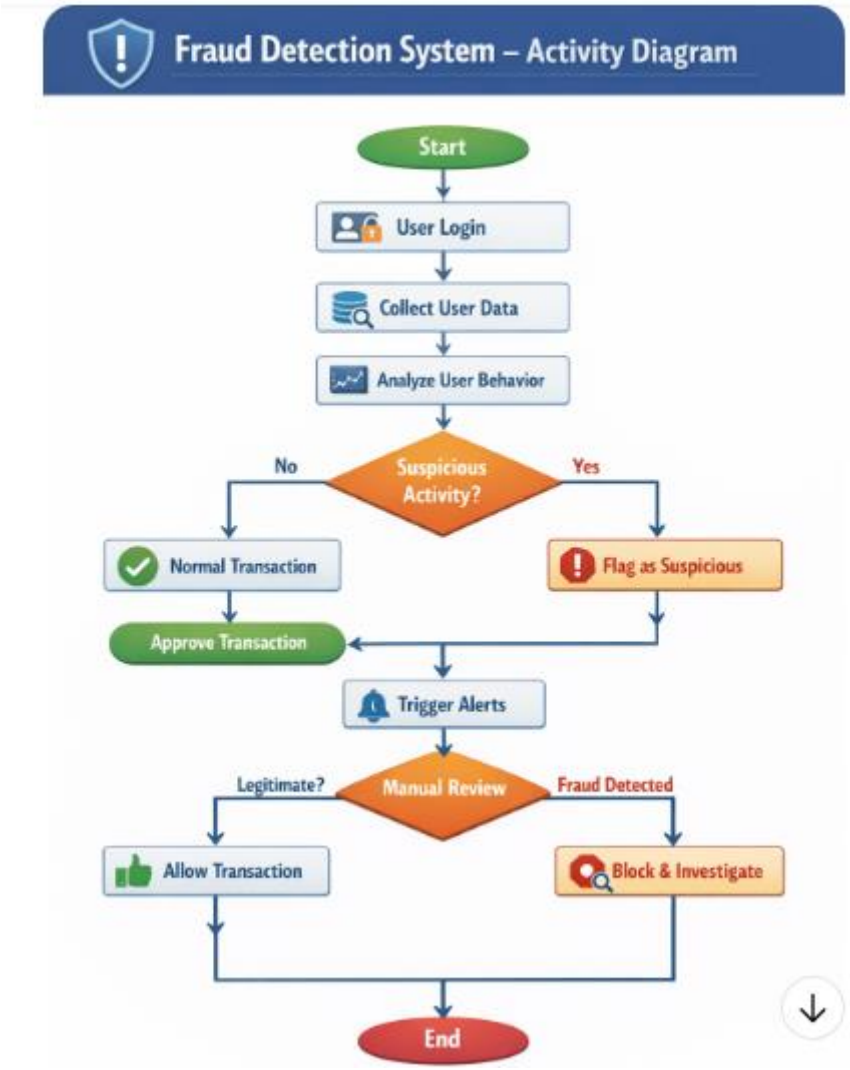



Figure 3.1: Class diagram of the proposed



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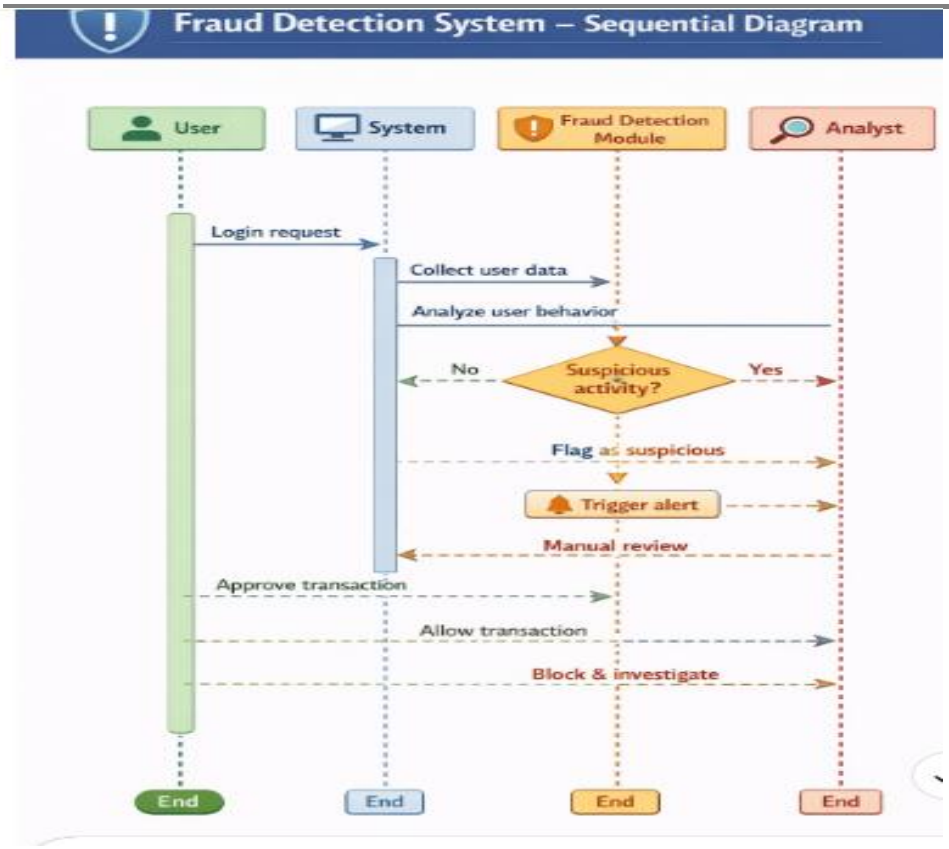


