

Acquiring Banks:

Will the unwind of COVID-19 measures
increase chargeback risk?

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Introduction



The implementation of COVID-19 support measures by the Government has materially reduced the risk of merchant insolvency during the periods of lockdowns and restrictions. However, soon these measures will unwind, and it is expected that many merchants will experience financial distress.

Acquiring banks will be critical to any merchant restructurings and requests for releases of liquidity held need to be considered against chargeback risk on an insolvency of the merchant and upcoming duties to consumers.

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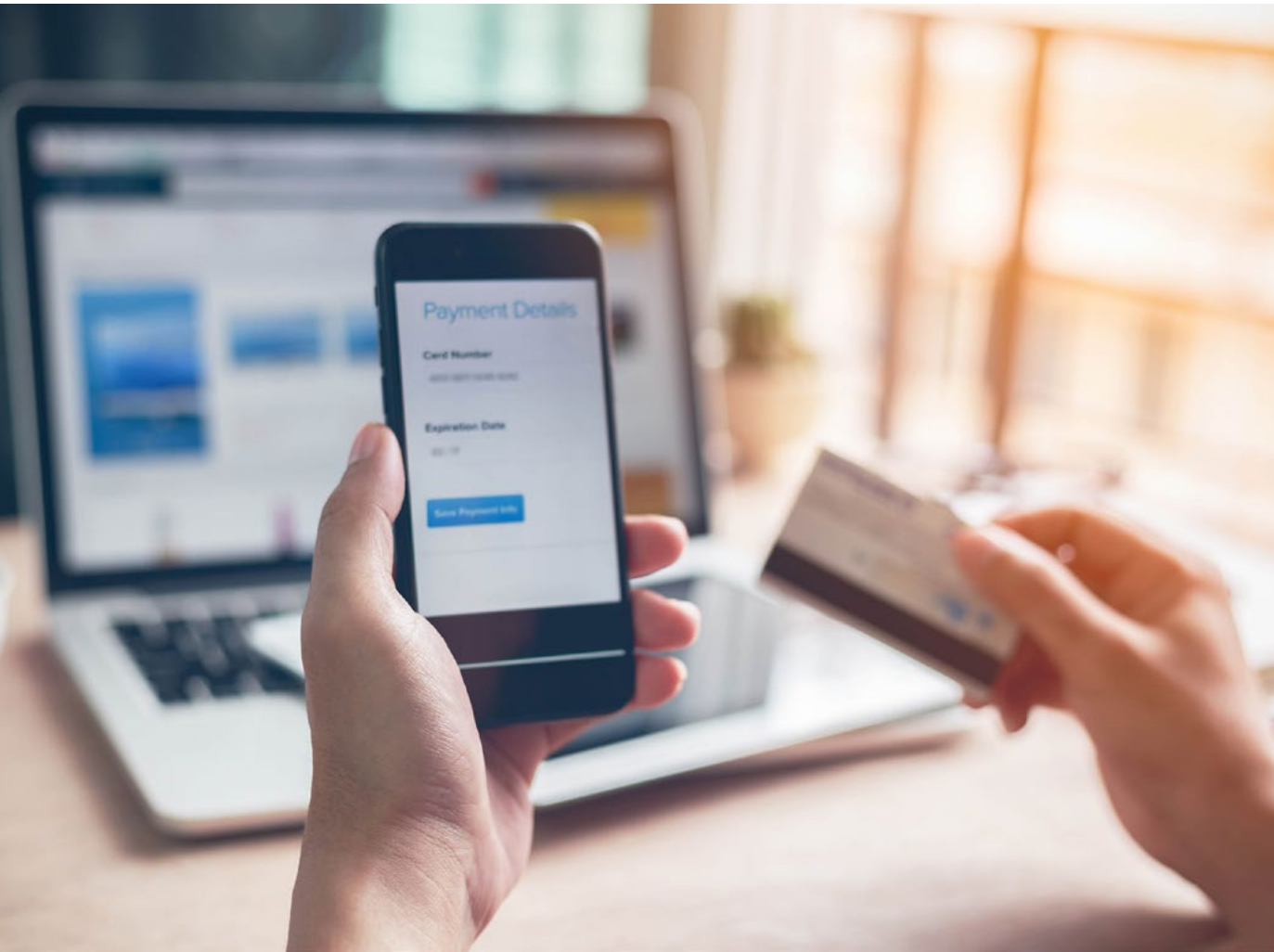


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Payment firm viability is a concern to the FCA and we consider the unwind of COVID-19 support may detrimentally affect acquiring banks

In its 2021/22 Business Plan the FCA highlighted concerns regarding the impact of COVID-19 on the financial strength of payment services firms.

