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MERCATOR ADVISORY GROUP

CHARGEBACKS AND DISPUTES: STRATEGIC SOLUTIONS

BHMI
Software for the Speed of Now

February 2020

Contents

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Introduction

Dispute resolution is an increasing problem for credit card issuers, merchants, and consumers. In the United States, an estimated 25 million disputed transactions occur each year, a volume that will likely grow to 33 million by 2022. As consumers switch from cash to cards for payment, the number of small transactions increases. These small transactions can cost as much as large ones to resolve. Simultaneously, improvements in online and mobile banking are making it easier for cardholders to dispute transactions, accelerating the increased volume. This trend requires changes in issuers' dispute management platforms to handle the changing and growing dispute volume as well as take advantage of new capabilities to use data to adjudicate errors and disputes. To keep up, any card issuer should consider evaluating its current solution with regard to speed, scalability, and versatility.

Growth in the volume of credit card transactions inevitably leads to an increase in dispute volumes. Disputed transactions regularly represent 5 basis points of transaction volume (that is, 5 disputed transactions for every 10,000 purchases). This rate may seem low, but when considering that the credit card industry processed 49.9 billion transactions in 2019, 5 basis points represents substantial volume. By the end of 2022, transaction volume in the U.S. will slightly exceed 66 billion, and disputed items will be 33 million per year. Credit card disputed items, which represent flaws in a process that requires every transaction to be irrefutable, are just the tip of the iceberg. Disputed transaction items also occur in payments by debit card, private label credit card, mobile person-to-person (P2P) payment, and in emerging payments such as same day ACH payments and real-time payments.

In this report, the emphasis is on disputed credit card transactions, but suffice it to say that similar issues exist throughout the lending spectrum. The challenge affects all payment forms as lenders continue to displace cash transactions and take more market share of high-volume, low-value payments. Depending on the complexity, dispute of a $10 item can require the same resolution effort as dispute of a $1,000 item, which is why card issuers or merchants often simply accept small disputes in the interests of time management.

Figure 1: In 2022, a projected 66 billion transactions in the United States will generate 33 million disputes, each belonging to one of four classifications.

66 Billion **Transactions**	33 Million **Disputed Transactions**	4 **Classifications** **-Fraud** **-Authorization Failures** **-Processing Errors** **-Consumer Disputes**

Source: Mercator Advisory Group

Irrefutability is essential in payments. Transactions must align with purchases made by authorized users. Cardholders are not responsible for purchases made by unauthorized users, and when challenged, issuers must remove disputed transactions from cardholder accounts until the disputes are resolved. Similarly, merchants that misrepresent their products or offer shoddy services do not have a right to charge customers; such transactions may also become disputed items.

For business and practical reasons, credit card issuers must deal with disputes raised by any party in a transaction. Network rules mandate speedy dispute resolution, as do many consumer credit regulations, such as the Fair Credit Billing Act[i] and Truth in Lending Act (Regulation Z).[ii] Issuers require an efficient process to protect the integrity of their receivables and not carry inaccurate transactions on their books. Consumers have the right to pay only the amount due, and merchants do not want to bear the responsibility when items return as chargebacks to their accounts.

Practically speaking, disputes fall into four classifications, as listed in Figure 1. The disputed item might be part of a fraud event. It could an authorization failure in which the merchant did not follow acceptance rules. Or it might be a processing error in which the merchant cannot properly document the transaction. In some instances, a transaction is disputed because the consumer does not recall the purchasing event or disputes the value of the acquired goods or services.

Dispute management requires technology to measure, process, and settle items without regard to size of the institution. Large issuers certainly need tools to classify transactions and simplify dispute management workflows quickly. Small issuers need the same quality to ensure consistency, industry compliance, and execution strategies that are fair to all parties.