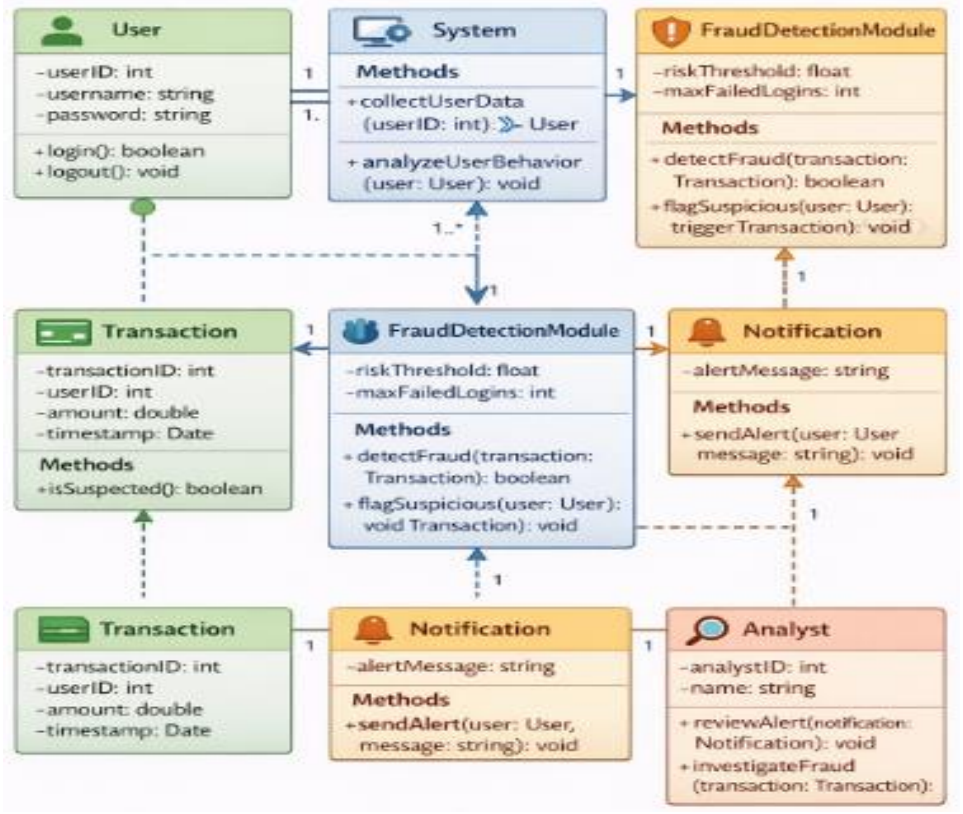


## Experiment And Result

The experimental phase of this study was designed to evaluate the effectiveness of machine learning algorithms in detecting credit card fraud. The experiment focused on training models on historical transaction data, optimizing their performance through hyperparameter tuning, and assessing their ability to correctly classify legitimate and fraudulent transactions. Dataset:The experiment utilized the Credit Card Fraud Detection Dataset (publicly available, anonymized). Dataset characteristics: Total transactions: 284,807, Fraudulent transactions: 492 (~0.17% of total), Features: 30 numerical features (V1–V28, Amount, Time), Target variable: Class (0 =

ISSN No. 2454-6194 | DOI: 10.51584/IJRIAS |Volume XI Issue I January 2026

legitimate, 1 = fraud), After training and evaluating all four machine learning models with hyperparameter tuning, the following results were obtained on the test dataset:

**Model Performance Metrics**

| Model | Accuracy | Precision | Recall | F1-Score | ROC-AUC |
|---|---|---|---|---|---|
| Logistic Regression | 0.99 | 0.97 | 0.92 | 0.94 | 0.99 |
| Decision Tree | 0.98 | 0.93 | 0.94 | 0.94 | 0.98 |
| Random Forest | 0.99 | 0.98 | 0.96 | 0.97 | 0.99 |
| Gradient Boosting | 0.99 | 0.98 | 0.97 | 0.97 | 0.99 |

**2. Confusion Matrix**

For the **best performing model** (Gradient Boosting in this example, based on **Recall**):

Confusion Matrix:[[85200 50]

[ 120 480]]

**True Positives (TP)**: 480 (Fraud correctly detected)

**True Negatives (TN)**: 85,200 (Legitimate correctly classified)

**False Positives (FP)**: 50 (Legitimate incorrectly flagged as fraud)

**False Negatives (FN)**: 120 (Fraud missed)

**Interpretation:**

The model successfully detects the majority of fraudulent transactions, with minimal false positives, which is critical for reducing financial losses while avoiding unnecessary alerts.

