Understanding Chargebacks

CHARGEBACK Advocacy℠
REDUCING TRANSACTION RISK

PART ONE

Basic Guidelines for Merchants

Bankers Insurance Group

Global Institutional Solutions

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Understanding Chargebacks: Basic Merchant Guidelines

Significance of Chargebacks

Chargebacks are a serious risk to any business that accepts charge cards.

The acceptance of credit cards — as a customer payment platform — is virtually mandatory for successful merchants. Integration of a transaction card system into a business serves to (1) increase revenues by virtue of enhanced shopping convenience and (2) improve operating efficiencies. Generally, the benefits of a card payment mechanism supersede the drawbacks. Nevertheless, managing a merchant account can be confusing, frustrating, and costly. There is one aspect of the transaction process that necessitates continual scrutiny, which may be more confounding and potentially damaging to a business than any other: **merchant chargebacks**.

What Is a Chargeback?

Chargeback is a dispute process created for the protection of the cardholder by the issuing bank. The procedure provides a mechanism for cardholders to file a complaint regarding fraudulent transactions listed on their statement. Once the cardholder initiates a dispute, the issuing bank investigates the complaint.

If the transaction is deemed fraudulent, the bank will refund the original value to the cardholder. Unless the merchant can prove that the transaction was, in fact, legitimate, the bank will reverse the value of the transaction from the merchant account. Further, it is likely that the bank will debit additional charges against the merchant account called chargeback fees. These fees are punitive in nature against the merchant. Unfortunately, even if the cardholder complaint is proven to be without merit and no refund is taken from the merchant account, the bank may still debit a chargeback fee.

The costs to a merchant of a chargeback judged to be fraudulent can be severe:

- Loss of the products or services sold to the customer (cardholder)
- Loss of the payment from customer
- Fees incurred for payment processing
- Chargeback penalty fees

Excessive chargebacks can result in punitive actions that negatively impact your company's cash flow.

However, other repercussions can be even more onerous to the business. Merchant accounts experiencing high levels of chargebacks can be labeled by credit card companies as fraudulent, thereby threatening the image and going concern status of a business. Issuing banks can also hold the merchant's remittance up to three months to cover fraud or increase their processing fees should the merchant account be deemed *risky*. These are measures that can severely impact the cash flow of a business.

The Cost of Chargebacks

ALL chargebacks have a negative impact on the merchant's business.

Incorporating a card payment platform is, for the most part, beneficial to a business. However, chargebacks can cause serious repercussions. If a cardholder disputes a transaction for one reason or another, the merchant becomes enmeshed in a complicated process causing potential forfeiture of the sale, exposure to punitive fees, and cumulative business-threatening consequences. Indeed, what's most outrageous about a chargeback, regardless of its legitimacy, is that the burden definitively falls onto the shoulders of the merchant.

The crux of this imbalance lies in the fact that credit card institutions skew their focus toward cardholder satisfaction. When in doubt, the cardholder is appeased so that they will continue to use their cards for additional purchases. These institutions exalt their cardholders' interests to such an extent that any form of dissatisfaction or complaint usually results in a chargeback - even to the detriment of an honest merchant.

All chargebacks are problems for the merchant – *guilty until proven otherwise!* The credit card industry has made it easy for consumers to file chargebacks and transaction disputes, while merchants are left with little industry support.

Chargebacks can result in an overall contraction of the company's margins.

The cost of chargebacks does not end only in transaction losses. Accumulating chargebacks has serious consequences for the merchant. Having too many chargebacks will cause a merchant to be labeled by the credit card institution as a ***high risk merchant*** which can lead to higher chargeback and processing fees. Businesses operating with narrow profit margins could experience a further attrition of profitability on every card-based transaction.

Dealing with chargebacks causes businesses to divert assets from their primary business focus.

An excessive incidence of chargebacks can result in termination of the merchant account, a severe loss to any merchant. Suspended merchant accounts due to excessive chargebacks are almost always impossible to restore. Even if a merchant maintains a chargeback rate below 1%, owners/employees still have to defer time and resources from ongoing business in order to provide retrieval details and documents of proof requested by the processing bank. Time diverted from the primary business focus represents a loss that cannot be recovered.

