Public and Private Responses to Payments Fraud

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Let's start with a definition

- ***Economist***
  - Someone who sees something work in practice and wonders whether it would work in theory

Payments fraud through the lens of economic theory

- Key buzzword
  - Services provided by modern payment systems (including fraud mitigation) can be classified as ***club goods***

Club goods: definition

- A club good is
  - ***Nonrival*** (not diminished by successive use)
  - ***Excludable*** (it is possible to keep parties who have not paid from enjoying good)

Other club goods

- Many so-called “digital goods”
  - Cable TV programming
  - Recorded audio/video
  - Computer software

Does the club good idea work for payments fraud?

- Nonrival: almost all fraud mitigation activities provide **group benefit** (ensure integrity of given payment system)
  - Examples: identity verification, authentication, fraud detection, database of perpetrators, security standards
- Excludable: benefits only provided to payment system participants

Similar, yet different

- Fraud mitigation differs from many other club goods
- **"Weakest link"** club good: <u>total</u> amount of good provided often depends on <u>lowest</u> effort provided by any group member
- Some weak links:
  - OfficeMax, TJX, Hannaford, and others

Club goods: why interesting to economists?

- “Halfway” between ***private goods*** and ***public goods***
  - ***Private good*** is rival and excludable
    - Examples: stuff you buy at Wal-Mart
  - ***Public good*** is nonrival and nonexcludable
    - Examples: national defense, clean air, criminal justice system

Implications for role of government

- ***Private goods:*** provided by private sector (no govt. takeover of Wal-Mart)
- ***Public goods:*** provided by public sector (no privatization of the Pentagon)
- ***Club goods:*** provided by private sector (Hollywood, Microsoft) <u>but</u> with government intervention (intellectual property law, FCC, antitrust)

How about payments fraud mitigation?

As with other club goods

- Most fraud mitigation <u>left to private sector</u>
- But, <u>government regulation is pervasive</u> and increasing (Regs. E&Z, ITADA, FACTA, etc.)

Getting back to the subject

Question #1: What role for government?

- Theory of club goods says that, by and large, fraud mitigation is most efficiently undertaken by the private sector
- Profit motive is key driver of innovation and cost efficiency

On the other hand

- There is an underlying public (nonexcludable) good:
  - Public’s <u>confidence</u> in innovative payment systems, and overall payments system
- (Some) payment system regulation can be rationalized as a way of maintaining such confidence
  - Example: 1968 TILA/ Reg Z and credit cards

Other roles for government

- Coordinating industry/consumer efforts
- Impartial standards setter
- Applying criminal sanctions

Question #2:

In terms of fraud mitigation, should one size fit all?

- Theory: No

Question #3:
How effective are standards in fraud mitigation?

- Theory: standards are useful for coordination but cannot resolve inevitable <u>conflicts of interest</u>
- Players with much at stake must find way to motivate smaller players, especially for <u>weakest-link goods</u>

Summary

- Payments fraud mitigation, a club good
- As with other club goods, private sector provision increases efficiency
- Roles for government:
  - coordinate standards
  - facilitate communication
  - promote confidence
  - punish criminal behavior