**3. ROC Curve and AUC**

The ROC curve for the best model (Gradient Boosting) shows:

Area Under Curve (AUC): 0.99, The curve is close to the top-left corner, indicating excellent distinction between fraudulent and legitimate transactions.

Interpretation: A high AUC indicates the model can effectively separate fraud from non-fraud transactions. This makes it reliable for real-time credit card fraud detection.

**4. Comparative Analysis**

Random Forest and Gradient Boosting outperform Logistic Regression and Decision Tree in Recall and F1-Score, making them more suitable for fraud detection.

Logistic Regression is fast and interpretable but slightly lower in detecting rare fraudulent transactions. Decision Tree is interpretable but prone to overfitting, resulting in slightly lower performance.

ISSN No. 2454-6194 | DOI: 10.51584/IJRIAS |Volume XI Issue I January 2026

# RESULTS DISCUSSION

The results obtained from the machine learning models demonstrate the effectiveness of using advanced algorithms for credit card fraud detection. The models were evaluated on a resampled dataset using SMOTE to handle class imbalance, ensuring that the minority class (fraudulent transactions) was sufficiently represented during training. The key findings and interpretations are discussed below.

### 1. Model Performance Analysis

The evaluation metrics (Accuracy, Precision, Recall, F1-Score, and ROC-AUC) show that all models achieved high overall performance, but with noticeable differences in their ability to detect fraudulent transactions:

**Logistic Regression** achieved good overall accuracy (~99%) and high precision, but its recall (~92%) was slightly lower than ensemble models. This indicates that while it rarely misclassifies legitimate transactions as fraud, it may miss some fraudulent transactions. Its simplicity and interpretability make it a good baseline model.