We consider this stems, in part from firms' exposure to retail markets where, as COVID-19 support measures are unwound, merchants may struggle to maintain liquidity under existing business models. To avoid insolvencies, merchants will likely attempt to restructure, and acquiring banks/acquirers can expect to be key stakeholders as merchants seek to maximise cash through releases of settlements and deposits. However, where merchants are unable to restructure, insolvencies may follow, and acquirers face a significant risk of increased chargebacks which could threaten the acquirer's own solvency.

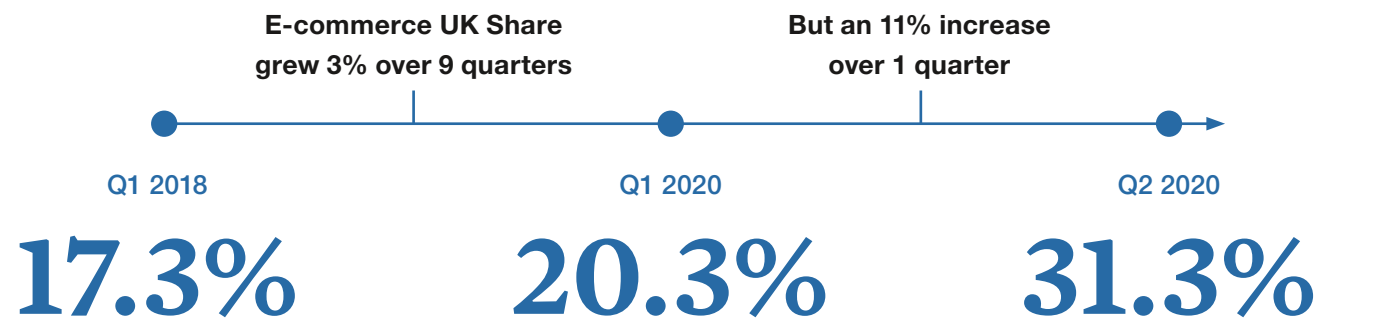
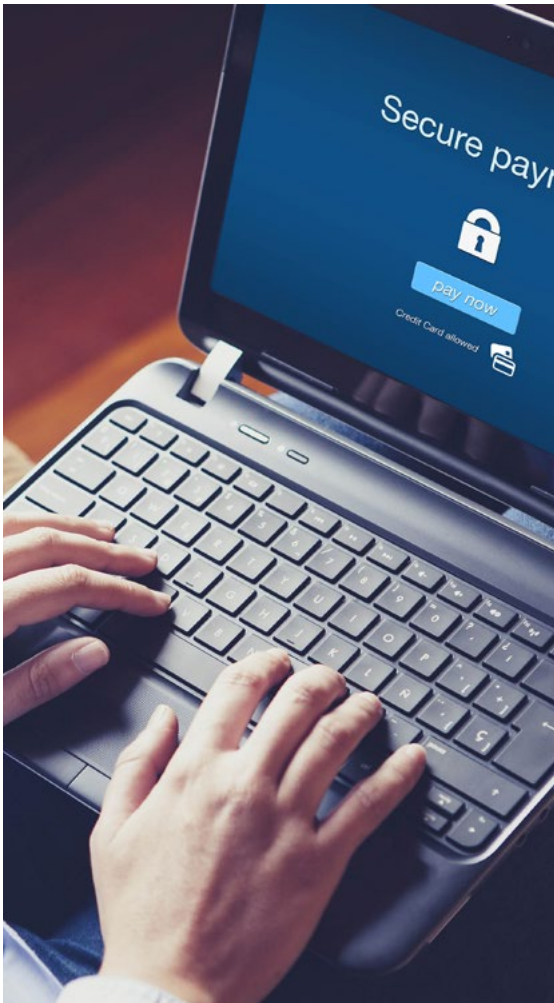


Chargebacks are on the rise and merchants are choosing not to appeal

COVID-19, and the associated lockdowns and retail outlet closures, have forced consumers away from traditional bricks and mortar, accelerating the shift in consumer payment behaviour towards e-commerce (OECD reported that, between Q1 2018 and Q1 2020, e-commerce's UK share grew by 3.0% to 20.3%, but this increased by 11.0% to 31.3% between Q1 2020 and Q2 2020)¹.

