

PAYMENT CARD FRAUD IN HUNGARY

(2005)

Payment System and Currency Issue Policy

Analysis structure

The analysis covers the fraudulent activities and losses written off in the card-issuing business and the fraudulent activities and losses written off in the acquiring business separately.

Fraudulent activity means fraudulent acts reported by cardholders or otherwise communicated to banks in the period under review, i.e. in 2005. Such fraudulent acts were investigated by the banks affected during the same year and shown as losses for some participant of the payment card business. In some cases, however, the completion of such investigations is likely to last well into next year.

Loss written off means the recording of financial damage as loss by some participant in the card business, i.e. the issuing bank, the cardholder and participating retailers or the banks of such (acquiring banks). Financial damage forming the basis of losses occurred in either the period under review or the year before; however, the investigations were completed in 2005.

Fraud and loss arising in the card-issuing business means any misuse in the use in Hungary and abroad of cards issued by Hungarian banks (this category includes the frauds and losses incurred in on-us transactions, i.e. those arising in the issuing bank's own network, in transactions conducted with the issuer's cards).

Fraud and loss arising in the card-acquiring business means fraud involving the use of domestically issued cards and foreign-issued cards in Hungary (frauds and losses incurred in transactions involving the use of the acquiring bank's own cards in its own network, that is on-us transactions, are not covered under this point of the analysis).

Frauds and losses in the card-issuing and the acquiring business contain some overlap, notably the losses incurred in connection with the use in Hungary of cards issued by Hungarian banks, outside the issuer's network, consequently, the figures from the two sectors cannot be combined!

Introduction

Frauds and losses written off in the card-issuing business

Frauds in the card-issuing business in 2005 amounted to HUF 218 million, representing an increase of 7% and accounting for 0.004% of the overall issuing turnover (same as in 2004).

- In terms of all frauds, the ratio of fraud arising from the use of counterfeit cards (35%) dropped to second place for the first time. In value it is almost the same as last year (HUF 77.2 million).
- Fraud resulting from the use of stolen cards amounted to HUF 86.1 million, an increase of 26% compared to the year before. The ratio among the total fraud is 39%, meaning that it is the highest fraud category.
- Fraud caused by way of mail, phone or internet amounted to HUF 16.2 million, representing 7% of the total (same as in the previous year).
- Fraud from other forms of misuse (which cannot be classified under the aforementioned categories) dropped to half of what it was last year (HUF 20 million); for the most part these frauds result from purchases made within the limit using legitimate cards.
- Fraud in connection with lost cards represents 6% of the total (its value is HUF 12.4 million).
- Although the value of fraud arising from fraudulent application amounts only to HUF 5.5 million, the rate of increase is significant (twenty-four times higher).

Losses written off in the card-issuing business amounted to HUF 208 million (increased by 5% compared to last year).

- Issuing banks wrote off 38% of all losses, and they charged 44% on the cardholders and 17% on the acquiring banks.
- In spite of the fact that according to the relevant Government Decree, since 1 December 2002 a cardholder is only liable for losses incurred prior to notification up to a limit of HUF 45,000, unless a loss has been incurred as a result of proven wilful misconduct or gross negligence by the holder, the ratio of losses charged to cardholders has increased steadily during the last three years.

Frauds and losses written off in the acquiring business

- Frauds incurred in the acquiring business show an increase of close to one-third by comparison to last year; HUF 134 million, accounting for 0,0026% of the overall acquiring turnover
- The use of counterfeit cards amount to 30% of the total fraud, in an amount of HUF 40 million.
- The percentage and the amount of fraud caused by stolen cards is the same: 30% of the total fraud, HUF 40 million.
- Fraud caused by way of mail, phone or internet increased fourfold; HUF 29 million, 21% of the total fraud
- The total losses amounted to HUF 73 million, 23% of which was covered by the acquiring banks, with 21% charged to their retailers and 56% on the issuing banks. The percentage of losses covered by the acquiring banks increased significantly by comparison to last year's figure (when it was 2%), that may be attributed in part to the international card companies' liability shift rule.

