THE CHARGEBACK TRIANGLE

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FOREWORD

This original report, sponsored by Verifi, Inc., examines the near- and long-term effects that chargebacks have on each party to a retail transaction, along with the opportunities that exist to streamline the chargeback process or even avoid chargebacks altogether.

This research report was independently produced by Javelin Strategy & Research. Javelin Strategy & Research maintains complete independence in its data collection, findings, and analysis.

OVERVIEW

Chargebacks were a $31 billion problem in 2017 — a burden that extends far beyond the liability for disputed transactions. Complying with complex and arcane rules that vary across networks and transaction types shoulders merchants with a tremendous financial burden. Short deadlines challenge merchants' ability to gather documentation and assess the best disputes to fight. Issuers face pressure to give credence to all cardholder disputes or risk running afoul of regulators. For both parties, alienating customers by making them jump through hoops or saddling them with the cost of a disputed transaction can jeopardize future business. On top of these challenges, merchants and issuers must balance the need to please their customers with minimizing the risk of "friendly fraud": disputes fraudulently filed by the individual who made the purchase.

Addressing the challenge of chargebacks requires coordinated effort among the three primary parties in the dispute: the merchant, the issuer, and the customer, creating the chargeback triangle. Greater collaboration between issuers and merchants can help preempt chargebacks and eliminate the burden of a formal dispute process. Victory is measured not only by avoiding financial liability for the transaction but also by securing the relationship with the customer who is disputing the transaction.

This study examines the experiences and perspectives of consumers, issuers, and merchants as they relate to chargebacks, so as to illuminate ways to reduce costs and bolster customer satisfaction during a dispute and any chargeback attempt that might follow.

EXECUTIVE SUMMARY

Key Findings

Chargebacks were a $31 billion problem in 2017, and merchants bore nearly two-thirds of the cost. In 2017, chargebacks cost issuers and merchants more than $31 billion, which represents less than half of 1% of all U.S. retail sales. Those costs aren't evenly distributed, nor are all costs easily measured. Of the billions spent on chargebacks, two-thirds is being borne by merchants ($19 billion), while issuers were stuck with significantly less ($12 billion).

Of the $12 billion in costs that issuers incur, the vast majority is from liability. Combined liability for credit, debit, and prepaid card chargebacks account for $7.1 billion, or just more than 60% of total issuer chargeback costs. In contrast, combined management costs — personnel, technology, and outsourcing — accounted for $2.4 billion, or 20% of issuer chargeback losses. Much of this can be traced back to issuers' legal responsibility to protect consumers' rights for disputing a charge. Rather than risk the ire of regulators, issuers will accept losses on potentially frivolous chargebacks.

Merchants are saddled with more responsibility and the resulting costs. While issuers generally do not require any evidence besides a cardholder's assertion to charge back a transaction, merchants bear a significantly greater logistical burden. Before the merchant can even determine which chargebacks it has a reasonable chance at representing, it must assess the transaction's legitimacy in the limited time provided by the chargeback dispute process. Consequently, 60% of merchants' chargeback-related costs arise from chargeback management expenditures, rather than from liability.

Managing timelines can cost merchants. Effectively managing chargeback disputes requires that merchants obtain documentation to assess the legitimacy of the disputed transaction, including internal data on the customer and third-party information such as delivery records. Obtaining that documentation in a timely manner can be a significant impediment for merchants. Technology silos within organizations prevent visibility between systems, and decisions are made without the benefit of seeing all of the data.

For every dollar disputed, merchants and issuers incur $1.50 more in costs. When these costs are examined in greater detail, it becomes apparent that the cost of managing the chargeback process frequently exceeds the value of the product or service being disputed. For every dollar in disputed transactions, an additional $1.50 is spent on fees, management expenses — including technology and outsourcing — and personnel.

Consumers entirely bypass the merchant in three-quarters of fraud-related disputes. Merchants face a great challenge in getting customers to reach out to them in cases of suspected fraud: Cardholders bypassed merchants and went directly to their issuer in 76% of cases. However, merchants are more effective at engaging with cardholders when there are problems with the delivery of a good or service.

Poor communication can cost merchants. Unrecognized transactions are second only to fraud in causing consumers to dispute charges with their issuer. Although in many cases these might actually be fraud, unrecognized charges can also arise from unclear payment descriptors: the business information that appears on a customer's bank statement. If consumers cannot effectively link a transaction to the business where it occurred, it is nearly impossible for them to question the transaction without disputing it with their issuer.

Regardless of whether a dispute is related to fraud, consumers generally hold merchants most responsible. Consumers overwhelmingly perceive merchants to be responsible for the issues they experience with a transaction — more than half for a fraud dispute (56%) and two-thirds for non-fraud disputes. The resulting animus might be driving consumers to seek resolution that is especially damaging to merchants, or it might partially be a function of where they first seek to find resolution.

Merchants suffer more customer attrition from chargebacks than issuers do from disputes. Although both merchants and issuers bear the risk of losing future business following a dispute or chargeback, at merchants that track post-chargeback activity, 63% of consumers decrease their patronage. This is significantly higher than the decline in card usage experienced by issuers, even when cardholders don't get their money back after a dispute: 43% for fraud disputes and 39% for non-fraud disputes.

More challenging dispute processes strongly affect customers' willingness to continue patronizing an organization. Unsurprisingly, when disputes are resolved after a single call, consumers report minimal changes to their financial behaviors: 81% report no change in their card usage, and 64% report no change in their willingness to shop at the merchant where the dispute occurred. When the dispute took four calls to resolve, 54% of consumers reported that they either decreased or stopped use of the affected card entirely, and 63% reduced or stopped their patronage of the merchant.

Issuers and merchants are placed in a bind in prioritizing the disputes and chargebacks they actively manage. These organizations can either deploy simple rules-based approaches, such as value thresholds, which potentially miss significant opportunities, or they can invest in the personnel and resources needed to investigate these transactions. In doing the latter, they risk wasting expensive resources on every dispute or chargeback that is not successfully pursued. It is unsurprising, then, that merchants consider assessing the relative value of fighting a chargeback among the top challenges they face in dealing with these transactions.

Both merchants and issuers broadly agree that it has become too easy for consumers to dispute transactions. More than half (53%) of issuers and 72% of merchants believe that it is too easy for customers to dispute transactions. By lowering the barriers to initiate a dispute, these organizations might be contributing to a growing risk of "friendly fraud": legitimate transactions that a customer later disputes in order to avoid making payment.

Nearly half of the chargebacks experienced by in-app digital goods merchants are thought to be the result of friendly fraud. Friendly fraud is especially challenging for merchants who offer purchases only in digital (or remote) channels, where friendly fraud is 34% more prevalent than for physical-channel merchants. In a way, digital channels make customers nearly anonymous: They are put in a position where they don't have to explain anything to a merchant face-to-face, which makes acting on scenarios like buyer's remorse easier. Along those same lines, it can be difficult to determine who actually consumed something like a digital good, allowing the customer to claim that it was a child, or that she simply cannot attribute it to anyone and so therefore it must be fraud.

Assessing friendly fraud risk can be a challenge for issuers. While issuers claim to experience only half the rate of friendly fraud that merchants see (17% compared to 34%), this disagreement might arise from lack of visibility, rather than actual differences in friendly fraud rates. Except in the most obvious cases of customers repeatedly trying to abuse the dispute process, financial institutions are unlikely to be able to identify chargebacks as friendly fraud until the chargeback process has run its course and the chargeback is resolved in favor of the merchant.

Transaction disputes are common among consumers, but many could be resolved without a formal chargeback. Nearly half (45%) of all consumers have disputed at least one transaction within the past year, and 25% have disputed more than one. Problems with the delivery of goods and services, including non-receipt of goods and receiving the incorrect item, are the most common reasons for disputed transactions, and these are often resolvable directly with merchants.

Issuers are motivated to quickly settle disputes to preserve top-of-wallet status. For cardholders with accounts at multiple issuers, switching primary cards is as easy as moving one to the back of the wallet. Although consumers might be inclined to place most of the blame for disputed transactions on the merchant where the transaction occurred, drawn-out resolution processes shift more of that blame to the issuer.

Providing a refund on a disputed transaction can build cardholder loyalty. For disputes initiated with issuers where the full value of the dispute was not refunded, cardholders were notably more likely to reduce usage of the card. In stark contrast, when the full value was refunded, not only did the dispute not reduce card usage, for more than a third of accountholders, usage significantly increased for both fraud-related (36%) and non-fraud (38%) chargebacks.

Some issuers with a lack of adequate reporting might be exposing themselves to unnecessarily high levels of friendly fraud. Nearly a quarter of financial institutions report that they do not track the number of transactions disputed by each accountholder, leaving them vulnerable to friendly fraud perpetrated by individuals seeking to game the system. Among issuers who do not track serial disputers, the most prevalent rationale is that they do not wish to inconvenience customers with the follow-up tracking that the process entails; 44% of issuers who do not track customer chargeback frequency cite this as their reason for not doing so.

Lack of transparency in the chargeback process imposes unnecessary costs on merchants. Nearly a fifth of merchants (18%)

are unable to effectively identify the reasons that their chargeback representments fail because the reasons are not made clear to them either by their processor or the card network. An additional seventh of merchants (14%) indicated that the complexity of the rules for submission was among the most significant reasons for their representments' failing.

In more than 8 in 10 cases, contacting the merchant first prevents a chargeback. When merchants are contacted by the cardholder about an issue before initiating a dispute, they report nearly overwhelming success in preventing the issue from becoming a chargeback. Only 16% of cases where accountholders reached out to the merchant first to resolve the dispute ultimately resulted in a chargeback being filed with the issuer.

Recommendations

Support information-sharing to streamline dispute and chargeback processes. Greater information-sharing can help merchants and issuers know which disputes are worth pursuing, enabling both to move beyond simplistic heuristics such as transaction size to more effectively deploy their resources. Merchants in particular can benefit from reduced investments in manual processes, and issuers can take advantage of this information-sharing to help get ahead of cardholders who might be, or could eventually end up, abusing the dispute function.

In non-fraud disputes, direct customers to merchants. When disputes arise from issues with the good or service, issuers can save themselves and merchants the labor and fees involved in remediating a chargeback by routing cardholder disputes to the merchant. Obviously, some disputes will still require the full chargeback process, such as true cases of fraud that slipped past online merchants' fraud detection systems.

Merchants should positively engage with customers even after a chargeback. Bolstering the perception that a merchant is acting in the best interests of a customer — even one that is unhappy with a product or service and has pursued a dispute — needs to be a priority for merchants because their relationships with customers are most likely to suffer. This includes even going so far as recognizing their role in returning the funds to a customer's account after a dispute.