The rise in e-commerce transactions, together with the ever-changing restrictions on travel and related issues regarding refunds and insurance claims, has increased the number of “cardholder not present” chargebacks. Chargebacks911 noted in its [2021 Chargeback Field Report](#) that merchants reported a 25% increase in chargeback issuances, due principally to COVID-19. To compound the issue, it also found that merchants experienced increases in friendly fraud chargebacks. Friendly fraud chargebacks continue to be a significant proportion of all chargebacks and the merchants surveyed noted that they are not able to successfully deal with them.

Chargebacks911 also [reported](#) that merchants appear to consider the threshold for successfully challenging chargebacks to be too high and the process to be too time consuming, even when friendly fraud has occurred. The cost of doing so, together with not wanting to lose essential business with customers, means many merchants simply choose not to challenge chargebacks and instead absorb the financial impact.



¹ OECD/ 2020, E-commerce in the times of COVID-19, <https://www.oecd.org/coronavirus/policy-responses/e-commerce-in-the-time-of-covid-19-3a2b78e8/>

Increased risk of merchant insolvencies provide acquirers with significant chargeback risk

As COVID-19 support measures unwind, many merchants are expected to encounter significant financial distress as deferred tax and rent obligations become payable and COVID-19 loans mature. In particular, it is widely expected that traditional bricks and mortar merchants in the retail, travel, hospitality and leisure sectors will be among those most exposed.

In distressed situations we typically see an increase in chargebacks with merchants unable to deploy the financial resources necessary to challenge them.

This is particularly true where a merchant enters insolvency, as significant chargeback liabilities are likely to arise where the merchant is no longer able to perform its obligations to the consumer (e.g. honour warranties or deliver goods which have been ordered).

In addition, where a merchant is insolvent the merchant's estate typically has insufficient funds or information to support the acquirer when investigating chargebacks, making them more difficult to rebut.

To prevent insolvency, merchants are expected to call on acquirers to support their liquidity requirements

In the majority of instances, a restructuring of a distressed merchant (where the majority of the operating business continues to trade as a going concern) will provide better returns for creditors as a whole than an insolvency. Where merchants are unable to negotiate a consensual restructuring with stakeholders, we expect merchants will look to leverage one or more of the UK's statutory processes to impose a restructuring on dissenting creditors, such as a CVA, Scheme of Arrangement or the newly introduced Restructuring Plan.

Typically, a merchant restructuring will include a request for liquidity (i.e. a “new money ask”) from the incumbent creditors and shareholders. Given the volume of cash collateral and / or receipts that can be held by acquirers, the merchant may ask the acquirer to participate in any such new money ask.

This, together with the critical nature of the acquirers' supply makes acquirers significant stakeholders in restructurings and acquirers should ensure they are included in key negotiations.

Recent examples of where acquirers have been a key contributor to restructurings (preserving jobs and minimising chargeback risks) include Virgin Atlantic, where card acquirers materially aided the £1bn+ rescue in 2020 by releasing up to £200m of cash held.

Releasing cash in this way can mitigate material risks for acquirers, as the chargeback exposure can often be significant. In the case of Thomas Cook, the amount requested was reportedly £50m, whereas the customer claims reported by the liquidator amounted to £585m, many of whom will be protected by the statutory and card scheme chargeback protections.

Regulators are concerned whether consumers are sufficiently protected when making payments



Where a merchant has fallen into insolvency, consumers may face harm and, where they suffer a loss vis-à-vis the merchant, usually seek recourse through a chargeback. Although the acquirer does not typically deal with the consumer directly, when chargeback obligations arise, acquirers need to be mindful of the increasing oversight of the regulator.

