

# Turning the Risk Discount into a Trust Premium

A buySAFE® White Paper  
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## Consumer anxiety—a lack of confidence and a lack of trust—is threatening the online business of small and mid-size retailers.

When consumers feel that the Internet is not a safe place to do business, they become anxious. Whether or not such a high level of fear is warranted, the effect on online retailers is daunting. Needless to say, this consumer anxiety creates a complicated challenge for online merchants, especially small and mid-size retailers, who are finding it increasingly difficult to establish trust with their potential buyers. Buyers who perceive risk may not buy at all; if they do buy, they will discount the price that they are willing to pay.

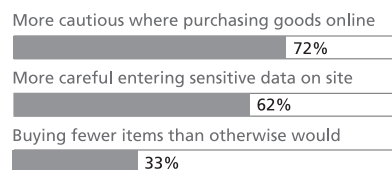
### Risk . . . and the Perception of Risk

The majority of sellers take steps to represent themselves in a credible and trustworthy fashion. However, some fraudulent sellers have created scams worthy of prominent media attention. As Internet fraudsters become

#### Online Shoppers are Concerned

How U.S. Internet consumers are being affected by phishing and identity theft activity, based on a survey of 5,000 adult online users in May\*

##### Among concerned online shoppers:



\*Margin of error is +/- three percentage points

Source: Gartner Research<sup>1</sup>

more sophisticated, the number of online criminal schemes and computer attacks is rising dramatically. The FTC reported in January 2005 that Internet-related complaints accounted for 53 percent of fraud reports and \$265M of \$548M in reported losses in 2004. Clearly, online buyers are exposed to significant transaction risks, most of which are extremely hard to detect and protect against. Media coverage of these risks results in a perception of the problem that is greater than the true

threat for buyers. The risks, and the perceptions of the risks, have a major impact on online buyer behavior.

### The Risk Discount & The Trust Premium

The perception of risk leads buyers to avoid buying or, at best, to discount the prices they are willing to pay. That is, online buyers decrease the price that they are willing to pay based on their perceived level of risk in the transaction. A great deal of evidence—ranging from academic research to anecdotal evidence and buySAFE Bonded Seller experiences—supports this conclusion. This is called the “Risk Discount.”

Conversely, buyers who discount the prices they are willing to pay in high-risk transactions are willing to pay a premium for a low-risk transaction. That is why buyers are willing to pay a major online retailer more for an identical product than they are willing to pay a lesser-known Internet merchant. This is called the “Trust Premium” and it is the inverse of the risk discount. For small to mid-sized online merchants, turning the risk discount into a trust premium has never been more critical to profitability.

### The Relationship Between Risk and Return

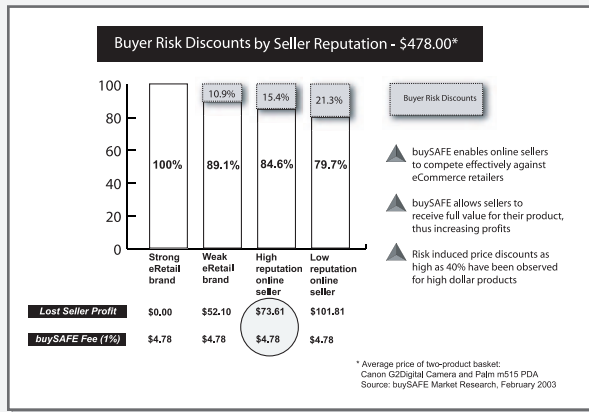
A significant body of literature in the field of economics discusses the relationship between risk and return (Sharpe, Miller & Modigliani, etc.). As any investor will tell you, a greater risk is attractive only if it offers a greater return. Studies that examine the relationship between risk and pricing in online transactions have consistently found a similar relationship. Online shoppers seek to compensate for greater risk by decreasing the price they will pay.

Two independent studies focusing on low-priced products have demonstrated that discounts suffered by sellers with weak reputation scores range from 6.8%<sup>2</sup> to 7.6%<sup>3</sup>. A third study, based on higher-priced Palm PDAs, found a price discount of 12.6%<sup>4</sup>. The impact on even higher-priced items could be as high as 40%.

Most recently, a report issued by the investment firm of Piper Jaffray on June 27, 2005, concluded that “respect-ed branded sellers are pulling the large numbers of

fraud-averse online shoppers away" from lesser-known sellers, and that remaining buyers "are applying what amounts to a 'fraud discount'" and forcing prices lower.<sup>5</sup>

Buyers perceive risk in a transaction because they have limited knowledge of the seller's ability and willingness to perform. They do not know as much about the seller as they would need to know in order to feel comfortable. Nobel laureate in economics Joseph Stiglitz has pointed out that buyers seek to increase their level of comfort and



confidence by screening (limiting the selection of sellers they will deal with). Stiglitz's fellow Nobel laureate George Akerlof showed that several market institutions have arisen to alleviate consumer anxiety, including brands, the safe havens of chain stores, and guarantees.