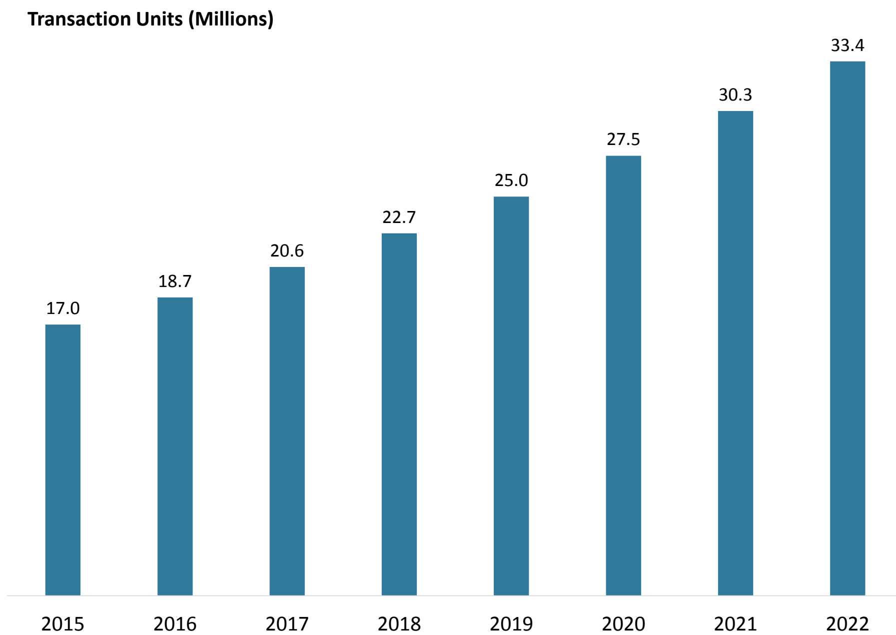
Dispute Volumes Are on the Rise

Payment card transactions of all types in the U.S. will exceed 150 billion units annually by year end 2020, and credit cards will represent 49.9 billion units, valued at $4.18 trillion, according to Mercator Advisory Group projections. This is a 136% increase in volume and a 141% increase in value. The credit card trajectory will continue as we look toward 2022, when transaction volume will likely rise to 66.8 billion units, valued at $4.72 trillion.

Historically, disputes have run between 4 and 6 basis points (bp) of transaction volume, it is likely that more disputes of low-value transactions will occur as credit card issuers push toward displacing small cash payments. The Federal Reserve Bank of San Francisco reports steady reduction of cash usage in the U.S. market, the average monthly payments made with cash having fallen from 14 per month to fewer than 12 between 2016 and 2018. In the interim, debit transactions remained steady between 11 and 12 payments per month, and "credit card usage increased from 8 to 10 payments." [iii]

As illustrated in Figure 2, we expect to see disputed credit card items increase from 24.95 million in 2019 to 33.4 million in 2022.

Figure 2: Disputes will rise to 33.4 million by 2022 in the U.S. as payment volumes increase.



Source: Mercator Advisory Group

As card transaction volumes rise, cash transactions fall. And, as the cash transactions decline, there will be an increase in card transactions below $25. According to the Federal Reserve study, 50% of cash payments were less than $25, and 25% of cash payments were less than $10 in 2018. Specifically, in the range of payments under $10, activity fell from 12.6 transactions on average in 2016 to 11.2 transactions in 2018.

Electronic payments will continue to displace cash purchasing as e-commerce increases beyond its current 11.2% of retail sales,[iv] mobile payments and wallets gain scale, and emerging payments enter the payments market.

Rising Volumes Bring Rising Costs

Both Mastercard and Visa view the efficiency and effectiveness of payment disputes and chargebacks as essential for cardholders, issuers, and merchants. To improve workflows, both brands recently overhauled their processes. The revised programs are Mastercard Dispute Resolution (MDR)[v] and Visa Claims Resolution (VCR).[vi] The two dispute management programs are logically similar but have nuances that must be learned by credit card issuers and managers. Dispute management programs integrate the logic into their offerings.