As part of its 2021 annual report, the Payment Systems Regulator (PSR) reported on its concerns in relation to consumer protection, noting that it wants *“to see measures that protect consumers by making it easier for them to make a claim when something goes wrong with their purchase”*.

Furthermore, in May 2021, the FCA consulted on a new Consumer Duty, which proposes to raise standards on conduct to *“help ensure they [Firms] put their customers' interests at the centre of their business models”*. This includes firms which do not transact with the end customer directly.

Although any changes are not expected to be introduced until 2022 at the earliest, acquirers should actively monitor the FCA's publications and be proactive in adopting any recommendations.

ATOL reforms are having an impact on Merchant Acquirers

The Civil Aviation Authority is currently consulting on a number of changes to the ATOL scheme to further protect customers following the failure of travel businesses (See our recent article, [Changes to ATOL Protection: How Might the CAA's Proposed Changes to ATOL Funding Model Affect the Industry and Wider Stakeholders Involved?](#)). Included in the reforms is a proposal to segregate customer funds, which would only be paid across to the travel business upon completion of the contract. It remains to be seen whether segregating funds in this way might drive some merchants to renegotiate acquirers' hold back rights in due course. It is widely reported that acquirers are supportive of this to mitigate chargeback risk and are encouraging travel businesses to introduce this ahead of the conclusion of any reforms.

Similar attempts to protect customers' deposits / advanced payments were proposed in 2016, including a suggestion that such claims rank higher in the insolvency creditor hierarchy. However, this was considered unfair to other unsecured creditors (including trade creditors) and it was expected to result in more costly borrowings for merchants, as prepaid claims would reduce the amount payable to floating charge holders.



What acquirers need to consider to ensure they can mitigate these risks

As noted by the FCA, there are concerns over the ability of payment firms to absorb the financial impact of COVID-19. Without active monitoring of their portfolio of merchants, some acquirers may be at risk of distress and insolvency resulting from chargebacks if significant numbers of merchants become insolvent.

From our experience both as an advisor to acquirers and merchants, and from taking insolvency appointment over merchants, the following steps should be taken by acquirers:

1. Actively monitor merchants

Particularly in sectors considered most at risk or those with material increases in chargebacks (e.g. retail, travel, hospitality and leisure). Ensure news channels are monitored, request and review management information from the merchant, including cash flow forecasts, merchant's refund requests and status of discussions with other financial stakeholders. Where merchant service providers make use of the acquirer's gateway/platforms/processing, ensure visibility over their merchants as well.



2. Communicate potential disputes to merchants early

Working with issuers to give the merchant time at the beginning of the process to investigate and refund the customer will help prevent that burden hitting the acquirer and reduce the fee (and therefore financial burden) on the merchant.

3. Consider a Buy Now Pay Later (BNPL) offering

Many payment firms are including BNPL options within their gateways. Currently, BNPL credit products are unregulated, and typically do not allow for chargebacks within their terms and conditions. As such, the recourse to the consumer is only through a refund dispute, meaning there is no obligation for the acquirer to pay on insolvency of the respective merchant. However, BNPL is expected to be regulated soon, and acquirers should be mindful of any retrospective action by the FCA and Financial Ombudsman Service.



4. Review contracts with merchants in case they are uncooperative

Perform a legal review of contractual rights to allow you to defer settlements, suspend services, increase chargeback fees, or request further collateral to mitigate any exposure.



5. Get on top of your own cash flow forecasts

In particular, include a reasonable worst-case scenario which forecasts the failure of an appropriate number of merchants and resulting cash impact. Use this to understand whether there is a liquidity or capital requirement.

6. Actively review and update Solvent Wind Down Plans (SWDP)

In addition to being a regulatory requirement, a detailed SWDP and its outputs and triggers allow management to be better equipped to anticipate issues before they become problems. We consider the SWDP in more detail in our article, [Why are Savvy Financial Services Directors of Stable and Growing Firms Talking About Solvent Wind-Down Plans?](#)



7. Engage early

In distressed situations it is likely that acquires will be asked for support with liquidity. Engaging early can enable acquirers to help shape a restructuring, rather than being presented with a *fait accompli*, where acquires are simply asked to fill the hole left by other stakeholders. Consider the balance between the amount requested from the merchant against the possible liability upon failure of the merchant, noting that any claims against the merchant will be unsecured (and may therefore go unpaid).