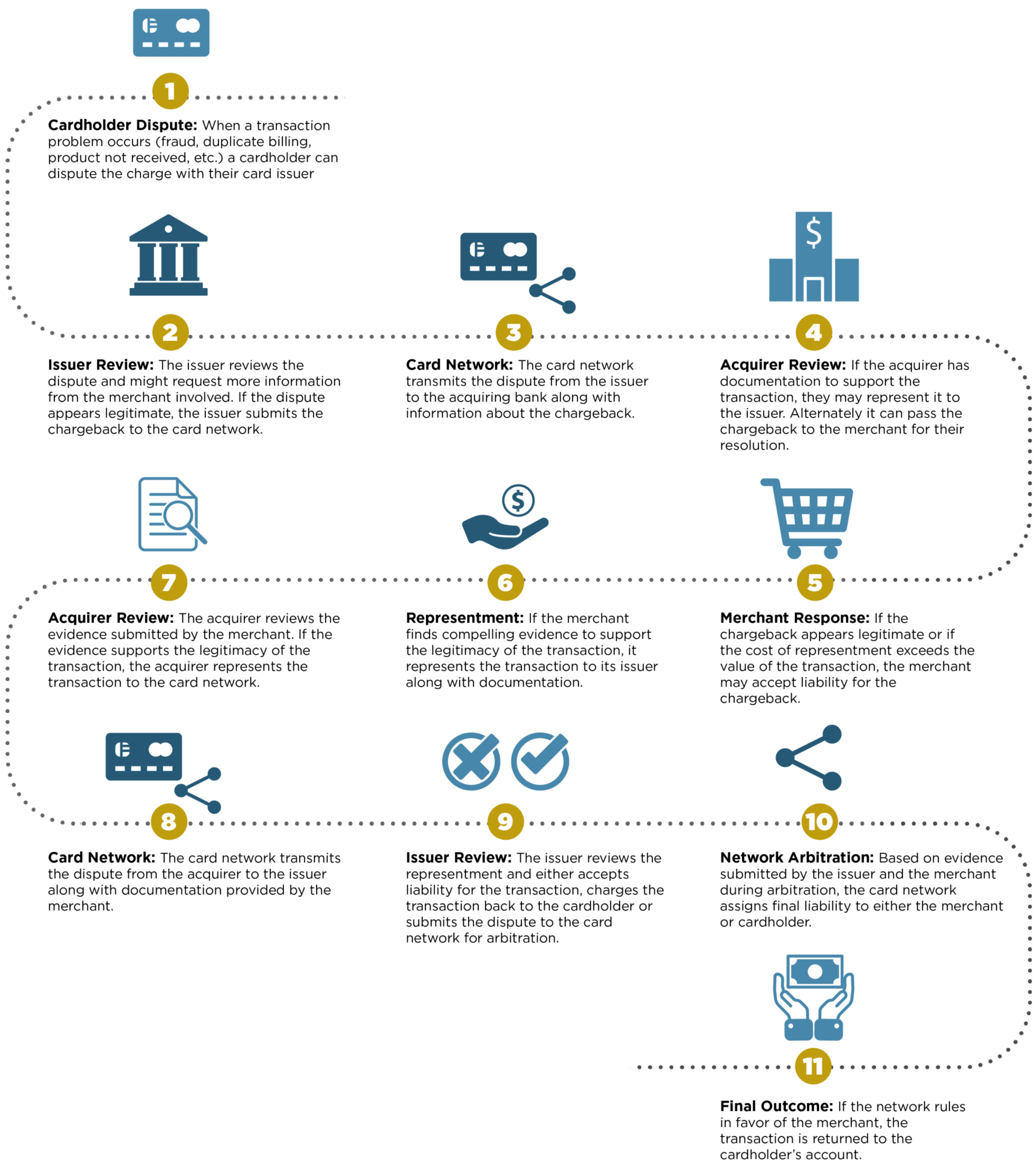
Issuers should capture dispute reasons online before routing the customer to customer service. Triaging transaction disputes by asking the customer to identify the reasons for disputing the transaction through online or mobile banking can reduce the burden of disputes on the call center by allowing customer service representatives to focus their time on resolving the dispute, rather than simply gathering facts. In some cases, identifying that the dispute arises from a problem with the way a good or service was delivered can enable an issuer to remediate the dispute without even directing the customer to a call center. Providing the cardholder with additional information about the transaction could remind a customer that he was responsible for the transaction, or he could be rerouted to a merchant first.

Provide the capability of informing a customer of where a dispute stands, but don't require constant phone interaction from them. For issuers, providing a ready way for a customer to understand where his dispute is in the resolution process — such as by tracking it within an app or through email — can help cut down on unnecessary calls to customer service, whether to an issuer or merchant. At the same time, the more calls a customer has to make as part of the dispute process, the greater the chance that she will do business elsewhere in the future.

Track the rate at which individual customers dispute transactions. Issuers and merchants can choose how to react based on their distinct approaches to customer service, but without information on whether customers are gaming the system, they leave themselves exposed to an unnecessarily high degree of friendly fraud risk and cannot expect to institute effective controls based on such a phenomenon.

CHARGEBACK LIFECYCLE OVERVIEW

Figure 1: Simplified Chargeback Flow



Source: Javelin Strategy & Research, 2018

When a consumer has a problem with a transaction, she can choose to address that issue either with the merchant where the transaction occurred or with the card issuer (Figure 1). The problem will become a chargeback only if she decides to dispute the transaction with her issuer. For the initial dispute, there is essentially no burden on the cardholder to substantiate her claim beyond specifying the reason for the dispute. Consumer protection laws provide the rights to dispute a charge within specific parameters.

Broadly speaking, chargeback causes can be divided into four categories:

- A problem with the good or service (e.g., the ordered product was not received or arrived damaged, or the product or service was not as described)
- Billing errors (e.g., the cardholder was billed multiple times for the same transaction or was billed an incorrect amount)
- Processing errors (e.g., late presentment, expired card, etc.)
- Unauthorized or unrecognized transactions (e.g., fraud)

Once the dispute is filed with the issuer, the issuer has a few decisions to make. First, it must decide whether the cardholder dispute appears to be within the parameters allowed under law or network rules or requires further scrutiny. In making this decision, the issuer may consider whether the account has a history of making questionable disputes or whether there are any suspicious indicators associated with the account. Some disputes require additional contact with the consumer to obtain more information.

If the issuer determines that more information is required, it may file a retrieval request: a request for a copy of the original sales draft from the merchant. Failure to provide this information can result in the merchant's forfeiting its right to represent the transaction if it subsequently becomes a chargeback.

If the dispute appears legitimate or sufficiently low-risk, the issuer can provide a refund for the value of the transaction — known as a provisional credit — before deciding whether to proceed with a full chargeback. If the value of the disputed transaction is low enough that the cost of processing the chargeback would likely exceed the value of the transaction, the issuer may simply decide to write off the transaction and accept the loss, reimbursing the accountholder without filing a formal chargeback. Regulatory requirements place strong pressure on issuers to refund consumers' disputes for any potentially fraudulent transaction, so issuers are unlikely to refuse to process a dispute for a cardholder except in the most transparent cases of accountholders trying to abuse the dispute process.

If the issuer does not decide to unconditionally reimburse the cardholder, it may decide to issue a provisional credit for the amount of the disputed transaction. If the resolution process is expected to take an excessively long time (5, 10, or 20 days, depending on the type of account and transaction), the issuer may be required to issue provisional credit, along with a written notice of the terms of the credit.[1] In the event that the chargeback is not substantiated, the cardholder is not reimbursed and will be notified of the reason for the decision.

Should the issuer decide to proceed with the chargeback, the transaction is submitted to the payment network, which then directs the chargeback to the merchant's acquiring bank. The acquiring bank may directly represent the chargeback to the issuer if the acquirer has sufficient documentation to support the legitimacy of the transaction. Alternatively, the acquirer may decide the chargeback is valid and deduct the funds from the merchant's account or pass the chargeback along to the merchant for its review.

Once the merchant receives the chargeback, it has the option of representing the dispute with supporting evidence documenting the legitimacy of the purchase. The type of supporting evidence required will depend on the nature of the chargeback. If the cardholder alleges that the product was never received, the merchant may submit documentation from the shipping company that the package was delivered intact. For purported fraud, the merchant may submit details around the user's account activity, including evidence that the IP address, email address, and physical address had previously been associated with valid purchases.

If the merchant is unable to find sufficient compelling evidence, determines that it was itself at fault for the error resulting in the chargeback, or finds that the cost of representment would exceed the value of the transaction, the merchant accepts the chargeback, and the funds are deducted from its account, along with any applicable fees.

After the merchant represents the transaction, the acquirer reviews the representment with the merchant's documentation and either submits the transaction to the issuer through the network if the evidence supports the legitimacy of the transaction or ends the representment and assigns liability to the merchant.

Once the represented transaction is received by the issuer, the issuer may either accept liability for the transaction, including any fees associated with the chargeback and representment, or submit the chargeback for arbitration with the card network, which reviews the relevant documentation and assigns final liability for the transaction to either the cardholder or the merchant.

Visa Claims Resolution Initiative

In April 2018, Visa is scheduled to complete the rollout of its Visa Claims Resolution (VCR) initiative, an effort to streamline and expedite the chargeback process.[2] The new system automates many aspects of the dispute process, including eliminating invalid disputes where possible, screening chargebacks submitted through the process to ensure that they meet the necessary criteria for the dispute category.

Visa estimates that the VCR initiative will reduce the duration of the dispute resolution process to 31 days from its current average of 46.

Additionally, the VCR initiative will consolidate the chargeback reason codes into fraud (code 10), authorization (11), processing errors (12), and consumer disputes (13), reducing the complexity of the dispute process.

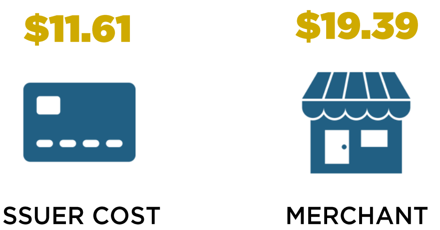
THE COST OF CHARGEBACKS IN 2017

A common measure of success for any business is profitability. For issuers and merchants alike, managing chargebacks can lead to significant but avoidable costs — anathema to success. This is especially true because spending on chargebacks undermines the ability of these organizations to deploy capital to areas of their businesses that could enhance growth, whether that be customer service, marketing, product development, or sales. Chargebacks have a cumulative negative effect on businesses in these two industries and the economy as a whole.

In 2017, chargebacks cost issuers and merchants more than $31 billion, but those costs aren't evenly distributed, nor are all costs easily measured (Figure 2). Of the billions spent on chargebacks, two-thirds of the burden is being borne by merchants. And although the amount lost to chargebacks represents less than half of 1% of all U.S. retail sales (about $5 trillion), there are costs that are less immediately tangible that issuers and merchants must also contend with, specifically those resulting from the loss of customers who choose to do business elsewhere after a dispute (see *Consumers*, Page 21).[3]

Merchants Sustain Two-Thirds of the Total Cost of Chargebacks

Figure 2: Total Chargeback Costs, in Billions of Dollars

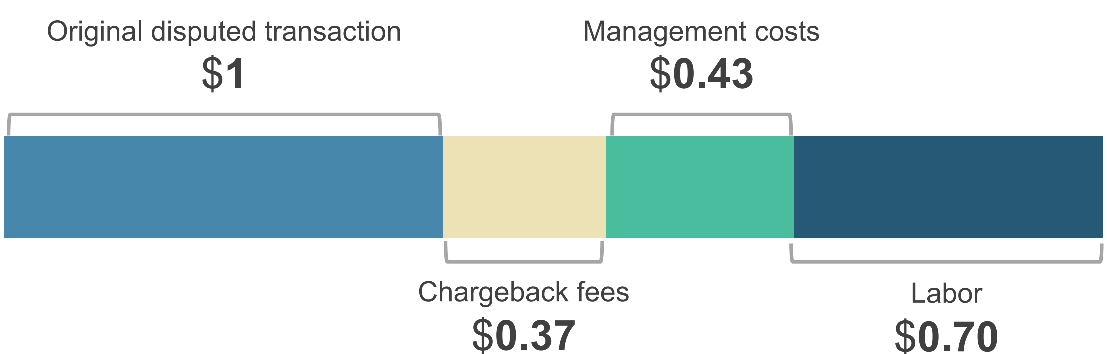


Source: Javelin Strategy & Research, 2018

When these costs are examined in greater detail, what becomes apparent is that it isn't the value of the product or service being disputed but rather the management costs that are the larger concern. For every dollar in disputed transactions, an additional $1.50 is spent on fees, management expenses — including technology and outsourcing — and personnel (Figure 3). This should factor into the calculus of the decisions of any issuer or merchant when considering how it is going to handle a disputed transaction or chargeback. The ultimate question each party needs to answer here is whether the potential follow-on costs of its current means of managing these transactions bring an appropriate return on investment.