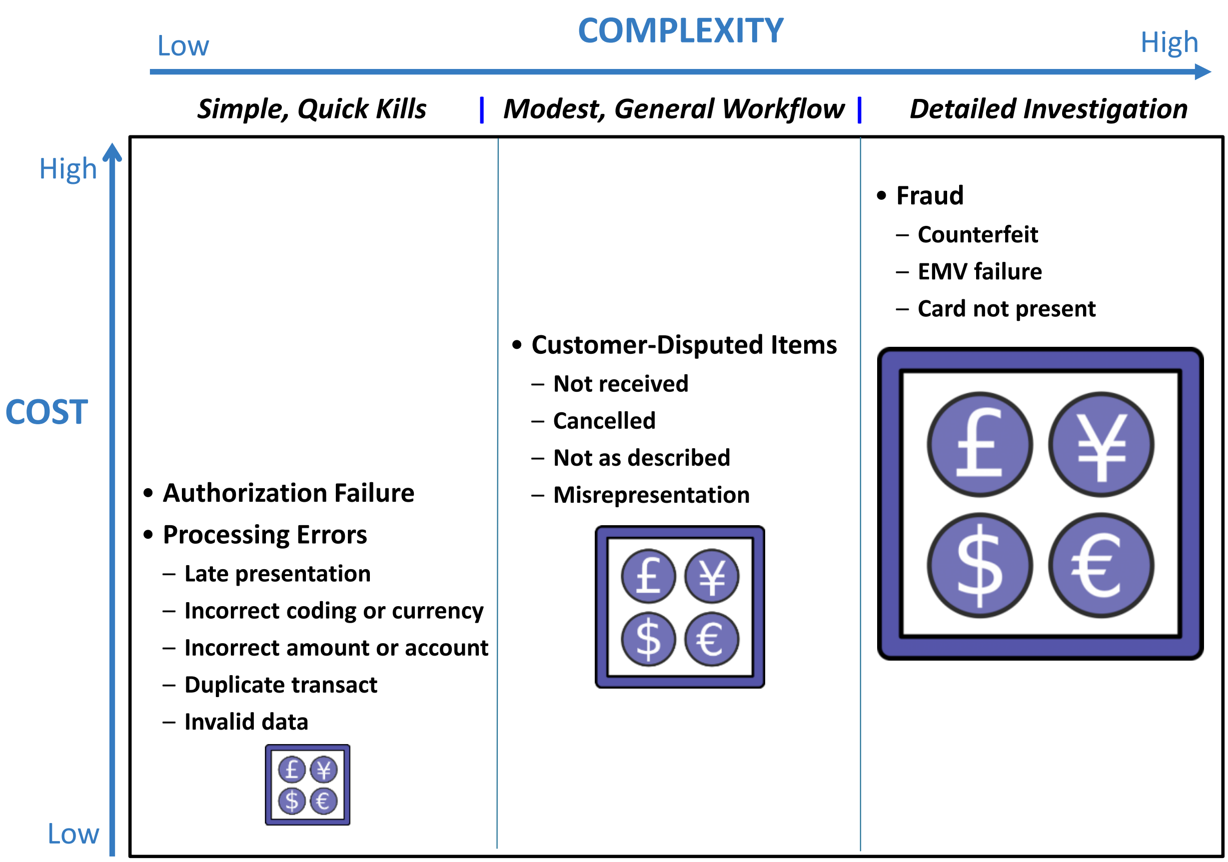
Both Mastercard and Visa align with the classic structure of disputes discussed earlier in this paper. Dispute items fall into the four classifications shown in Figure 1: fraud events, authorization failures, processing errors, and general payment disputes. Something credit managers must watch for is that the codes do not align perfectly between the payment network brands, and there are services that one brand offers but the other does not. An example is Mastercard's pre-arbitration process, which is also known as a Second Presentment.

Dispute classification is an essential component because it permits rapid identification and simplified workflows. As an example, in VCR Visa uses code 10 to indicate a fraud dispute, 10.1 to report EMV/Counterfeit Fraud, 10.2 for EMV/Non Counterfeit Fraud, 10.3 for Other Fraud/Card-Present, 10.4 for Other Fraud/Card-Not-Present, and 10.5 for Visa Fraud Monitoring Program.

Coding logic enables payment parties to maintain dynamic workflows in order to adapt to reclassification of disputes. For example, a processing error might be reclassified as a fraud event, or a "not received" item might ultimately be slotted into a fraud category.