1. Frauds and losses written off in the card-issuing business

1.1. Fraudulent activity

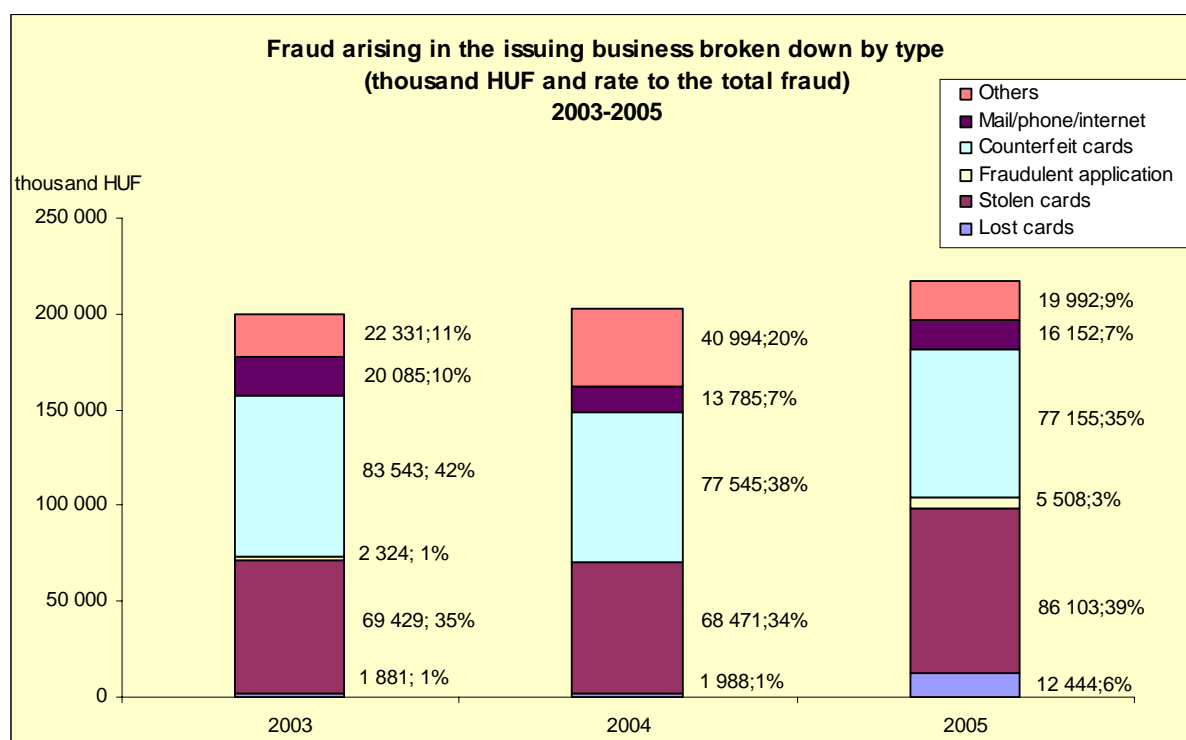
The absolute value of fraud from the use of domestic issued cards increased by 7% compared to last year, reaching HUF 218 million in 2005. The ratio of fraud in overall issuing turnover (domestic and foreign transactions conducted with domestically issued cards) remained the same, it was 0.004% in 2005 and before.

The amount of fraud per one card was thirty forints (one forint less than the year before), in other words each cardholder would suffer this fraud if the overall fraud were to be distributed evenly among them. It took 6,171 unauthorised transactions to accumulate the total amount of fraud, namely, each fraudulent transaction caused an average damage of HUF 35,366 (down from HUF 39,486 in 2004).

As for the number of fraudulent use, three out of every one hundred thousand transactions constituted some kind of card misuse during 2005 (same as the year before).

Of the total fraud, 16% arised within the ATM and POS network of the issuing banks (1% higher than the year before), while the rest within the network of other domestic and foreign banks.

The charts below shows the amounts of frauds broken down per type, indicating the percentages within the total fraud for the past three years:



As the chart indicates, the first two places changed during 2005.

Frauds resulting from the use counterfeit cards are showing a gradually decreasing tendency in recent years, is pushed back to second place, yet it still accounts for over one-third of the total nonetheless. In terms of value, there is no change to speak of in comparison the last year. In this particular category further decrease is expected stemming from the EMV chip migration,

promoted by international card companies such as MasterCard and Visa and the related liability shift¹. The use of EMV² chips has been declared mandatory by the SEPA Cards Framework³ (SEPA = Single Euro Payment Area), and the majority of local banks plan to introduce SEPA conform products by January 2008. This means that, in addition to magnetic strip, cards will also have an EMV chip installed. Although Hungary is not yet a member of the Single Euro Payment Area, two banks have already made its move and installed EMV chips on some of their cards to make counterfeiting them significantly more difficult; at the end of 2005, 18% of all cards was considered SEPA compliant.