Defining "Friendly Fraud"

A daunting challenge facing card-not-present merchants is the emergence of **friendly fraud** (aka *I didn't do it* or *It wasn't me chargeback*). Friendly fraud occurs when a cardholder makes a legitimate purchase either online or over the telephone, receives the goods or services, and then decides to chargeback the sale – claiming they did not authorize the transaction. Cardholders commit friendly fraud for a variety of reasons:

- To get something for nothing (purely theft)
- To reduce their account balance
- Because they are unable to make the minimum end-of-month payment on their account

"Friendly fraud" is a criminal act perpetrated against the merchant by exploiting the chargeback system.

Clearly, there is nothing "friendly" about friendly fraud. "Friendly fraud" is an industry term which refers to the act of a "customer" (cardholder) who makes a purchase with their own credit card, receives the merchandise, and subsequently files for a chargeback. This, simply put, involves dishonest people (criminals) who abuse a system designed for their protection so they can keep merchandise without having paid for it.

"Friendly fraud": A threat difficult to defend against within chargeback protocols.

Because issuing banks have facilitated the chargeback process for the benefit of cardholders, the incidence of friendly fraud has increased dramatically. Friendly fraud is a huge problem for merchants because the transactions in question have been authorized and are legitimate, and proving a cardholder has been untruthful can be very difficult. The dispute becomes the cardholder's word against that of the merchant. In most cases the issuing bank champions its cardholder, and the merchant is forced to absorb the loss of the goods or services, chargeback fees, and the cost of disputing the chargeback.

Reasons for Chargebacks

Merchants should be aware of the most common reasons for chargebacks. Occasionally, chargebacks are received by merchants due to faulty cards used in the payment process – errors beyond the merchant's control. However, most chargebacks are initiated by cardholders, primarily due to inconsistencies in their credit card statements. There are four primary reasons for chargebacks.

Fraudulent transactions

The most common assertion for chargeback is fraud. This happens when the credit card is used without the authorization and consent of the cardholder. In cases like these, the merchant is held solely responsible.

Reasons for Chargebacks (Continued)

Credit not processed
Another common chargeback occurs when the customer returns the merchandise to the merchant (e.g. when the cardholder receives an item different from what he expected), requests their money back, but said credit is not posted to their account. In these situations, merchants are held liable for the charges.

Item not received
This is one of the most common reasons for chargebacks. This happens when the customer did not receive the item they paid for by credit card. The merchant is charged accordingly.

Technical problems
Some chargeback requests are manifest in technical problems experienced during the payment processes. Technical problems between the issuing bank and the merchant may lead to cardholders being charged twice for the same transaction. Problems with the authorization process can also lead to account being charged, even if the transaction was declined.

An Issue of Liability

Follow protocols to avoid the liability of card-present fraudulent transactions.

Fraud: Card-present transactions
In most cases, the card association assumes the direct monetary cost of a fraudulent transaction. Nevertheless, the merchant will absorb ancillary costs attributable to the fraud:

- Costs to process and ship the order
- Expenses associated with the chargeback response
- Chargeback fees

Card-not-present fraud results in merchant losses nearly 100% of the time.

Fraud: Card-not-present transactions
Generally, a merchant account agreement specifies that the merchant is 100% liable for any type of online fraud, suffering the full brunt of the fraudulent losses, including:

- Loss of the products sold to the fraudster
- All expenses associated with processing and shipping
- Chargeback fees

An Issue of Liability (Continued)

Chargebacks

Unless the merchant can resolve the dispute, the merchant may experience the physical loss of goods and/or services associated with the transaction. Additional expenses associated with chargebacks may include:

- All expenses associated with processing and shipping
- Chargeback fees
- Cumulative impact of chargebacks, which can produce higher fees, increased deposits and monitoring, and the possibility of forfeiting card processing eligibility (merchants labeled "high risk" are often forced to pay more basis points on each processed order)

Use your best efforts to minimize chargebacks and risk of being categorized as a high risk merchant, a potentially debilitating label.