We are market leaders in providing restructuring solutions to merchants and have supported acquirers in negotiations....

Thomas Cook
Retail Merchant,
Advised Merchant Acquirers



We provided the European credit card acquirers to Thomas Cook plc with strategic and tactical advice on mitigating their exposure to the travel group during the multi-party restructuring negotiations and eventual insolvency/break-up of the business.

Arcadia
Retail Merchant,
Administrators



We are administrators of the retail group, which had c.13,000 employees.

As with most trading administrations, support of the merchant service providers (MSPs) was critical to continuing to trade and maximising value to creditors.

We immediately negotiated with the incumbent MSPs, including buy now pay later providers, articulating the benefits of our trading strategy and how this would reduce chargeback risk to the card acquirers.

...as well as supporting distressed payment firms more generally.

Raphaels Bank
Retail Bank,
Solvent wind down



The Bank's business comprised: personal unsecured lending; automotive lending; e-money cards; and deposits.

We assessed the exit options under a range of scenarios comprising the sale of parts of the business and wind down / share sale of the remainder.

There were several international e-money books with some AML issues and blocked accounts which needed specific management through liquidation.

We were appointed to advise the board and provide assistance as and when required through the implementation and are now liquidators of the residual entity.

Project Igloo
Foreign Exchange,
Restructuring support

The Group is a worldwide Bureau de Change business, which was impacted significantly by the collapse of international travel during the pandemic.

We supported the Group in considering its options, including formal restructuring mechanisms and advised on a consensual rebasing of its rental obligations and exiting certain countries.

We also supported the search for new investment and in planning for a downside case involving the closure (via insolvency) of the majority of its global business.

Aviation Merchants
Foreign Exchange,
Administrators



As part of the fall out from COVID-19, we have advised on a number of merchants in the aviation sector:

Virgin Atlantic – we advised the RCF Lenders, Senior Finance lessors and bond holders with debt of c.£1bn

UK airlines – we advised HM Government on the provision of export development guarantees to two major UK-based airlines

Retail Merchants



Project Tyne
E-Money, Crypto and cards,
SWDP and Solvency review

The Firm is an FCA regulated e-money institution, which was under regulator investigation and restrictions regarding concerns in its AML control framework.

We undertook a review of the Firm's solvent wind down plan, including its medium-term cash flow forecasts, to understand whether the Firm had sufficient liquidity to remediate its control framework or be wound up on a solvent basis.

We also supported the Firm in its discussions with the FCA.

Numex
Foreign Exchange,
Administrators

Our appointment followed concerns regarding the directors' conduct and the withdrawal of substantial sums from the Firm's client money account.

Upon appointment the Firm had minimal assets and our focus was to (1) investigate the treatment of client money and secure its return (which was all successfully returned); (2) ensure frequent engagement with the FCA to understand concerns; and (3) investigate the conduct of the directors and pursue recovery actions.

Teneo's Financial Services Restructuring Team

Teneo's Financial Services Restructuring Team includes market leading experts and provides pragmatic solutions to firms and their stakeholders in periods of stress.



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Selected recent credentials*

 <p>Private Equity fund Provisional Liquidators \$13.6bn assets</p>	 <p>UK-based independent bank Solvent Wind Down £243m assets</p>	 <p>Consumer credit – Rent to Own Accelerated M&A £30m loans</p>
 <p>Commodities Trader Liquidators \$1.2bn creditor claims</p>	 <p>UK-based challenger bank Solvent Wind Down Plan support £445m assets</p>	 <p>Spanish Systemic Bank Valuation under the EU's BRRD €147.8bn assets</p>
 <p>Private wealth bank Manager and Liquidator \$2bn AUM</p>	 <p>Debt management Accelerated M&A 38,000 clients</p>	 <p>Insurance Contingency Planning and options review £190m debt</p>
 <p>Consumer credit – HCSTC / mini-bonds Solvency review >50,000 customers</p>	 <p>Funds and Mini-bonds Administration and asset recovery 1,000 retail bondholders</p>	 <p>European Bank Wind Down & Liquidation £2.4bn AUM</p>

* Including when Teneo Restructuring was Deloitte UK's Restructuring Services team



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