Aggregate Chargeback Management Costs Dwarf the Transaction Value

Figure 3: Breakdown of Overall Chargeback Costs



Source: Javelin Strategy & Research, 2018

CHALLENGES, DISCONNECTS, AND OPPORTUNITIES

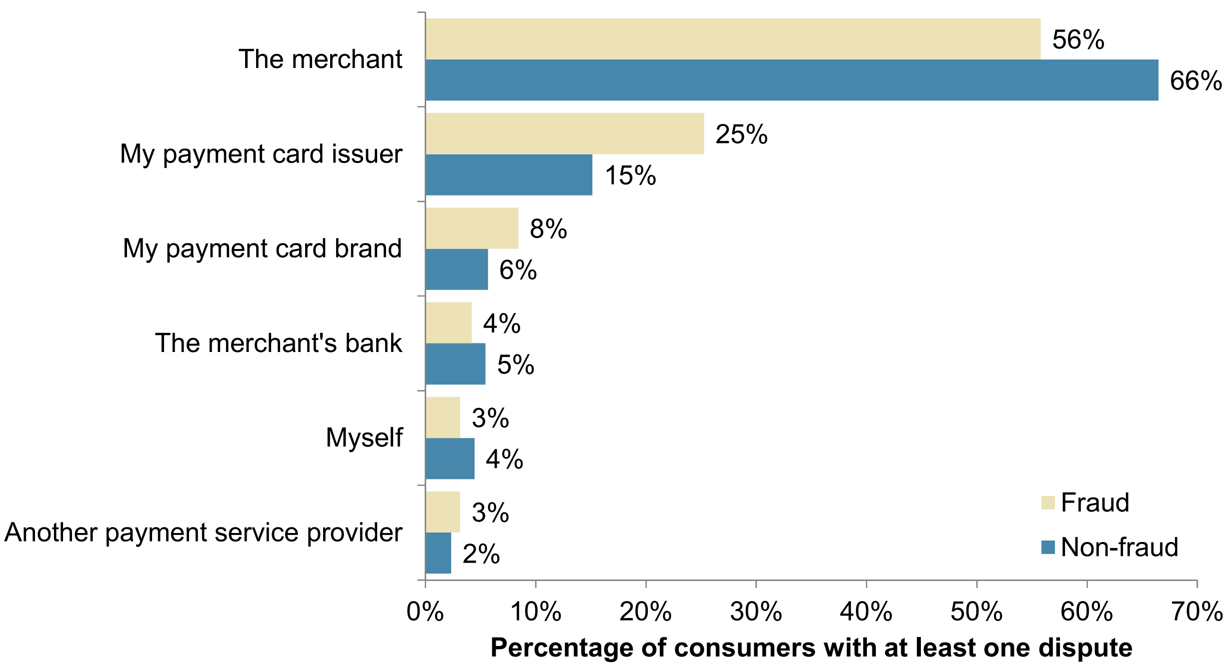
Each party to a disputed transaction has its own set of considerations, and this inevitably leads to conflict. Understanding where consumers, issuers, and merchants might have motivations or perceptions that could create tension is critical to optimizing the chargeback process for all. By recognizing areas of disagreement, issuers and merchants can adjust their strategies — and even partner together –– to better align their procedures, reducing unnecessary processes and the subsequent financial costs and negative experiences for consumers.

Navigating the Effects of Perceived Responsibility

Consumers overwhelmingly blame merchants for problems with a transaction. The resulting animus can compel them to seek resolution that is especially damaging to merchants, or the ill will might even be a function of where they first sought resolution. When disputing a transaction, consumers often bypass the merchant and work directly with their issuer, even when the problem would be more quickly and cheaply resolved by dealing directly with the merchant (Figure 4).

When Transactions Go Wrong, Consumers Most Often Blame the Merchant

Figure 4: Who Consumers Blame for Problem Transactions, by Type of Dispute



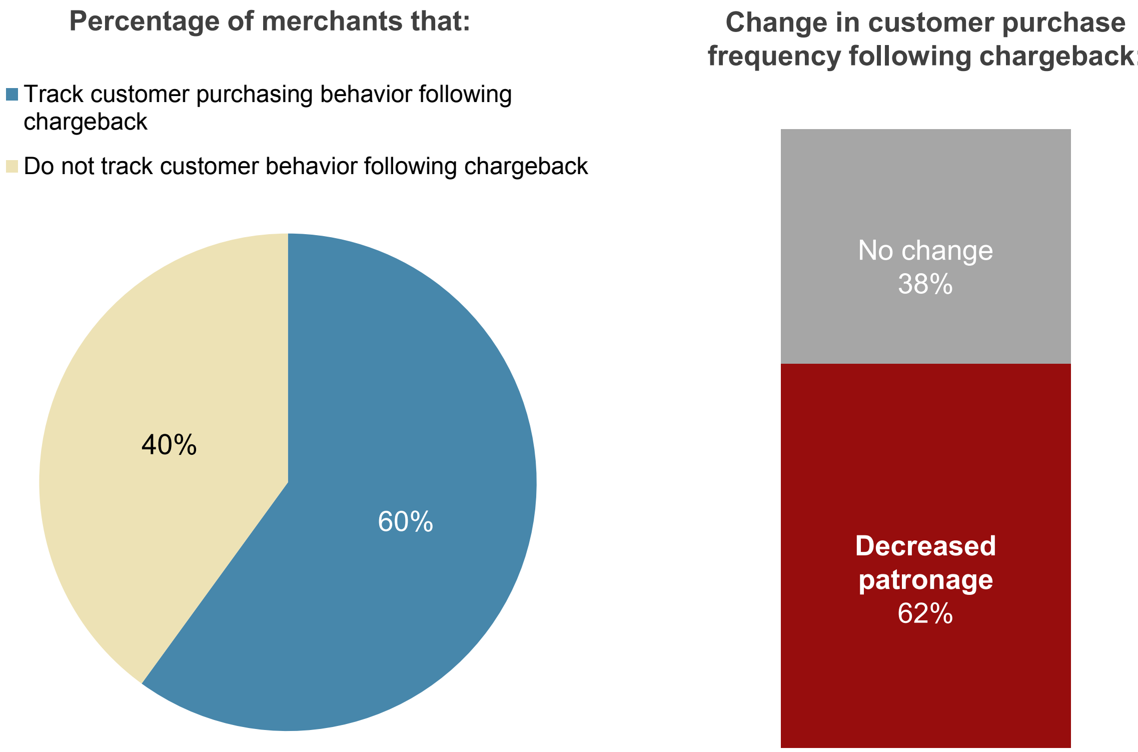
Source: Javelin Strategy & Research, 2018

Redirecting consumers before they contact an issuer about a disputed charge needs to be a priority for merchants because they have the most to lose. First, merchants are much more likely to lose the patronage of a customer following a chargeback than are issuers. Among merchants that track post-chargeback activity, 62% of consumers decrease their patronage — a challenge that issuers face far less frequently, even when cardholders don't get their money back after a dispute (Figure 5 and Figure 13). The process that issuers follow in responding to a cardholder's dispute indelibly affects the way the customer responds to the merchant after a chargeback. In addition, the loss of the customer relationship can be much more damaging on a transaction-by-transaction basis for a merchant than for an issuer because merchants generally lose more revenue per transaction than issuers, who take a relatively small slice through interchange fees, especially for debit card transactions since the Dodd-Frank Act of 2010.

For issuers, the financial liability of a cardholder for a disputed transaction is a key concern because of applicable regulations and the effects that the liability has on the customer experience. Issuers have to consider the implications of Federal Reserve Regulation E[4] and Regulation Z[5], which address the dispute rights of debit and credit cardholders, respectively. To avoid thorny questions related

Chargebacks Undermine Patronage of a Merchant More Than Half the Time

Figure 5: Change in Patronage of Merchants After a Chargeback



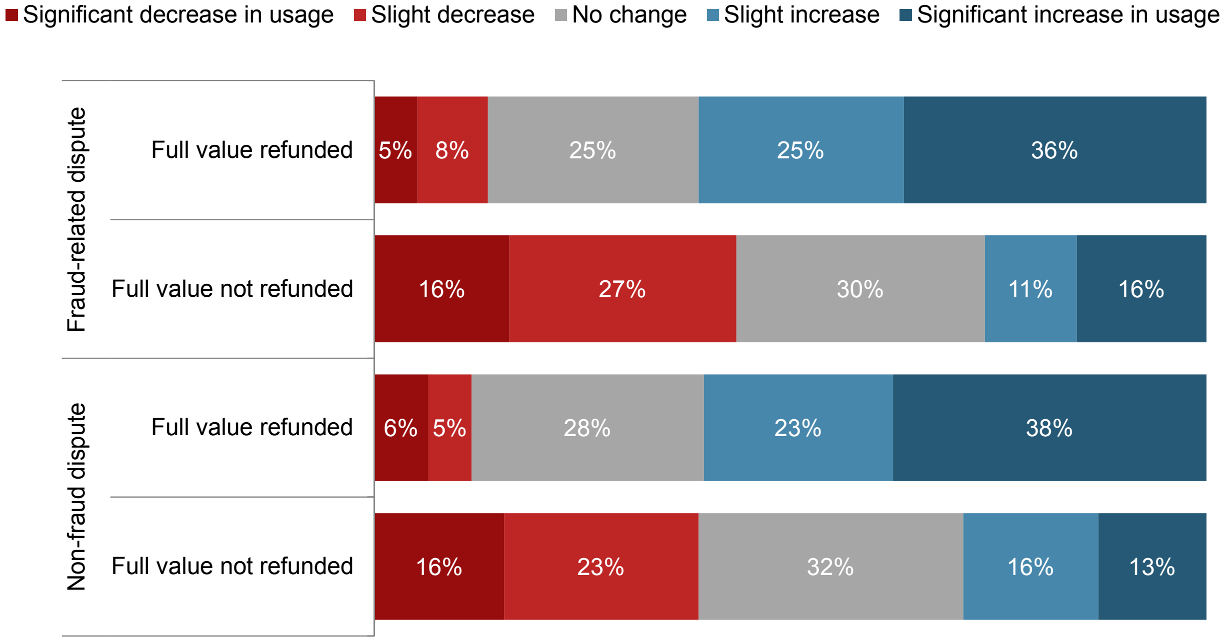
Source: Javelin Strategy & Research, 2018

to compliance with these regulations, an issuer who does not think a dispute is valid may still submit the transaction for chargeback to meet regulatory filing deadlines, issue a temporary credit, and work to ensure that the customer's right to dispute is protected (see Issuers, Page 25). This pushes the onus onto the merchant to respond and reduces the chance that the issuer needs to confront the customer. Having a lesser burden placed on the customer by the issuer can fuel a dynamic in which the issuer is more likely to be positioned as the benevolent party in the chargeback process.

Ensuring that the cardholder is made whole is a major deciding factor in whether a consumer will continue using the card after a dispute. This further motivates issuers to provide temporary credits and place the burden back on the merchant to prove a transaction was legitimate through the chargeback process. Consumers are generally willing to continue to use their card after a dispute as long as they are fully refunded for the transaction (Figure 6). In fact, for about a third of cardholders, use of the card notably increases, perhaps because the issuer demonstrates to the cardholder that it is looking out for the cardholder's best interests. This only furthers the notion that the issuer, which is the first organization the customer is likely to have contacted in the event of purported fraud, was the one responsible for putting money back into their pockets.

Failure to Receive Funds Back After a Dispute Undermines Top-of-Wallet Status

Figure 6: Change in Usage of Card After a Dispute



Source: Javelin Strategy & Research, 2018

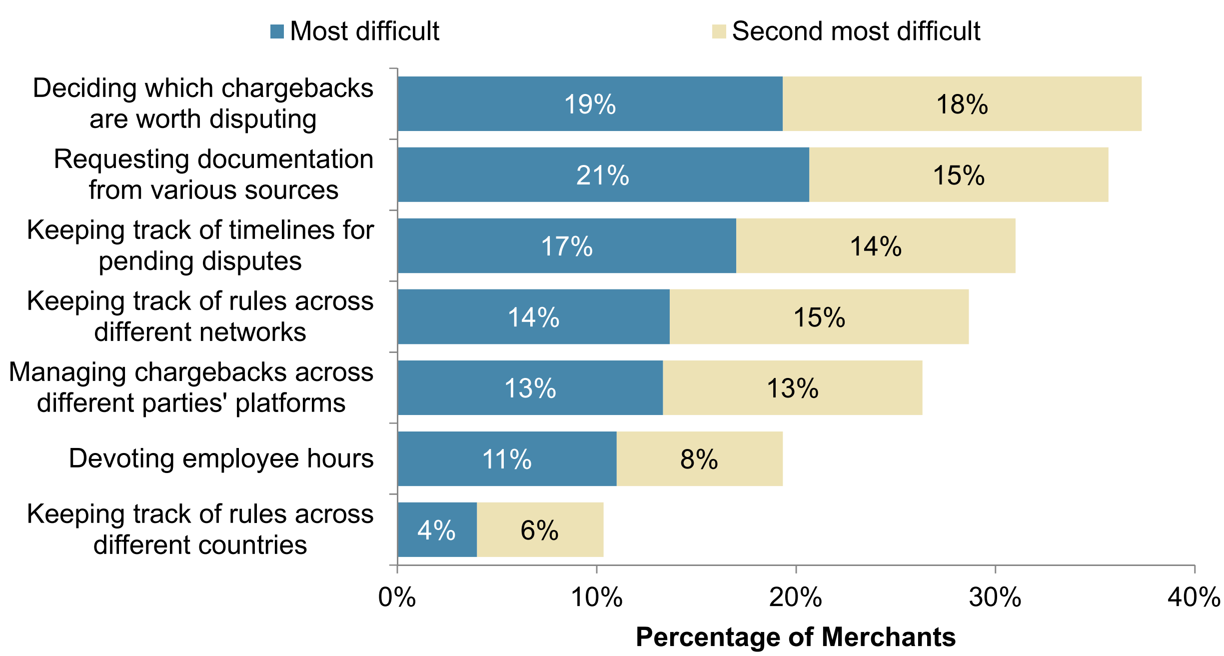
Choosing Which Chargebacks to Challenge

Issuers and merchants are placed in a bind in prioritizing the disputes and chargebacks that they actively manage. These organizations can either deploy simple rules-based approaches, such as value thresholds, which potentially miss significant opportunities, or they can invest in the personnel and resources needed to investigate these transactions. In doing the latter, they risk wasting expensive resources on every dispute or chargeback that is not successfully pursued. It is unsurprising, then, that merchants consider assessing the relative value of fighting a chargeback among the top challenges they face in dealing with these transactions (Figure 7).