As it is the case for other types of fraud, the service provided by most banks proved very efficient in this case as well, namely that they send an SMS to the cardholder after each use, to enable them to take immediate action in the event of any unauthorised use, meaning that if the card was used by someone else. Another beneficial service is the monitoring system designed to watch suspicious transactions. Taking into consideration the relatively low number chip cards, in the domestic market these two methods will play a larger role in keeping the level of fraud caused by counterfeit cards under control.

Frauds from unauthorised transactions conducted with stolen cards took first place in the period under review – showing an increase of 26% in comparison to the previous year in terms of value, and it took the lead also in terms of percentage among all other forms of fraud. The SEPA Cards Framework mentioned above urge the broader and mandatory use of PIN⁴. It leaves it up to the issuing banks to decide for which cards they will require the mandatory use of PIN for POS⁵ purchases as well (for cash withdrawals at ATMs⁶ use of the PIN is mandatory). Making use of the PIN mandatory substantially reduces the possibility of unauthorised use of stolen cards, provided that clients pay attention to the proper storage of PIN (meaning that it is not written on the card or on a note that is kept with the card, and that is kept secret as prescribed in the card agreement).

The third major item is the category entitled Other frauds. The activities of a criminal organisation involving several banks since the beginning of 2004 (where they conducted purchases with legitimate cards within the limit in neighbouring countries) are now under control, manifested in the amount of fraud that has been reduced to half.

The value of transactions conducted with cards by way of mail/phone/internet through the unauthorised use of data from a card has increased by 17% compared to last year, however, its share among the total fraud is unchanged.

¹ 'Liability shift' means that the liability for fraudulent card transactions will pass to the bank that did not make its cards EMV chip compliant and did not upgrade its ATM and POS terminals to chip capability.

² 'EMV' means a standard drawn up and applied by the consortium comprising JCB, MasterCard and Visa (EMVCo), designed to ensure the inter-operability of chip cards, chip terminals, financial messages and related services.

³ 'SEPA Cards Framework' means the set of principles and regulations drawn up by the Cards Working Group operating under the European Payment Council, designed to enable European cardholders to effect bank card payments and cash withdrawals in the SEPA zone with the same ease and under the same conditions as in their country of origin.

⁴ 'PIN (Personal Identification Number)' means a – generally – four-digit secret code known only to the cardholder, used for the identification of cardholder at ATMs and POS terminals.

⁵ 'POS (Point of Sale)' means electronic terminals used mostly in the cashiers of retailers, enabling the cardholder to conduct payment transaction with their cards, where the use of PIN may also be required.

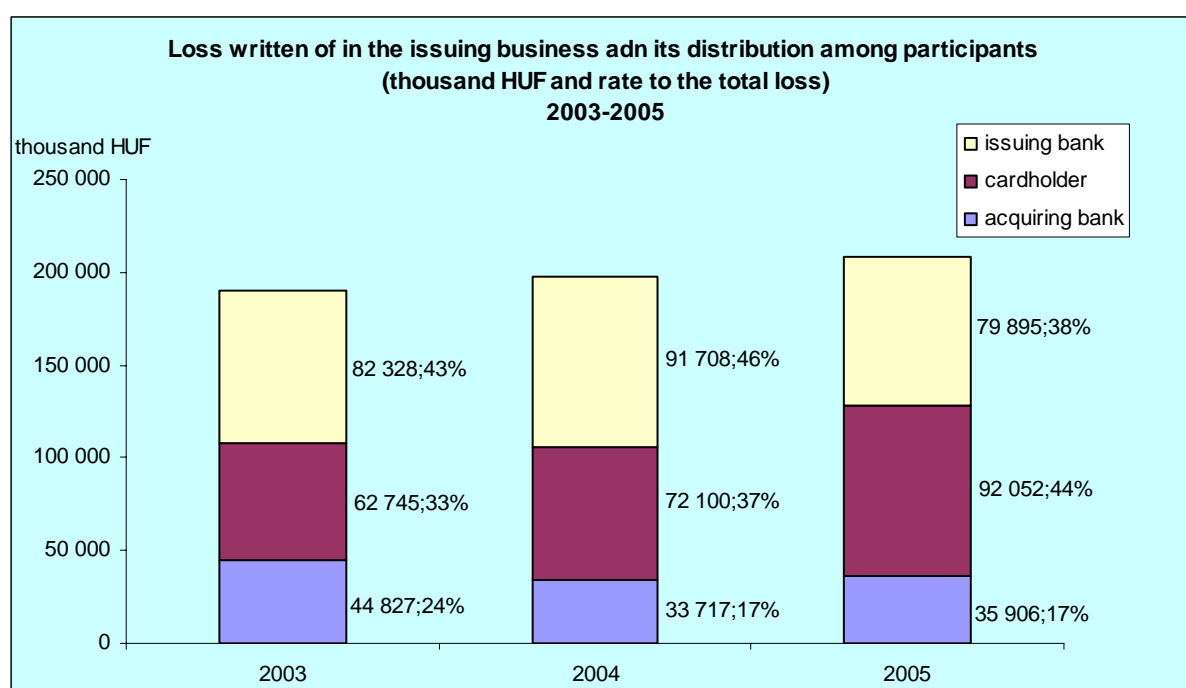
⁶ 'ATM (Automated Teller Machine)' means an electronic equipment designed for cash withdrawals, enabling the cardholder to withdraw cash using his card and PIN.