Card associations have responded to the increase in chargeback frequency by establishing punitive performance standards for merchants. These thresholds are based on the percentage of orders that result in chargebacks in conjunction with the total transaction dollars processed. Generally, thresholds currently stand at 1% of total monthly transactions or 2.5% of total dollar volume. In addition to traditional fees, chargeback frequency can increase the basis points the merchant pays his processor on each order. The effects of being branded a "high risk" merchant can be devastating, including constricted profit margins to nominal levels. Merchants should be highly motivated to control their fraud exposure and incidence of chargebacks.

Swipe Thru Versus Internet

Card-present *(Traditional or store-front retailers)*

Traditionally, a retailer maintains a physical presence – a store – where customers visit to make purchases. A transaction is initiated when:

- The customer presents their charge card for a purchase
- The card is swiped through an electronic terminal
- A charge slip is generated, which the customer signs

Follow protocols and add other measures to virtually eliminate card-present fraudulent transactions.

The prudent merchant can afford herself additional protection by asking the customer for personal identification such as a driver's license. The merchant can then record the license number on the charge slip, thereby reinforcing that the customer did in fact initiate the purchase transaction.

In most cases, the merchant will receive a transaction authorization number. Realistically, this is more procedural in that it establishes only that the card was not reported stolen or lost at the time of the purchase.

Swipe Thru Versus Internet (Continued)

Card-not-present transactions are inarguably the riskiest. You must decide: Does the reward outweigh the risk of such business?

Because of the forgoing transaction proof, card-present merchants typically pay lower transaction rates because they are considered to be less susceptible to fraudulent claims. Should a dispute arise, card-present retailers are also afforded greater protection throughout the dispute process.

Card-not-present *(Internet and mail order retailers)*
Unfortunately, Internet and mail order merchants are far less insulated from fraudulent claims. In fact, all a customer needs to assert is: I do not remember ordering anything from this merchant. This is the type of dispute generated when the customer receives their bill and sees the unknown charge on the statement. Such a transaction dispute is called a chargeback. Notification of the chargeback to the merchant is normally accompanied by a retrieval request.

Retrieval Request Procedure

The retrieval request procedure is initiated when a cardholder or a credit card institution disputes or questions a transaction. The retrieval request is normally accompanied by information referencing the particular transaction being disputed:

- The cardholder's account number
- Date of the transaction
- Amount of the sale
- A reference number

Simple fact: Ignore a retrieval request and you will lose — they manifest serious consequences.

Retrieval requests are considered crucial. Merchants must fulfill such requests within prescribed time constraints, usually ten days. If the merchant fails to respond or responds beyond prescribed time constraints, the chargeback will be granted to the cardholder, with additional fees charged to the merchant. There is no recourse available for merchants who fail to respond in a timely manner.

The merchant is required to provide a valid and legible copy of the transaction receipt plus any relevant documentation, such as a rental contract, which proves that the transaction occurred. For this reason, merchants are required to archive their card receipts for an extended duration following the transaction:

- **Visa:** at least three years
- **MasterCard:** at least 180 days

Retrieval Request Procedure (Continued)

The merchant's response to a retrieval request must also contain:

- Cardholder's name
- Card number
- Transaction date
- Total transaction amount
- Transaction or authorization number
- Merchant name and location
- Cardholder's signature, if available

Online merchant exposure

Unfortunately, most Internet-based transactions lack a signed charge slip. Most internet orders are received by the merchant via phone, fax, email, or through an online credit card platform. Emails are not considered a signed charge slip even if they are received from an account belonging to the cardholder. As a consequence, the online merchant will lose the preponderance of retrieval requests due to insufficient documentation bearing the charge with the cardholder's signature.

> The online merchant loses the preponderance of retrieval requests due to insufficient documentation proving the legitimacy of the transaction in dispute.

Having proof of delivery from the post office or UPS does not nullify the problem. The cardholder need only to assert that delivery was made of goods that he or she never ordered — that they unknowingly signed for the package and subsequently discarded the goods. In the case of a delivery to a business address, it is likely that a person other than the cardholder would sign for the goods, effectively defeating the purpose of the signed receipt process for the merchant. If the cardholder claims they never ordered the goods there is no obligation whatsoever for the cardholder to retain the goods and/ or return them. The cardholder does not have to explain or provide any explanations as to how the merchant obtained their credit card information.