Knowing which chargebacks are worth challenging is made easier when merchants have access to sufficient documentation from those transactions. Obtaining that documentation in a timely manner, though, can be a significant impediment for merchants. Technology barriers within organizations prevent visibility between systems, and decisions are made without all of the data being made available. Greater sharing of information can help merchants and issuers know which disputes are worth pursuing, enabling both to move beyond simplistic measures such as transaction size to more effectively deploy their resources. Issuers can also take advantage of this information-sharing to help get ahead of cardholders who might be, or could eventually end up, abusing the dispute function (see *What Is Fraud Among Friends*, Page 19).

Assessing ROI and Obtaining Documentation Top List of Merchant Challenges

Figure 7: Difficulties Merchants Face in Dealing With Chargebacks



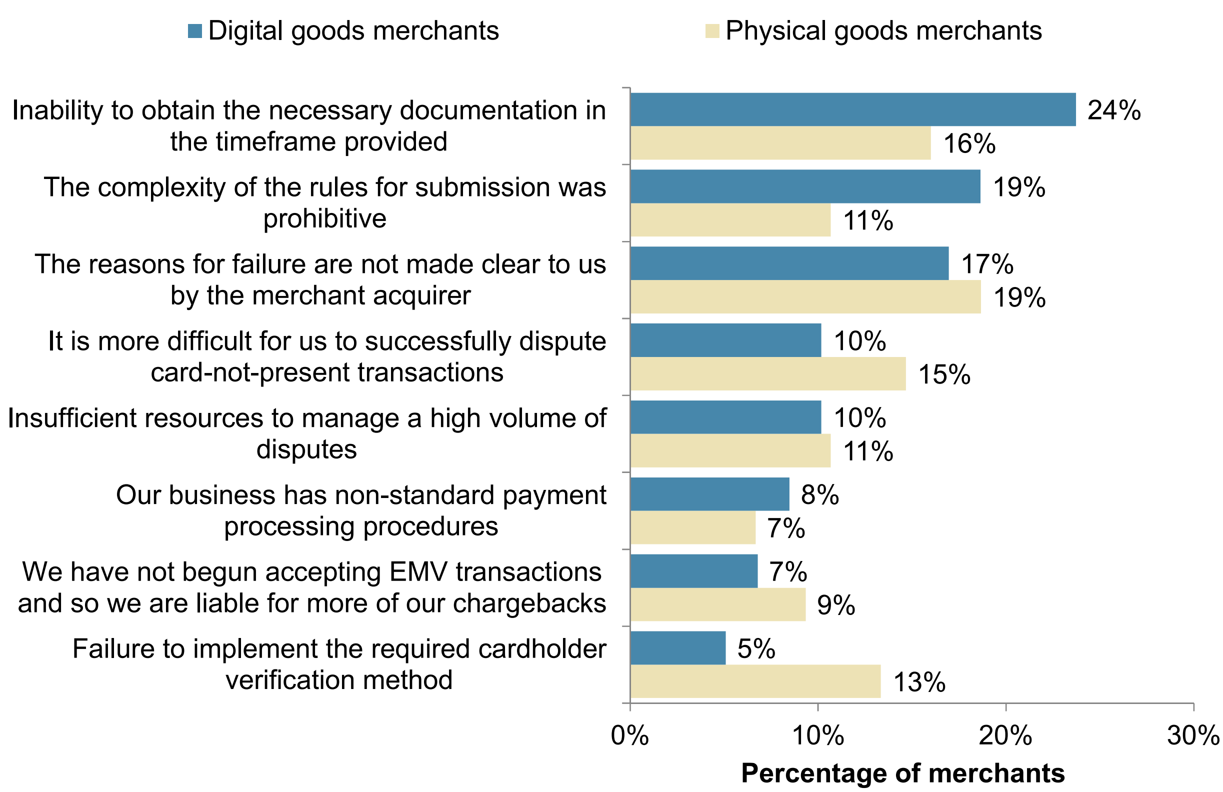
Source: Javelin Strategy & Research, 2018

Even once merchants have decided which chargebacks to dispute, an inability to find the appropriate documentation to successfully represent the transaction is a significant cause of failure of merchant disputes. This causes particular problems for merchants in emerging digital goods spaces, where network rules around compelling evidence are still catching up to the realities of online and mobile commerce. For transactions that occur entirely digitally, merchants often have to rely on identifiers such as email and IP addresses to establish that the customer in the disputed transaction is the one linked to the card account.

Just less than a quarter (24%) of merchants selling digital goods indicated that the inability to obtain the necessary documentation was the most common reason for their representment attempts' failing, compared with just 16% for merchants who solely sell physical goods (Figure 8).

Obtaining Documentation In the Allotted Time Challenges Merchants

Figure 8: Reasons That Disputes Fail for Digital and Physical Goods Merchants



Source: Javelin Strategy & Research, 2018

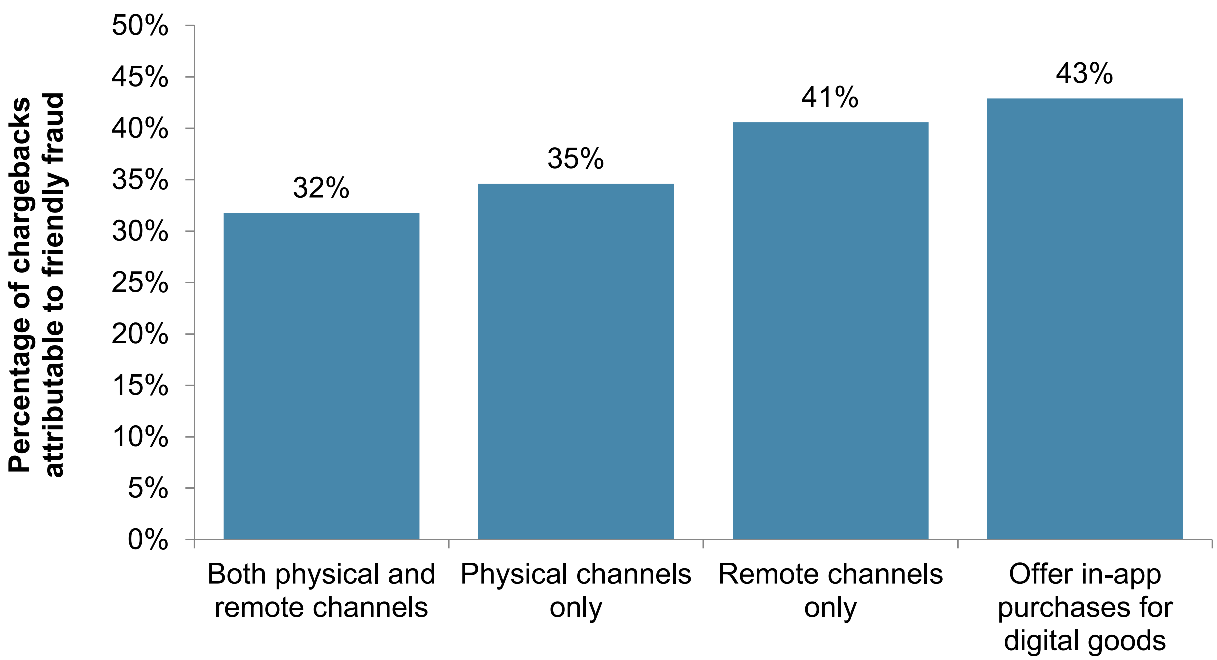
What Is Fraud Among Friends?

Both merchants and issuers broadly agree that it has become too easy for consumers to dispute transactions. The desire to automate functions to reduce costs and to increase the speed of resolution has enabled consumers to dispute transactions more easily. By lowering the barriers to initiating disputes, these organizations might be contributing to a growing risk of "friendly fraud." This is defined as legitimate transactions that a customer later disputes in order to avoid making payment. These can arise because of buyer's remorse, family members making unapproved purchases, a premeditated intention not to pay, or even a desire to cease doing business with a merchant without contacting the merchant directly (see *Issuers* and *Merchants* sections, pages 25 and 28). Merchants and issuers, though, have very different perspectives on just how pervasive the problem of friendly fraud really is.

Friendly fraud is especially challenging for merchants who offer purchases only in digital (or remote) channels. In a way, digital channels make customers nearly anonymous: They are in a position where they don't have to explain anything to a merchant face-to-face, which makes acting on scenarios such as buyer's remorse easier. Along those same lines, it can be difficult to determine who actually consumed a digital product, allowing the customer to claim that it was a child or that the customer simply cannot attribute it to anyone and it therefore must be fraud. The advent of an increasing number of digital

CNP Merchants Face 34% More Friendly Fraud Than Card-Present Merchants

Figure 9: Prevalence of Friendly Fraud by Merchant Channels



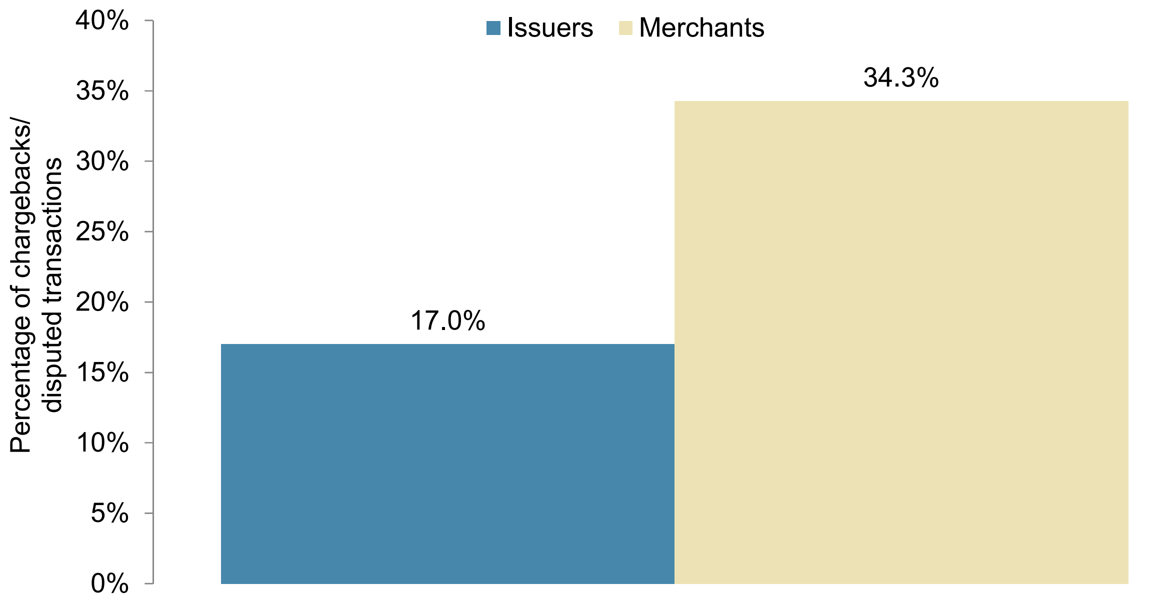
Source: Javelin Strategy & Research, 2018

subscription services has undoubtedly contributed to this trend as well, with some customers not remembering they had subscribed or simply forgetting to cancel and using the dispute function as a way to "roll back time" and obtain a refund without engaging with the merchant. In fact, merchants that offer in-app purchases for digital goods report that 43% of the chargebacks they face arise from friendly fraud (Figure 9).