The value and share of frauds committed by using stolen cards increased by a factor of six during 2005 (even though it is the one before last). Compliance with the provisions prescribed for stolen cards may help to suppress these frauds.

The value of fraud from fraudulent application is the least significant in terms of percentage, the rate of increase is significant (twenty-four times higher) nonetheless. The total fraud amounts to five million forints, 80% of which is related to cards sent by a direct mail campaign, and that were activated not by the addressee, but by another person in the name of the addressee.

1.2. Losses written off

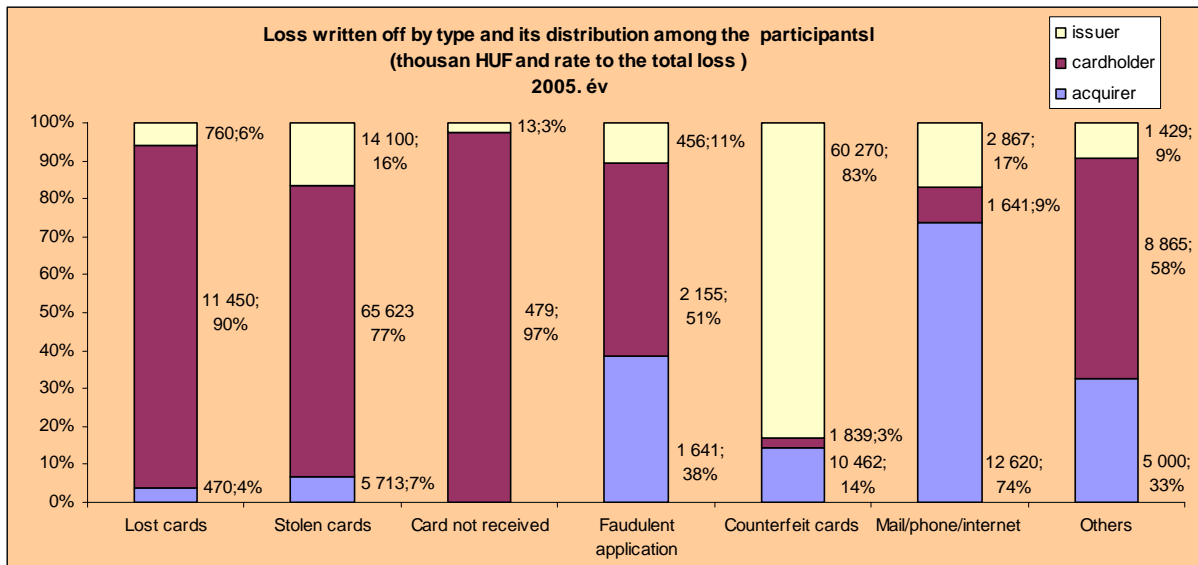
The losses incurred during the year under review and the previous year increased by 5% in comparison to the previous year, reaching HUF 208 million in 2005.



The share and value of losses charged to cardholders have been increasing steadily in recent years (the latter by 28% in 2005). This stands true even though the cardholder is held liable – according to the relevant legal regulation⁷ – since 1 December 2002 for losses incurred prior to notification up to a limit of HUF 45,000, unless a loss has been incurred as a result of proven wilful misconduct or gross negligence by the holder.

The share of loss charged to cardholders varies for the different types of fraud cases. The chart below indicates the amount of losses written off broken down for each type of fraud, and the share of bearing these losses among the participants of the card business.

⁷ According to Government Decree 232/2001 (XII. 10.) on Monetary Circulation, Financial Transaction Services and on Electronic Payment Instruments cardholders are required to report the loss or theft of their card and/or PIN, or if noticing any unauthorized transaction shown on their bank statements.