An objective of dispute management workflows, however, is to drive down handling costs as agents work through volumes. Simple, quick kills such as late presentments are easy to process based on network rules. More complicated events such as counterfeit fraud require specialized handling. ***Figure 3*** is a matrix for system design based on minimizing complexity and cost.

Figure 3: Well-designed systems culls dispute volume by creating operating efficiencies.



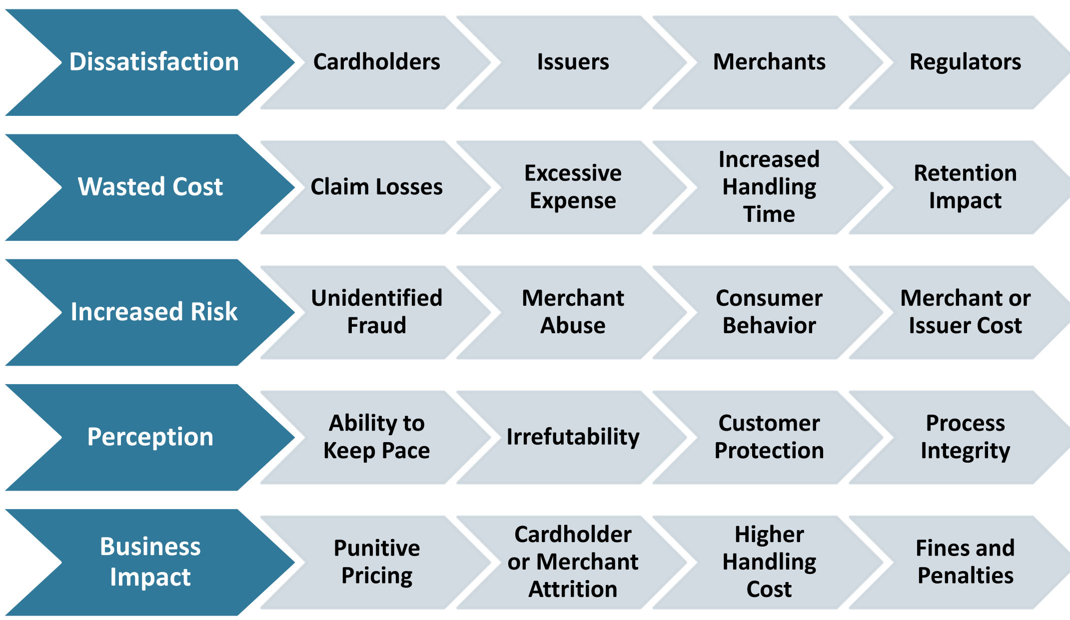
Source: Mercator Advisory Group

Classifying disputes helps both card issuers and merchants allocate resources to reduce expenses and risk. Simple issues, such as late presentments or duplicate transactions, follow a direct path of rejection and require only limited human intervention. Disputes classified as fraud require intense follow-through to ensure that future charge activity does not occur on the same accounts and to accelerate fraud investigation.

Financial Costs Are Only One Facet of Dispute Expenses

Financial exposure is only one facet of the dispute management cost, as ***Figure 4*** shows. Dissatisfaction affects all parties concerned. Cardholders do not want statements cluttered with inaccuracies. Issuers must have irrefutable transactions on their books. Merchants do not want to lose customers, nor do they want transaction chargebacks. Regulators see two challenges: They are responsible for protecting consumers from deceptive lending practices, and they must ensure that credit card portfolios operate safely and soundly.

Figure 4: Poorly handled disputes cause dissatisfaction, unnecessary expense, increased risk, and negative perception.



