Public and Private Responses to Payments Fraud

William Roberds
Research Economist and Policy Advisor
Federal Reserve Bank of Atlanta

2008 Payments Conference
Federal Reserve Bank of Chicago
June 6, 2008
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: total amount of good provided often depends on lowest 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) but with government intervention (intellectual property law, FCC, antitrust)
How about payments fraud mitigation?

As with other club goods

• Most fraud mitigation left to private sector
• But, government regulation is pervasive 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 confidence 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 conflicts of interest

• Players with much at stake must find a way to motivate smaller players, especially for weakest-link goods
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