Banks are most inclined to charge losses from frauds with cards that were reported stolen or lost, amounting to close to half of all losses (HUF 98 million), to cardholders. Presumably, the reason for this is that cardholders either neglect to keep a close eye on their cards, and they fail to even notice if it is missing (notify the bank beyond a period that is considered reasonable); or the thief is able to obtain the PIN as well, the use of which provides reasonable cause, although not conclusive evidence, for the cardholder's negligence.

Losses from the use of cards not received is trivial, it is below half a million forints annually, therefore the ratio of loss distribution for 2005 is not considered common.

The share charged to cardholders is more significant, over fifty per cent, for losses resulting from the fraudulent application for cards, and in connection with other frauds. The amount of loss written off in these two categories amount to nine million forints, comprising a 9% share. In both cases the losses suffered by retailers who accept the cards is also significant.

On general principle, the majority of losses (HUF 72.5 million; 35% share) from the use of counterfeit cards is written off by the banks in their own books. Notably because, in these type of fraud cases the cardholder is able to notice any irregularity only:

- upon receipt of the account statement, and finds any unknown transaction,
- upon receipt of a SMS from the bank of a transaction that he did not conduct, or
- when a transaction is rejected due to insufficient funds, whereas the cardholder is certain of having enough funds on the account.

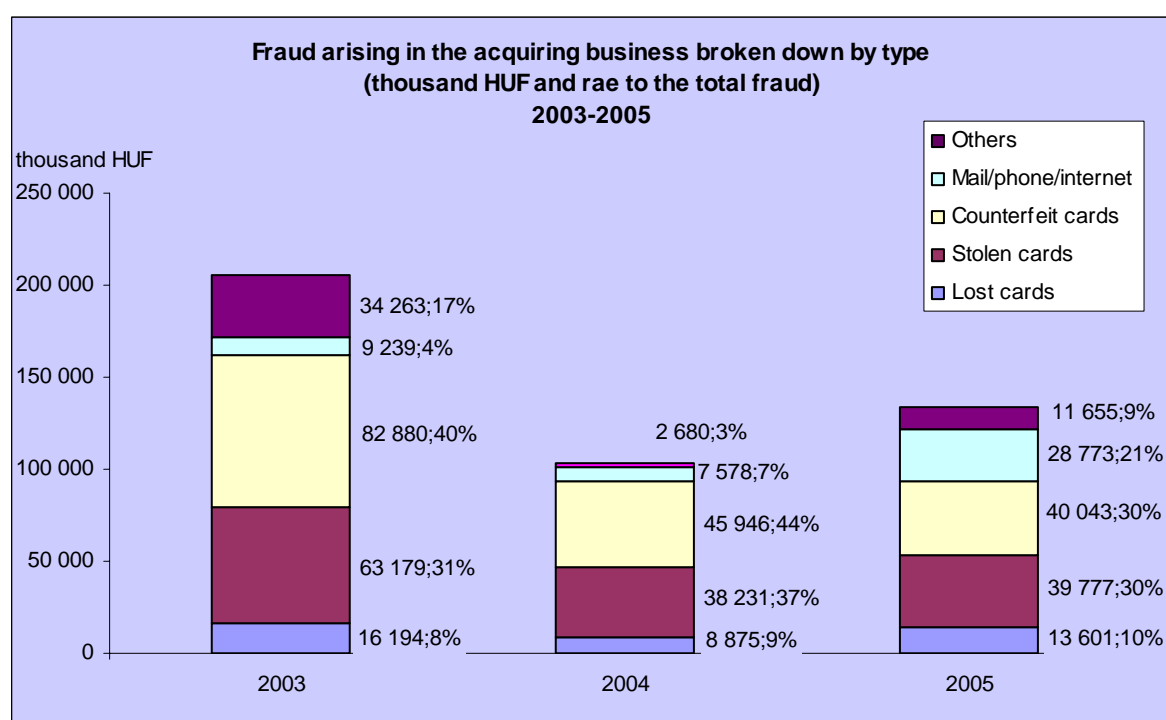
Banks charge the largest percentage of losses on to retailers in connection with frauds committed through mail/phone/internet (HUF 17 million, 8% share).

2. Frauds and losses written off in the card acquiring business

2.1. Fraudulent activity

In comparison to the previous year, frauds in acquiring turnover – meaning the transmission conducted in the network of an acquiring bank with cards issued by other domestic and foreign banks – increased by close one-third, reaching HUF 134 million and accounting for 0.0026% of the overall acquiring turnover (up from 0.0022% in 2004), nearly the same as in the previous year.