Source: Mercator Advisory Group

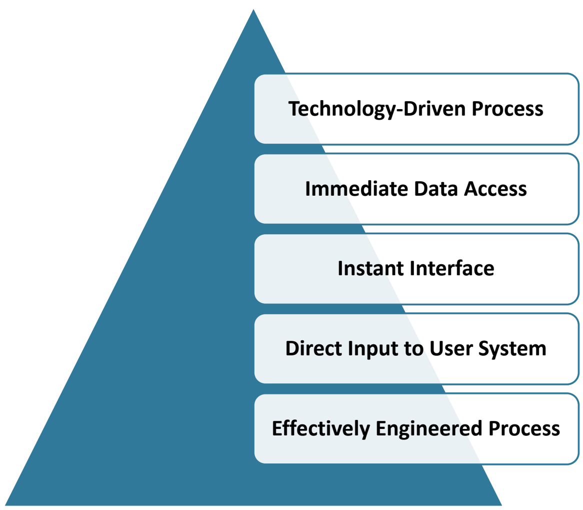
Wasted costs range from claim losses to operating expenses and lost customer revenue. Rejected disputes might end up in collection queues and entail phone calls that frustrate bank staff and annoy cardholders. Operational and reputational risk may occur due to improperly resolved disputes or even abuse by merchants. Cardholders may change their perception of an issuer as a “well-run local bank,” or they may reconsider a global payments provider to be a financial institution that has a process integrity problem or cannot keep pace with modern payments processing. There are also practical business impacts. Excessive disputed items and chargebacks can lead to industry penalties or customer attrition. Handling costs will be higher, and fines and penalties may be imposed.

Foundation for a Technology Strategy

A dispute management system is a specialized tool that facilitates the correction of flawed transactions. The elements of a well-designed system are shown in ***Figure 5***. A flawed transaction may be identified by the cardholder, the issuing bank, or the payment network. The technology will allow the user to classify the transaction into a network-mandated segment and help the user follow settlement and arbitration requirements to protect the customer and ensure that the financial institution posts only valid purchases on its financial books.

The system must recognize credit policy requirements and operational rules defined by payment networks and help users navigate actions and processing requirements. Transactions should build information at three levels: cardholder, merchant, and dispute classification.

Figure 5: Well-designed systems cull through dispute volume to create operating efficiencies.



Source: Mercator Advisory Group

The technology-driven process of a dispute management system relies on immediate data access. The system must be able to accept inbound feeds regarding disputed items and mark the core system of record. Interfaces must be in real time to adjust to updates and ensure that the credit card platform suspends the disputed item and frees up available credit in the cardholder's account so the item or items in question do not penalize the cardholder.

Practical engineering is required to ensure that workflow is compliant with regulatory requirements and efficiently executes the next action on the account, which might be to initiate an investigation, trigger a response based on system rules, or drive the item into a fraud management scenario.

Failure to execute the process will lead to rework or to potential loss if timing fails to meet the standard. Timing is an essential consideration because response dates follow a rigid protocol. To reduce the cycle time of dispute resolution, both Mastercard and Visa built in requirements for better operating efficiencies.

Visa, for example, indicates that disputes typically take 46 days to resolve, more complicated dispute events requiring up to 100 days.[vii] Under the new operating guidelines of Visa Claims Resolution, the objective is to reach disposition within 31 days. Requirements accelerate resolution timing for pre-arbitration and arbitration of dispute claims, necessitating that issuers and their supporting technologies prioritize investigations, responses, and conclusions.

With the recent network changes in place, timing is ideal for credit card issuers to reconsider their current platforms. Enough time has passed to stabilize operational and systemic changes. A process review should analyze current operating trends to understand if the portfolio experiences change in dispute types or volume as well as to determine the average resolution time by dispute type. The review might identify staffing opportunities that would reduce costs or allow reallocation of productive hours into other operational segments. The overarching goals should be to ensure cardholder satisfaction, align closely with network standards for fairness and efficiency, and build a risk-averse process that leverages the power of applied intelligence to the dispute management process.