Issuers, on the other hand, are far less skeptical of their customers' intentions than merchants. Merchants believe that 34.3% of their chargebacks arise from friendly fraud, while issuers see half that rate (17.0%) (Figure 10). With more information from the customers — who typically contact them first — issuers might be inclined to place more faith in customers who are disputing a transaction. In part because of regulatory requirements that direct issuers to ensure that cardholders are fully reimbursed for fraud that occurs on their account, issuers' customer service staffs are trained not to push back against customer dispute claims. In this environment, questioning the legitimacy of consumers' claims creates the risk of both damaging the cardholder relationship and attracting the ire of regulators. Conversely, merchants who are likely to have difficulty obtaining documentation and even engaging with these customers are understandably less able to discern the intention of the customer when confronted with a chargeback.

Skepticism of Fraud Disputes Runs Deeper Among Merchants Than Among Issuers

Figure 10: Prevalence of Friendly Fraud Among Merchants and Issuers



Source: Javelin Strategy & Research, 2018

CONSUMERS

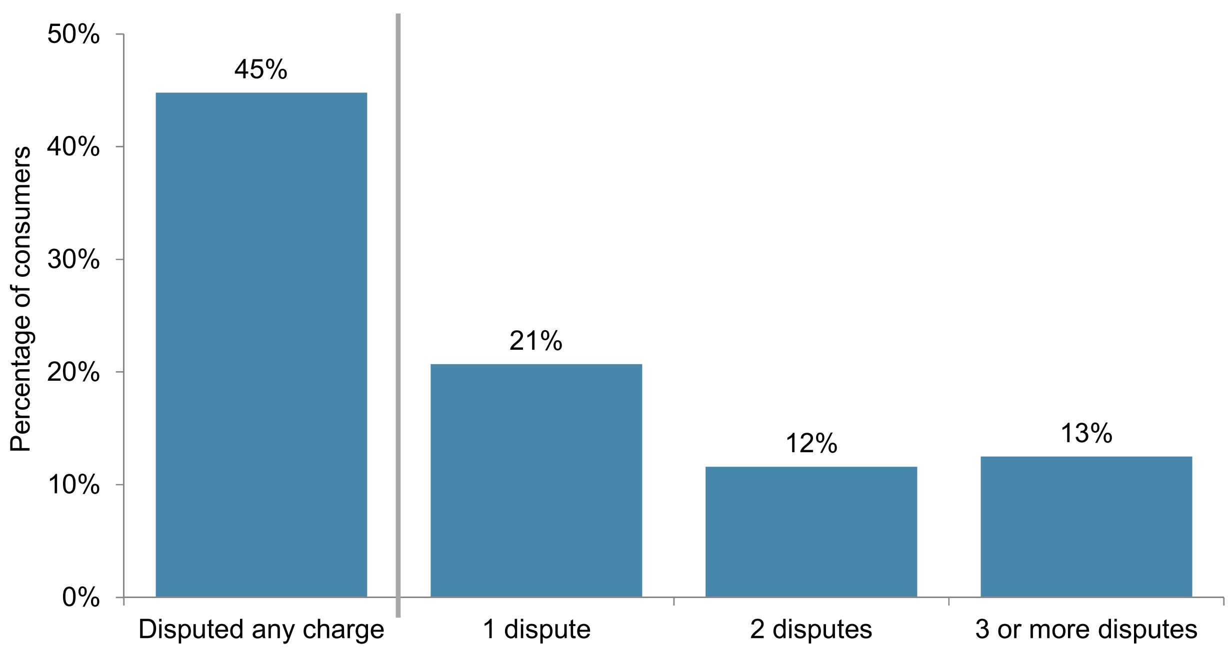
Transaction disputes are far from uncommon with consumers. In fact, nearly half (45%) of all consumers report they have disputed at least one transaction within the past year, and 25% have disputed more than one (Figure 11). Fortunately, many of these disputes are resolved without becoming formal chargebacks. Problems with the delivery of goods and services, including non-receipt of goods and receiving the incorrect item, are the most common reasons for disputed transactions, and these are often resolvable directly with merchants.

However, these categories are closely followed by "fraud" and "unrecognized transaction," both of which tend to result in consumers' bypassing the merchant and directly disputing the transaction with their issuer.

In cases of actual or suspected fraud, consumers are more likely to reach out to their issuer first. In many of these cases, the victims might never have had a relationship with the merchant where the fraudulent transaction occurred and are thus aware that they did not make the purchase. Additionally, depending on how the transaction appears in the victim's banking portal, it might not be possible to clearly determine which merchant could be contacted to resolve the issue. Regardless, in 76% of cases in which a dispute arises because of suspected fraud, the merchant has no

Nearly Half of Consumers Disputed a Transaction in the Past Year

Figure 11: Frequency of Transaction Disputes Among Consumers



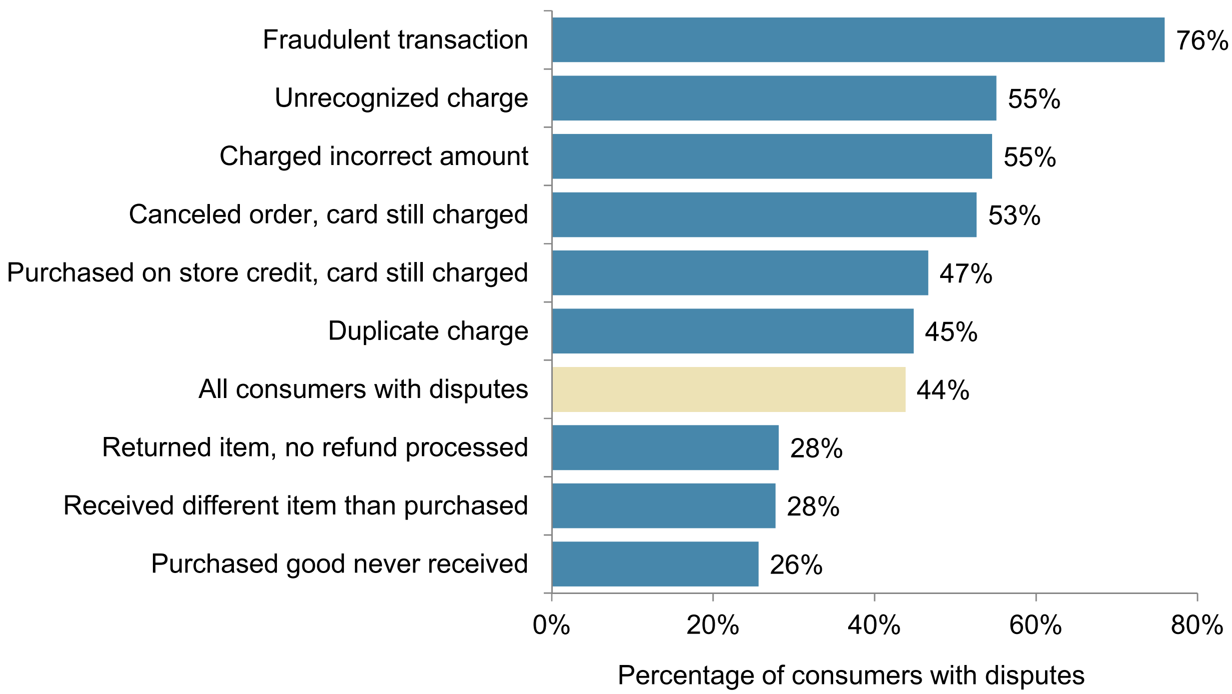
Source: Javelin Strategy & Research, 2018

opportunity to remedy the issue before it receives notice of the chargeback (Figure 12). Cases in which the cardholder does not recognize the transaction or in which the incorrect amount is charged also result in consumers' bypassing the merchant more than half the time. Some unrecognized transactions may result from having the merchant's business name not match the payee name that appears on the customer's online banking statement, which can make it prohibitively difficult for consumers to properly identify whom they should contact before disputing the charge with their issuer.

Among all dispute types, consumers bypass the merchant in nearly half of cases (44%), leaving the merchant with no chance to preempt the dispute before it becomes a chargeback. However, when the dispute arises from problems with a good or service — defective goods, billing errors, etc. — consumers reach out to the merchant in about three-quarters of cases. This is undoubtedly positive for merchants, because they can often resolve these issues reasonably easily if the customer contacts them first, preventing the problem from escalating into a chargeback. Unfortunately, this still leaves 26–28% of cases in which consumers with disputes bypass the merchant entirely, making it much more difficult for merchants to avoid chargebacks.

Consumers Tend to Bypass the Merchant for Fraud Disputes

Figure 12: Percentage of Consumers With Disputes Who Contacted the Issuer, by Reason



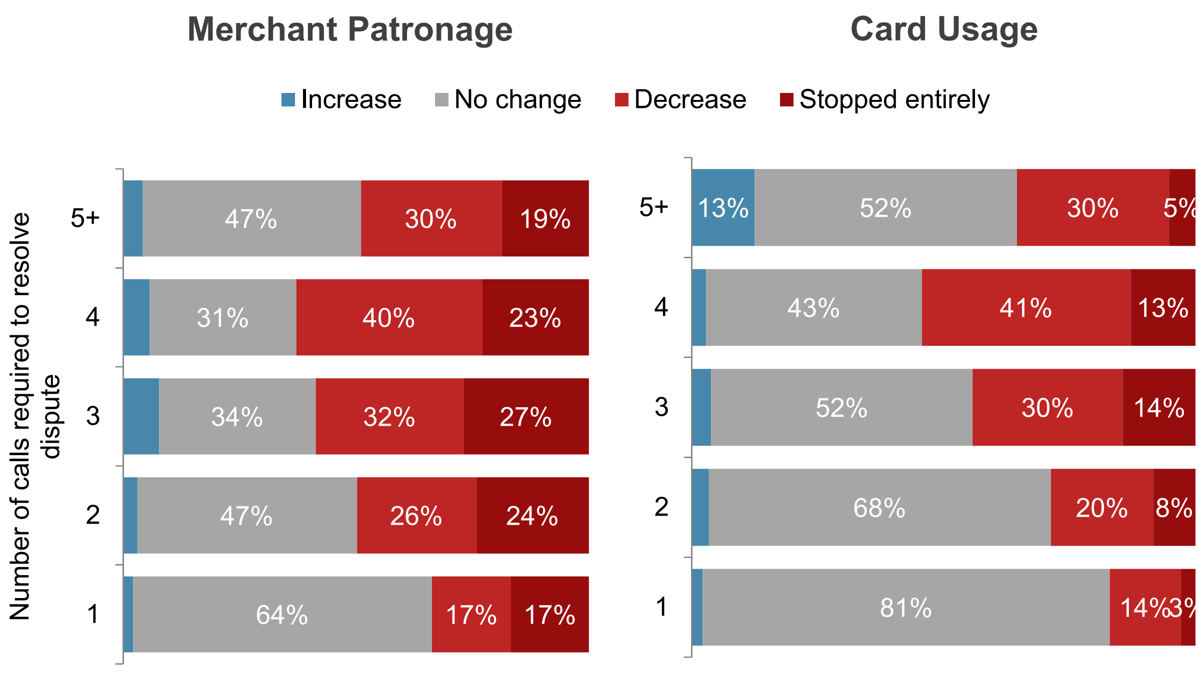
Source: Javelin Strategy & Research, 2018

With the overwhelming majority of disputes resulting in consumers' receiving a refund or replacement, the hurdles consumers have to clear before reaching a final conclusion are a significant part of how negative they perceive the resolution process to be. The number of calls a consumer must make before reaching final resolution is a major indicator of how much of a burden was placed on the cardholder during the dispute process.

Naturally, more challenging dispute processes strongly color customers' perceptions of the entities they do business with and their willingness to continue patronizing those institutions. Unsurprisingly, when disputes are resolved after a single call, consumers report minimal changes to their financial behaviors: 81% report no change in their card usage, and 64% report no change in their willingness to shop at the merchant where the dispute occurred. When the dispute took four calls to resolve, 54% of consumers reported that they either decreased or stopped using the affected card entirely, and 63% reduced or stopped their patronage of the merchant (Figure 13).