The charts below shows the amounts of losses broken down per type and indicating the percentages within the total fraud in the acquiring business for the past three years:



The two largest type of fraud are – as always – the fraud arising from the use of cards that were reported stolen or lost, and those from the use of counterfeit cards; showing the same amount and the same percentage (both HUF 40 million and 30%). The value of fraud from the use of counterfeit cards dropped by 13% compared to last year's figure, where as the value of transactions conducted with stolen cards rose by 4%. As for counterfeit cards the chip migration referred to in paragraph 1.1 has already made an impact, however, in view of the relatively low number of terminals capable of reading chip cards (at the end of 2005, 22% of retailer POS terminals; all at a single bank), the reduction is due rather to the use monitoring system to screen suspicious transactions and to the sending of SMS after each transaction.

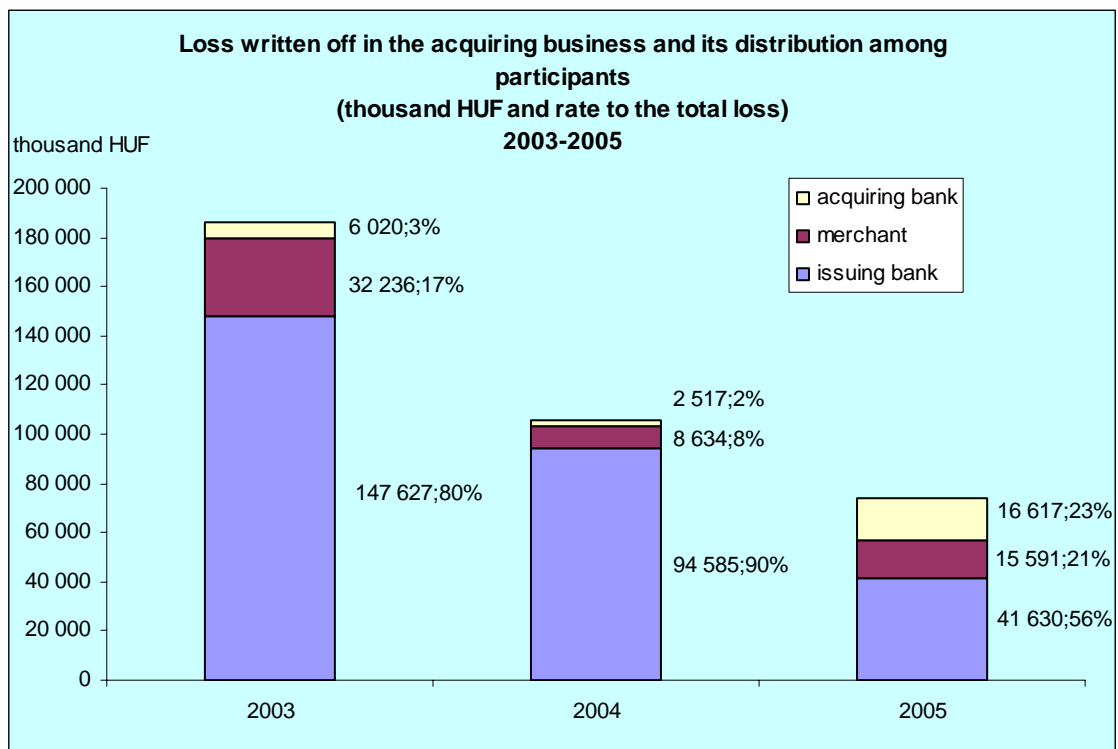
The value of fraud committed by way of mail/phone/internet is showing signs of steep growth, increased by a factor of four and it not accounts one-fifth of the total fraud for 2005. Criminals

are becoming more and more sophisticated in their methods in connection with mail and phone orders (MO/TO = Mail order, telephone order), and also electronic commerce over the internet.

2.2. Losses written off

According to the findings of the examination of losses, participants of the payment card business have written off HUF 73 million last year (30% less than the year before); and the investigation of several cases are carried over to next year.

The chart below demonstrates the share of loss borne by the various participants in terms of value and percentage among all losses.



Previously, acquiring banks were inclined to charge the majority of losses upon their retailers or upon the issuers, in 2005, however, they had to write off more than one-fifth of these losses (six times over in terms of value). Since international card companies are already using the principle of liability shift referred to in paragraph 1.1, in all likelihood this largely contributed to such an increase in their losses.