Trends and Solutions

Five trends make dispute management an essential focus area for 2020:

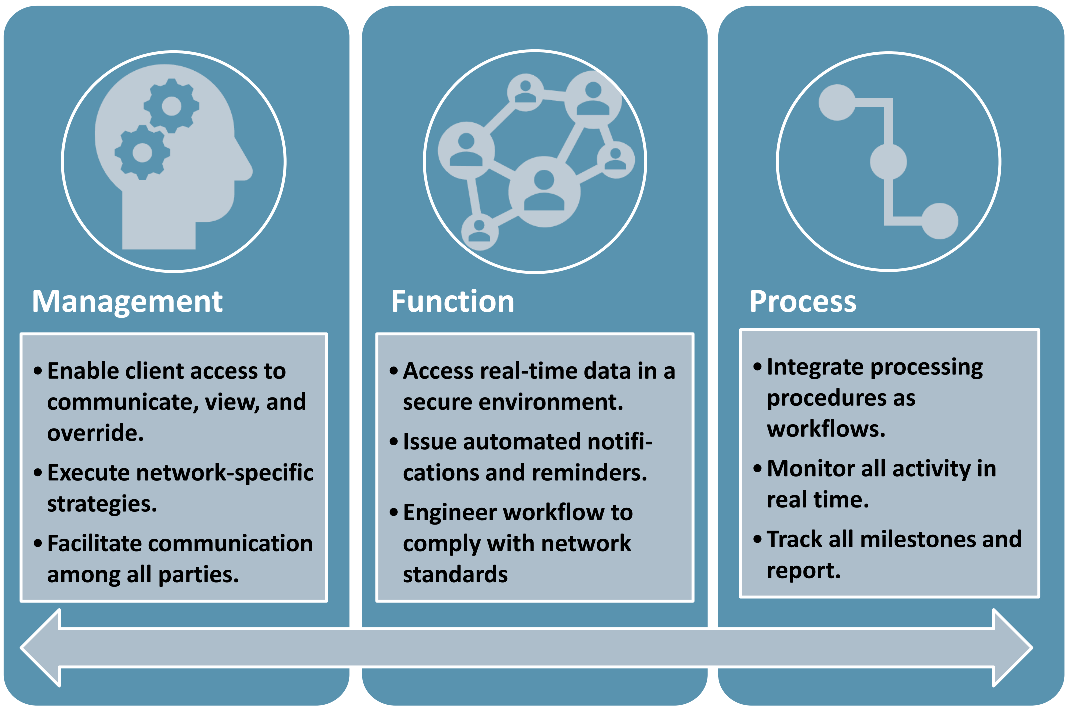
1. Transaction volumes are on the rise, and with that comes increased disputed transactions.
2. Payment networks and regulators are focusing on the dispute resolution function because disputed transactions create consumer vulnerability, inflate portfolios with unacceptable volume, and cause merchant friction.
3. Credit card issuers now offer online dispute functions on mobile devices and websites that simplify a dispute claim and enable the complaint to launch with just a few clicks.
4. The increase in e-commerce and mobile payments has brought a high volume of low-value transactions, which will be increasingly important as the volume of electronic payments continues to grow.
5. Finally, as competition in payment markets continues, it is critical to reduce cardholder attrition, which is driven by cardholders' dissatisfaction with events such as unresolved disputes.

An effective dispute management process requires management controls, functionality, and process management, as illustrated in ***Figure 6***. Bank and merchant counterparties must scrutinize each dispute item to determine if there is potential fraud risk or a process flaw. The integrity of the current process is secure and reliable, with a 99.95% perfection rate, but the remaining 0.05% of transactions require attention by cardholders, issuers, and merchants to ensure that every item in the payment system is irrefutably the responsibility of the authorized account user.

Dispute management functions are subsystems that must communicate with credit card platforms and fraud management systems. From a management perspective, they need to follow network rules and ensure communication among all parties. Functionally, the process must act in real time and be able to interact with data from a variety of sources. Transactions and accounts must follow schedule requirements, and flow must comply with industry and financial institution mandates.

Banks and credit unions should consider how they want to manage the dispute process for their credit, debit, and other transaction products. The decision affects payment card issuers of all sizes and platform types. Various technology platforms exist, such as on-premise software, cloud delivery, or through a platform service provider, but consideration should include the benefits of specialized functionality as a distinguishing factor. An objective is to shift the paradigm of a transaction dispute as an operational burden to a scenario where the event can provide insight into a process flaw, which will benefit each party.

Figure 6: An effective dispute management strategy ties together management, functions, and process.