Drawn-Out Resolution Dramatically Alters Customer Loyalty

Figure 13: Impact of Dispute Resolution Process on Patronage and Card Usage



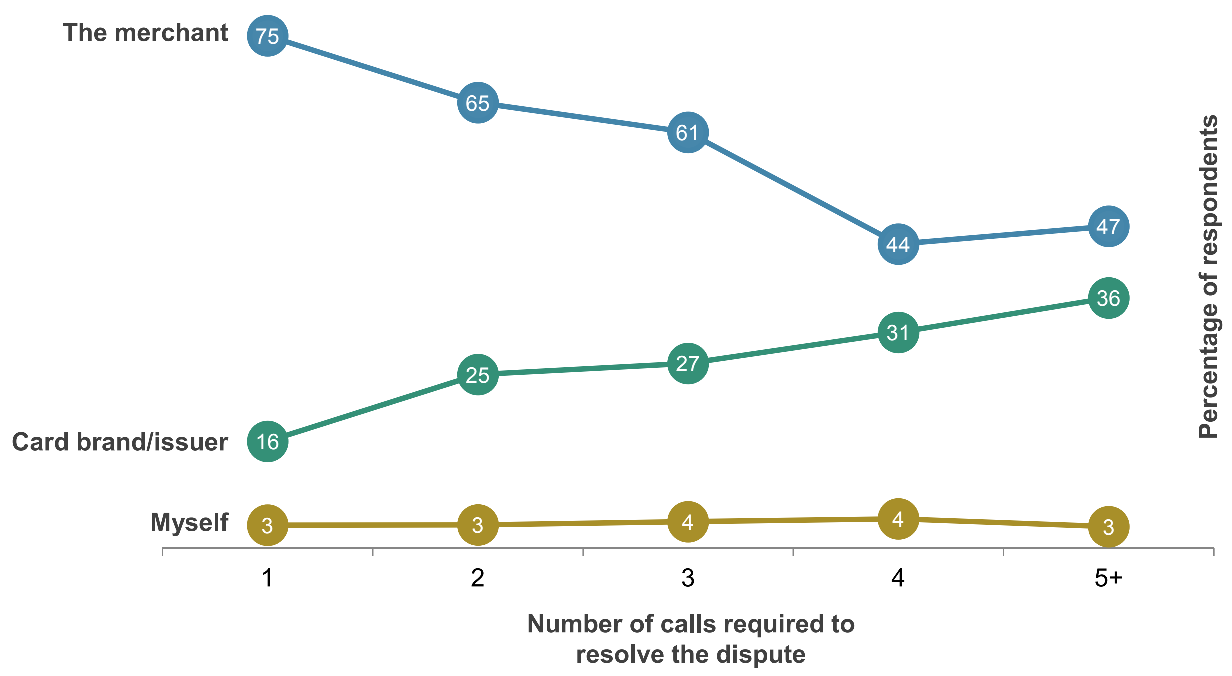
Source: Javelin Strategy & Research, 2018

Among consumers, chargebacks can have a ripple effect, affecting not only the merchant involved but also similar merchants. Nearly two -thirds (63%) of consumers with disputes report they are more cautious about patronizing merchants similar to the one where the issue occurred (Appendix, Figure 24). This is a particularly great risk when the problem arose from something central to the business's model, such as a failure to cancel a recurring payment with a subscription-based service.

In addition to changes in card usage, issuers in particular have a significant amount to lose from extended resolution processes. When the dispute was resolved quickly, consumers were much more inclined to assign blame for the issue to the merchant, with only 16% indicating that the card brand or issuer was to blame (Figure 15). As the number of calls increases, consumers become much more inclined to place blame on the financial institution: 36% of consumers with disputes taking five or more calls to resolve placed the blame for the issue on their card brand or issuer.

Negative Resolution Processes Move Blame From Merchants to Issuers

Figure 14: Party Believed to be Responsible, by Number of Calls Required to Resolve Dispute (Percentage)



Source: Javelin Strategy & Research, 2018

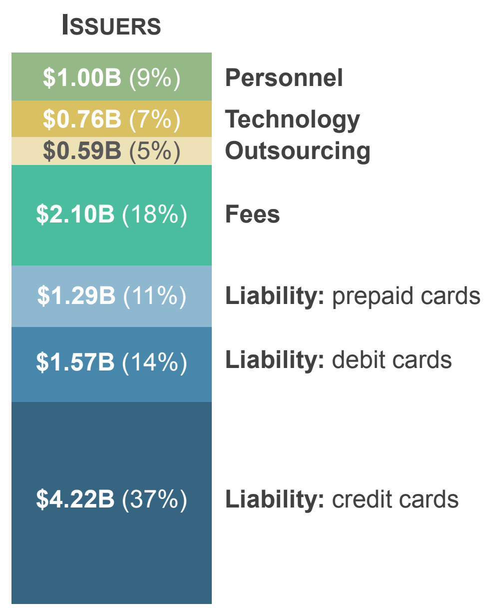
ISSUERS

The chargeback process cost issuers in the U.S. just over$11.5 billion during the past year (Figure 15). The vast majority of these costs arose from liability, with combined liability for credit, debit, and prepaid card chargebacks accounting for $7.1 billion, or just more than 60% of issuer losses. In contrast, combined management costs — personnel, technology, and outsourcing — accounted for $2.4 billion, or 21% of issuer chargeback losses.

For card issuers, even more than for merchants, the customer relationship is paramount, which accounts for much of the cost breakdown for issuers. More than two-thirds of financial institutions (68%) indicate they would rather take a small loss associated with a frivolous chargeback than risk losing a customer by refusing to refund a disputed transaction (Figure 16).

Chargeback Management Costs Issuers $11.6 Billion Annually

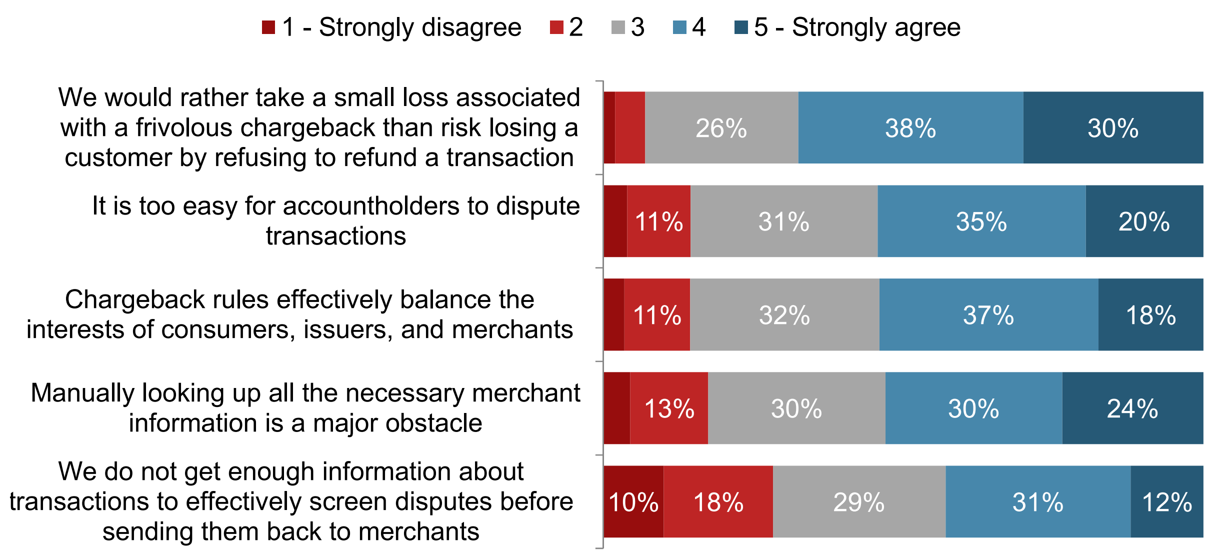
Figure 15: Breakdown of Issuers' Chargeback Costs, in Billions of Dollars



Source: Javelin Strategy & Research, 2018

Issuers Willing to Take a Loss on Frivolous Chargebacks to Protect Customer Experience

Figure 16: Issuers' Attitudes About Chargebacks



Source: Javelin Strategy & Research, 2018

Two major factors lie behind issuers' emphasis on protecting the customer experience: the top-of-wallet concept and regulatory compliance.

Top of Wallet

First, for cardholders with accounts at multiple issuers, switching primary cards is as easy as moving one to the back of their wallet. Although consumers might be inclined to place most of the blame for disputed transactions on the merchant that conducted the transaction, drawn-out resolution processes shift more of that blame to the issuer (Figure 14). The perception that a card is unreliable or that any issues could result in challenging a resolution can drive significant decreases in usage of the impacted card.

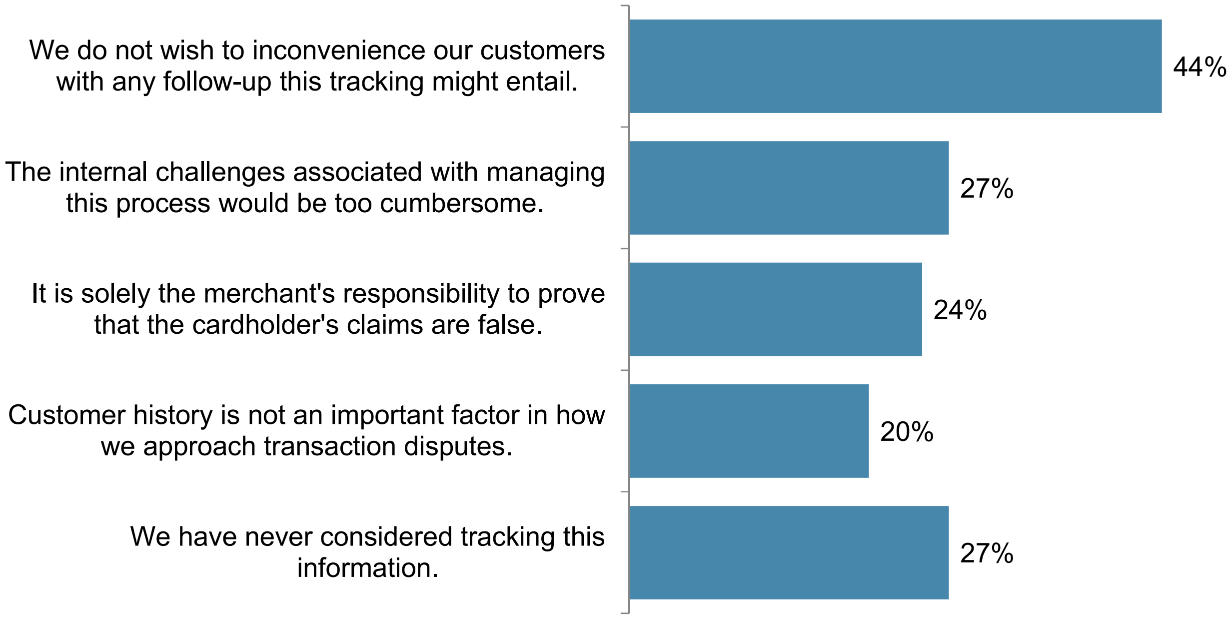
For disputes initiated with issuers in which the full value of the dispute was not refunded, cardholders were notably more likely to use the card less. In stark contrast, when the full value was refunded, not only did the dispute not reduce card usage, for more than a third of accountholders, usage significantly increased after both fraud-related (36%) and non-fraud (38%) chargebacks (Figure 6).

Regulatory Compliance

In addition to concern about the impact of poor dispute management on customer card usage, regulatory pressure provides issuers with strong incentives to err on the side of caution. Federal regulations provide consumers with robust liability protections from fraud. Under Federal Reserve Regulation E, U.S. consumers' liability for fraudulent

Fear of Inconveniencing Customers Is a Major Reason for Not Tracking Serial Disputers

Figure 17: Reasons for Not Tracking Dispute Frequencies Among Cardholders



Source: Javelin Strategy & Research, 2018

transactions on a debit card is limited to $50, although that limit can increase to $500 if the fraud is not reported in a timely manner. Regulation Z provides even more robust protections against fraudulent transactions on credit cards. Card association rules further increase consumer protections, with both Visa and Mastercard requiring member financial institutions in the U.S. to offer zero-liability guarantees to their cardholders.

Together, these factors compel card issuers in the U.S. to accept a third of the liability they incur from disputed transactions without initiating a chargeback. While much of this can be undertaken from a simple calculus — for small-value transactions, the cost of managing the chargeback would probably be higher than the value retrieved if it were successful — giving excessive credence to customer disputes can lead financial institutions to take excessive risks.