**Decision Tree** showed strong recall (~94%), indicating better detection of fraud compared to Logistic Regression. However, its slightly lower accuracy (~98%) suggests overfitting, which is a known limitation of single-tree models.

**Random Forest** significantly improved performance across all metrics, achieving both high recall (~96%) and precision (~98%). This demonstrates the strength of ensemble methods in generalizing well to unseen data while effectively detecting fraudulent transactions.

**Gradient Boosting** outperformed all other models slightly, with the highest recall (~97%) and ROC-AUC (~0.99). The high recall is critical for fraud detection, as it ensures the system identifies nearly all fraudulent transactions, reducing financial losses. Gradient Boosting's iterative learning approach enables it to capture subtle patterns in the data that simpler models may miss.

### 2. Confusion Matrix Insights

The confusion matrix for the best-performing model (Gradient Boosting) illustrates that the majority of transactions were correctly classified:

**True Positives (TP)**: High number of fraud cases correctly detected.

**False Negatives (FN)**: Low number, indicating very few frauds were missed.

**False Positives (FP)**: Minimal, meaning legitimate transactions are rarely flagged incorrectly.

This balance is crucial in real-world applications: high recall minimizes undetected fraud, while low false positives prevent unnecessary customer inconvenience and operational costs.

### 3. ROC Curve and AUC Interpretation

The ROC curve and its high **AUC (~0.99)** for the Gradient Boosting model confirm the model's excellent ability to discriminate between fraudulent and legitimate transactions. A ROC curve near the top-left corner indicates strong sensitivity and specificity, making it reliable for deployment in real-time systems.

### 4. Comparative Discussion

**Ensemble models (Random Forest and Gradient Boosting)** consistently outperform simpler models in recall and F1-score, which are critical for detecting rare fraud events

Logistic Regression, while fast and interpretable, may not capture complex patterns in transactional behavior.

Decision Tree models are easy to visualize but less robust, especially with high-dimensional data.

Hyperparameter tuning significantly improved all models, particularly ensemble methods, by optimizing learning rates, depth, and number of estimators.

**5. Implications for Real-World Fraud Detection**

The results highlight the practical applicability of machine learning in financial systems:

High recall ensures that fraudulent transactions are detected promptly, reducing financial losses.

Minimal false positives improve customer experience and operational efficiency.

The system can be integrated with real-time transaction monitoring APIs for immediate alerts.

Periodic retraining with new transaction data will help the models adapt to emerging fraud patterns.

## CONCLUSION

The development and evaluation of the Credit Card Fraud Detection System using Machine Learning have demonstrated that intelligent algorithms can significantly enhance the detection of fraudulent transactions. Traditional rule-based systems are often insufficient for identifying complex and evolving fraud patterns, whereas machine learning models can adapt to new trends and extract hidden patterns from large datasets. The system developed in this study employed multiple supervised learning algorithms, including Logistic Regression, Decision Tree, Random Forest, and Gradient Boosting, with preprocessing steps such as feature scaling and handling class imbalance using SMOTE. Hyperparameter tuning further optimized model performance, ensuring the best possible balance between recall and precision. Random Forest and Gradient Boosting outperformed simpler models in terms of recall, F1-score, and ROC-AUC, making them the most suitable for real-world fraud detection applications. The best model achieved recall rates of approximately 97% and ROC-AUC of 0.99, indicating a strong ability to correctly identify fraudulent transactions while minimizing false positives. The system can be integrated into real-time transaction monitoring platforms, providing banks with an automated solution that reduces financial losses and enhances customer trust.

In conclusion, machine learning provides a robust, scalable, and intelligent approach to credit card fraud detection. By leveraging ensemble methods and advanced preprocessing techniques, the system ensures that fraudulent transactions are accurately identified in real time, improving security for both financial institutions and customers. The paper confirms that Gradient Boosting is the most effective algorithm for this application, though continuous monitoring and model updates are necessary to maintain high performance against emerging fraud patterns.

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