Source: Mercator Advisory Group

A Solution That Addresses the Problem

BHMI, the sponsor of this white paper, is a specialized technology firm that offers the Concourse Financial Software Suite™ to address the problem of dispute resolution. The product includes software modules that provide real-time access to data, drive transaction research, execute settlement processing, and automate reconciliation. The Omaha, Nebraska firm serves clients around the globe.

BHMI's solution for dispute management comes from its Concourse – Disputes™ system, which automates life cycle management from initial claim entry to final resolution. Important functions, such as retrieval requests, dispute management, chargeback processing, and adjustment management are native to BHMI's offering. The application works for card issuers, merchant acquirers, and third-party processors, allowing all parties to handle higher claims volumes through streamlined process management. BHMI keeps its product current by integrating preconfigured network rules, which reduced the number of penalties and financial write-offs.

Conclusions

All parties involved in a disputed transaction require a fair and efficient dispute resolution process. Consumers want to be liable only for valid charges. Issuers need their books and records to represent all transactions accurately. Merchants require that chargebacks be fair and transparent. The volume of disputed transactions is on the upswing, not because of a deterioration in form or function but as the result of increased transaction volumes. Transactions continue to increase in volume, and electronic transactions are an ever more significant portion of payments. With new dispute procedures by Mastercard and Visa in place, timing is right for financial institutions to consider both strategic and technology options. This is an opportunity to shift dispute management from an operational burden to a strategic opportunity.

Endnotes

[i] https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/fair-credit-billing-act

[ii] https://www.occ.treas.gov/topics/consumers-and-communities/consumer-protection/truth-in-lending/index-truth-in-lending.html

[iii] https://www.frbsf.org/cash/publications/fed-notes/2019/june/2019-findings-from-the-diary-of-consumer-payment-choice/

[iv] https://fred.stlouisfed.org/series/ECOMPCTSA

[v] https://globalrisk.mastercard.com/online_resource/dispute-resolution-management/

[vi] https://usa.visa.com/dam/VCOM/download/merchants/visa-claims-resolution-efficient-dispute-processing-for-merchants-VBS-14.APR.16.pdf

[vii] https://www.mercatoradvisorygroup.com/Reports/Credit-Card-Dispute-Management--Transactions-in-the-Billions-Bring-Exceptions-in-the-Millions/

About Mercator Advisory Group

Mercator Advisory Group is the leading independent research and advisory services firm exclusively focused on the payments and banking industries. We deliver pragmatic and timely research and advice designed to help our clients uncover the most lucrative opportunities to maximize revenue growth and contain costs. Our clients range from the world's largest payment issuers, acquirers, processors, merchants, and associations to leading technology providers and investors. ***Advisory services*** include *Credit, Debit and Alternative Products, Prepaid, Merchant Services, Commercial and Enterprise Payments, Emerging Technologies,* and *Global Payments* practices, which provide research documents and advice. ***Primary Data services*** include the *North American PaymentsInsights series*, which report and analyze data collected in our bi-annual consumer surveys, as well as the annual *Small Business PaymentsInsights* and *Buyer PaymentsInsights series.* ***Consulting services*** enable clients to gain actionable insights, implement more effective strategies, and accelerate go-to-market plans; offerings include tailored project-based expertise, customized primary research, go-to-market collateral, market sizing, competitive intelligence, and payments industry training. Mercator Advisory Group is also the publisher of the online payments and banking news and information portal PaymentsJournal.com. Visit www.mercatoradvisorygroup.com.

About BHMI

BHMI is a leading provider of product-based software solutions focused on the back-office processing of electronic payment transactions. The company is best known as the creator of the Concourse Financial Software Suite™ – a unique integrated collection of back-office products allowing companies to quickly and easily adapt to the rapidly changing world of payments. Concourse is a cohesive and integrated package, including settlement, reconciliation, fees processing, and disputes workflow management, that reduces the cost and complexity of back-office processing. Concourse's continuous processing, near real-time architecture and powerful rules engine is ideally suited for new payment initiatives like P2P and enables companies to perform back-office processing for any type of payment transaction. To learn how your company can benefit from the power and flexibility of Concourse, please visit www.bhmi.com.