Worse, more than a quarter of issuers report that they do not track the number of transactions disputed by each accountholder, leaving them vulnerable to friendly fraud perpetrated by individuals seeking to game the system (Figure 10). Among issuers who do not track serial disputers, the most prevalent rationale is that they do not wish to inconvenience customers with the follow-up tracking that the process entails; 44% of issuers who do not track customer chargeback frequency cite this as their reason for not doing so (Figure 17).

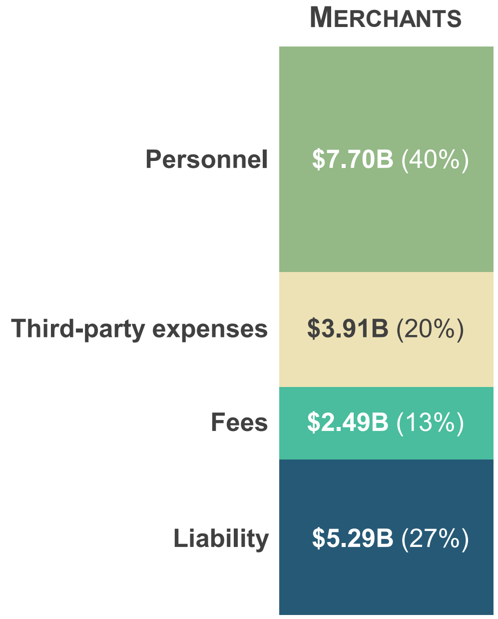
MERCHANTS

Although issuers generally do not require any evidence other than a cardholder's assertion to charge back a transaction, merchants bear a significantly higher logistical burden. Before the merchant can determine which chargebacks it has a reasonable chance at representing, it must conduct the legwork of finding documentation that indicates the transaction's legitimacy. For some transactions, this could involve the comparatively simple process of verifying that the cardholder signed his receipt at the register, but for many e-commerce transactions it is likely to be significantly more complex.

Consequently, 60% of merchants' chargeback-related costs arise from chargeback management expenditures, rather than from liability (Figure 18). Most of these expenses arise from personnel costs, which account for

Chargeback Management Costs Merchants $19.4 Billion Annually

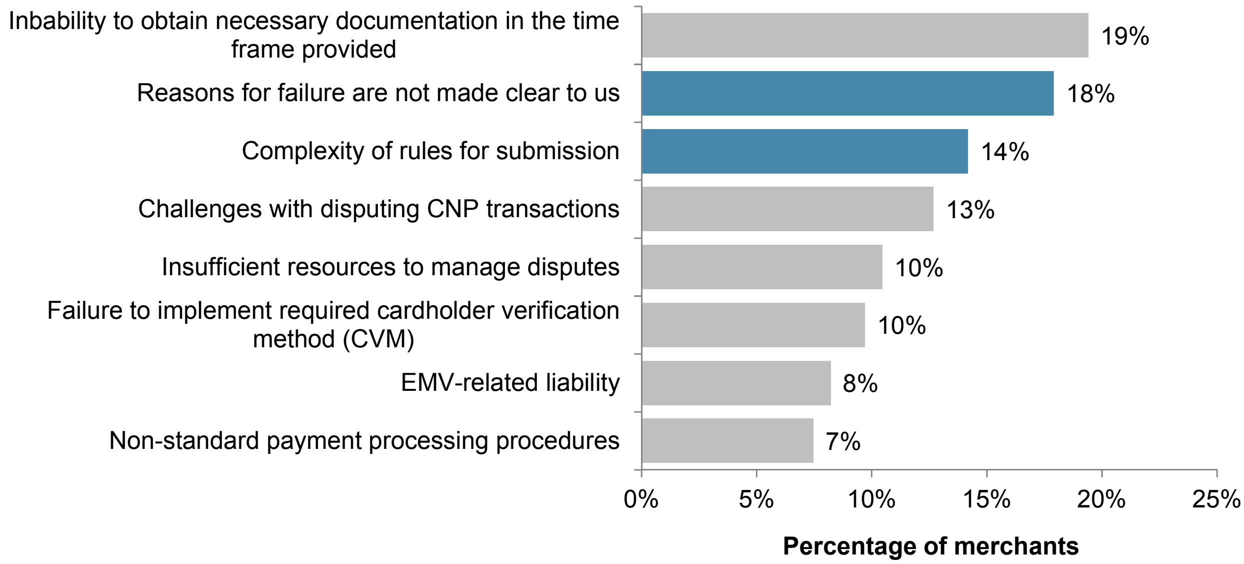
Figure 18: Breakdown of Merchants' Chargeback Costs



Source: Javelin Strategy & Research, 2018

Lack of Transparency, Unnecessary Complexity Burden Merchants

Figure 19: Reasons That Merchants' Representment Attempts Fail



Source: Javelin Strategy & Research, 2018

twice as much as third-party (technology and outsourcing) expenditures.

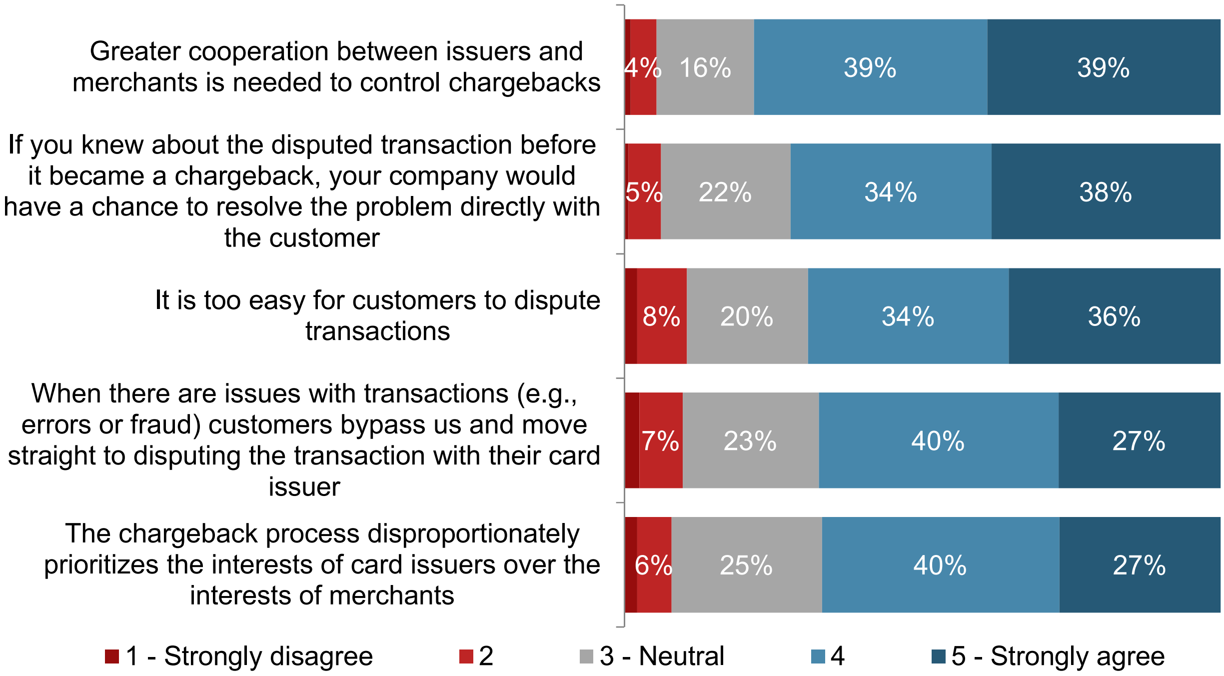
In addition to the challenges and costs associated with prioritizing chargebacks and finding documentation, opacity in the chargeback process imposes unnecessary costs on merchants. Nearly a fifth of merchants (18%) are unable to effectively identify the reasons that their chargeback representments fail because the reasons are not made clear to them either by their processor or the card network (Figure 19). An additional seventh of merchants (14%) indicated that the complexity of the rules for submission was among the most significant reasons that their representments failed.

Where opacity and unnecessary complexity dominate the chargeback system, it becomes nearly impossible for merchants to find ways to improve, either in managing their processes to prevent disputes from arising in the first place or in ensuring that liability is appropriately apportioned to the cardholder, merchant, or issuer.

Additionally, when merchants come out the worse for poor communication in the chargeback process, animosity between merchants and other parties to the payment process is fomented. Two-thirds (67%) of merchants agree that the chargeback process disproportionately prioritizes the interests of

Merchants Demand Greater Cooperation With Issuers

Figure 20: Merchants' Attitudes About Chargeback Process



Source: Javelin Strategy & Research, 2018

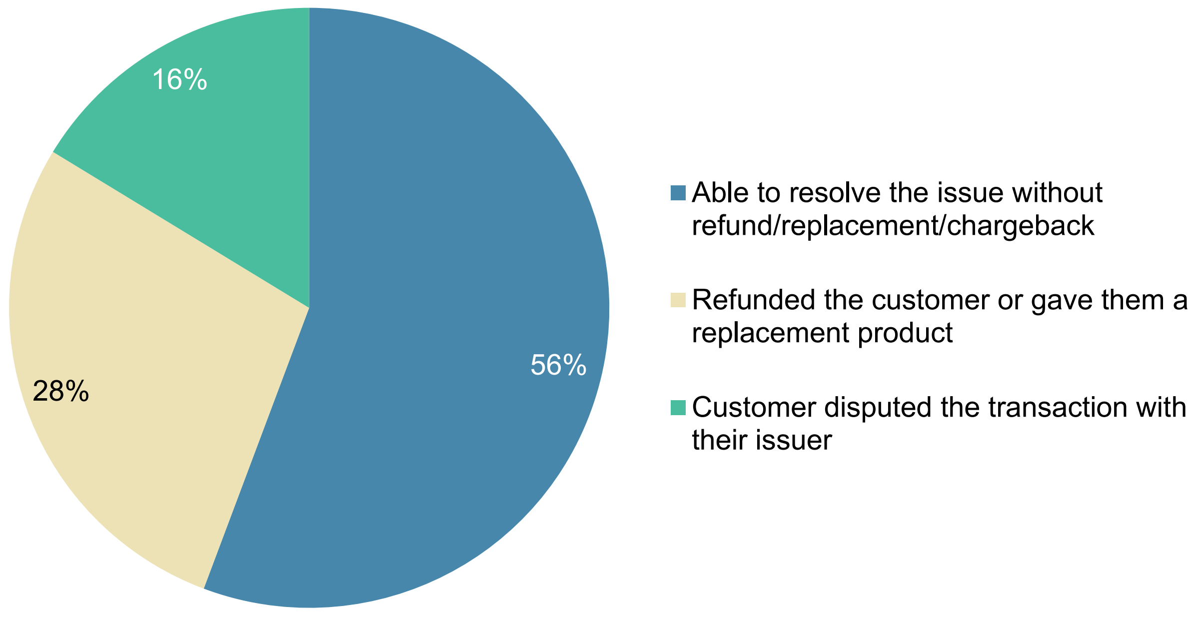
issuers over the interests of merchants (Figure 20).

This should serve as a call to improve communication between all parties in the chargeback process. Despite the tensions that exist between merchants and issuers, more than three-quarters of merchants (78%) believe that greater cooperation between issuers and merchants is necessary to successfully control chargebacks. This belief is held widely among merchants, regardless of industry, though merchants who sell exclusively though physical channels or who sell in both physical and remote channels are especially likely to see the value of collaboration (Appendix, Figure 25). More effective information-sharing among merchants, processors, issuers, and card networks can bring discontented merchants back into the fold and open avenues for cooperation among parties.

While nearly all merchants are rightly concerned that their customers bypass them when there are issues with transactions, this is a particular area of concern for digital goods merchants. Nearly three-quarters (72%) of digital goods merchants believe that their customers bypass them and directly dispute the transaction with their card issuer, compared to 64% of merchants who only sell physical goods (Figure 21).

Merchants Can Usually Preempt Chargebacks if They Are Contacted First

Figure 21: Outcome of Calls to Merchant Customer Service About Transaction Issues



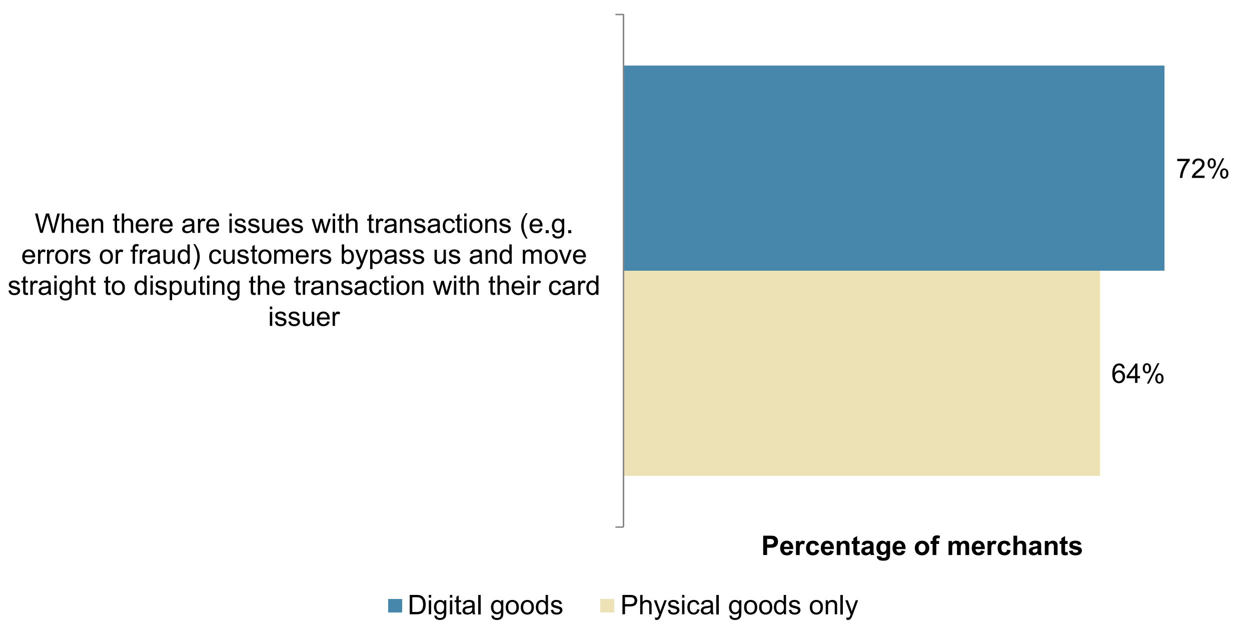
Source: Javelin Strategy & Research, 2018

The ephemeral nature of digital goods might lend itself to looser relationships with customers. Without ever having entered a physical store or interacted with a human employee, customers of digital goods merchants have fewer points of contact to build a relationship with their merchant.

Additionally, merchants who principally sell digital goods through mobile app stores like the Apple App Store or Google Play face the challenge of having an additional intermediary between them and the customer. This can make it more challenging for customers to know which party to contact in the event that there is fraud or a problem with the delivery of a good or service.

Digital Goods Merchants Particularly Concerned About Customer Bypass

Figure 22: Concern About Customer Bypass in Disputes, Digital and Physical Goods Merchants



Source: Javelin Strategy & Research, 2018

CONCLUSION

The chargeback process is complex and challenging, and it cost issuers and merchants $31 billion in 2017. All parties involved bear their own unique costs and burdens.

It is easy to assume that consumers have an easy time in the chargeback process. After all, the overwhelming majority do get fully reimbursed after a dispute. However, what should not be forgotten is that, with the exception of friendly fraud, chargebacks arise from often-preventable errors that interrupt the relationship between consumers, the merchants they patronize, and the issuers they trust with their funds. Although many problems could be resolved easily by directly contacting the merchant where the error occurred, in many cases consumers do not have that option. Incomplete information on bank statements and fraud at merchants where the consumer has never had a relationship inevitably cause consumers to charge back transactions. Preventing disputes and simplifying the resolution process when problems inevitably occur is crucial for issuers and merchants to retain the patronage of their customers.

Issuers face pressure from both regulators and customers to make the resolution process as easy for the accountholder as possible. This pushes issuers to write off losses even for frivolous customer disputes rather than risk violating the letter of the law. More effective information-sharing between issuers and merchants has the potential to ease this burden by enabling issuers to help their accountholders resolve issues with the merchant where the transaction occurred and more effectively screen for friendly fraud.

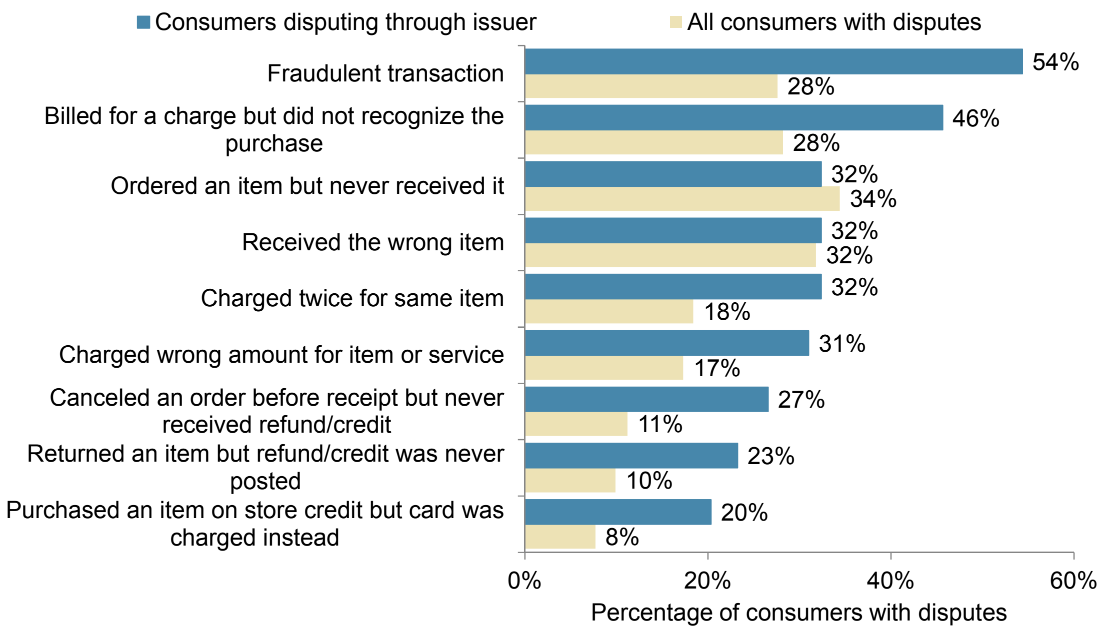
Merchants are generally successful at preventing chargebacks if the customer contacts them first, but getting that first contact can be challenging when nearly half of consumers with disputes bypass the merchant and move straight to their issuer. Once a chargeback occurs, merchants bear the burden of documenting the legitimacy of transactions. This is becoming a progressively more complex task as commerce moves from the physical point of sale to the more ephemeral world of mobile purchases and digital goods.

Unfortunately, the current state of the chargeback system can seem to pit merchants against issuers, with each believing that their interests are largely overlooked. Reducing the cost of chargebacks requires greater collaboration among all parties to resolve legitimate issues facing customers while minimizing the risk of friendly fraud.

APPENDIX

Problems With Goods/Services Lead Consumers' Dispute Causes

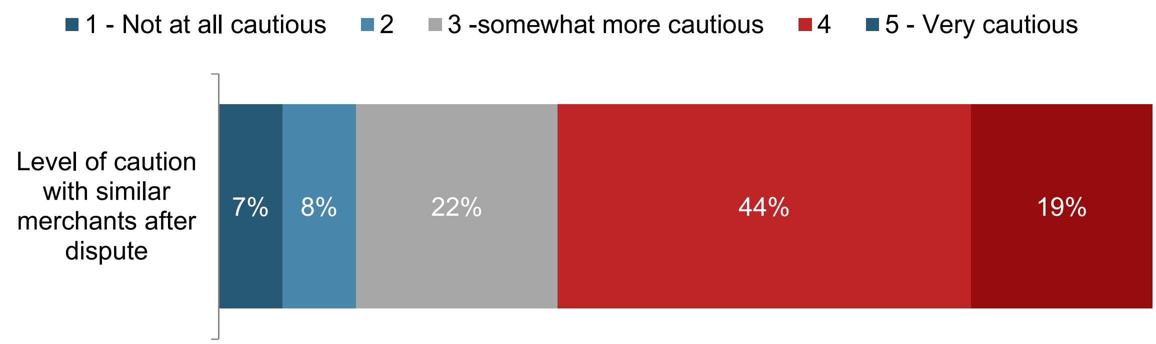
Figure 23: Causes for Initial Transaction Disputes Among Consumers



Source: Javelin Strategy & Research, 2018

Chargebacks Can Have Spillover Effect on Similar Merchants

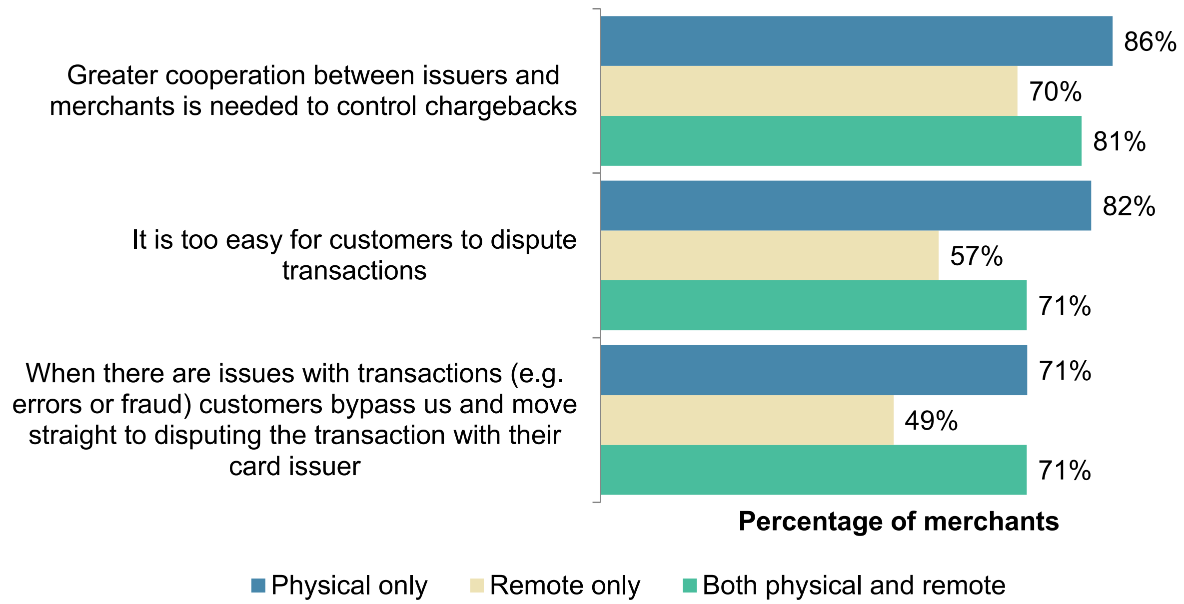
Figure 24: Impact Of Dispute on Consumer Willingness to Patronize Similar Merchants



Source: Javelin Strategy & Research, 2018

Merchants Broadly Agree About the Value of Collaboration

Figure 25: Attitudes About Chargebacks, by Merchant Channels



Source: Javelin Strategy & Research, 2018

METHODOLOGY

In October of 2017 JAVELIN conducted an online survey of 2,000 U.S. consumers, 300 executives influencing chargeback policy at U.S. merchants earning $10 million and greater in revenue, and 200 executives influencing chargeback policy at card-issuing U.S. retail financial institutions.

ENDNOTES

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ABOUT JAVELIN STRATEGY & RESEARCH

Javelin Strategy & Research, a Greenwich Associates LLC company, is a research-based consulting firm that advises its clients to make smarter business decisions in a digital financial world. Our analysts offer unbiased, actionable insights and unearth opportunities that help financial institutions, government entities, payment companies, merchants and other technology providers sustainably increase profits.

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Founded in 2005, Verifi is a leading, global provider of end-to-end payment protection, fraud prevention, and chargeback risk management services. We work with companies ranging from startups to Fortune 500 enterprises in a wide range of industries, delivering robust omnichannel payment solutions that protect revenue and help maximize profits.

Verifi's scalable solutions for risk mitigation and fraud prevention lead the payments industry in diminishing the impact of disputes and chargebacks. Our innovative collaboration network provides merchants and issuers alike with unmatched chargeback and fraud prevention, protecting resources and improving overall customer experience.

Headquartered in Los Angeles, California, Verifi currently serves over 30,000 merchant accounts globally. For information, visit: www.verifi.com.