*Specifically, buyers' risk perceptions are mitigated by:*

**1) Screening:** Many shoppers have so little confidence in online transactions that they take screening to its extreme and avoid online buying entirely. Fears over the safety and security of buying online are among the primary reasons for their reluctance to buy. Because the online buyer and seller are typically engaged in a one-time transaction, there is little incentive for the buyer to invest the time and effort necessary to research the seller thoroughly. It is easier not to buy. However, an objective, trusted, third-party institution can perform the thorough screening and ongoing monitoring of an online retailer's performance that consumers themselves cannot. By verifying a seller's identity and confirming that the seller is financially stable, has a record of reliability, and continually performs as promised, the institution gives buyers a strong signal that a seller will most certainly live up to the terms of sale.

**2) Brands:** Many shoppers find security in well-known brands. They will shop—and buy—in the online stores of national brands but will not buy from smaller online retailers because they feel that they do not know them, that they do not know what to expect from them, or that they have "never heard of them." To counter this effect for small to mid-sized online retailers, an objective, trusted third-party can help by lending its own brand to qualifying sellers—permitting them, and only them, to display a brand that indicates their having successfully passed the screening process. The third-party institution can enable smaller online sellers to compete more effectively with established, well-branded, online retailers. Shoppers who have come to respect and trust the third party's brand will know that they can trust the retailers who are permitted to use it.

**3) Safe Havens:** Shoppers often feel that they are at risk in any online marketplace or website where they have not bought before. They reduce their risk by shopping only in stores that they perceive as having the lowest level of risk—those that they feel are safe. Conversely, by establishing an online retail presence exclusively for retailers who have passed the screening process, the third-party institution can provide shoppers a place where they know that they can shop safely and provide qualifying retailers with a place where they are clearly presented as trustworthy.

**4) Guarantees:** A guarantee can go a long way toward making shoppers feel more secure, but shoppers rightly feel that a guarantee is only as good as the company issuing it. They perceive the guarantee offered by a small or mid-sized online retailer as just as risky as the rest of the transaction. However, they have confidence in a guarantee offered by a trusted third party because they see that the third party is willing to stand behind the retailer's performance. The third-party can guarantee all shoppers' transactions with the qualifying retailers. The up-front assurance of a nearly risk-free shopping experience backed by a financial guarantee in case of loss will have a significant impact on reducing buyers' risk discounts.

**How can a merchant without a well-known brand establish the kind of trust with buyers that will reduce the buyer's risk discount?** Fundamentally, a merchant must reduce or even eliminate the perception of risk before, during, and after the shopping experience. In an eCommerce environment fraught with fraud, addressing risk at every step of the buying process is essential to distinguishing trustworthy, reliable sellers.

## How Online Marketplaces Benefit from Reducing Risk...and the Perception of Risk

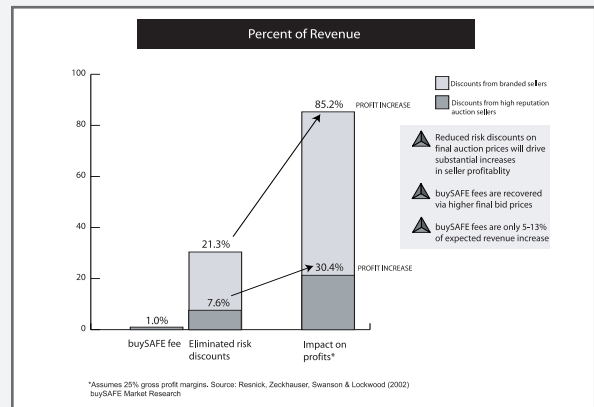
Online marketplaces will benefit greatly from reductions in real and perceived risk. First, the markets will appeal to a much larger pool of potential shoppers. This vastly increases the addressable audience. Second, reduced risk translates into higher purchase prices, faster sell through, and more sales—all of which result in higher fees to the marketplace.

Numerous studies suggest that neither the marketplace itself nor a payment provider is the best provider of a trust mechanism, because they each have business interests that favor one side of the transaction. Instead, the buyer and the seller both prefer a trusted, objective, third party as a discerning mediator. As a trust broker in a three-way agreement, the third party succeeds only when both the buyer and the seller are satisfied with the transaction. From the shoppers' point of view, the success of a trust mechanism depends on its success at increasing their level of comfort and confidence through screening, branding, providing safe havens, and guaranteeing.

## The Trust Premium Defined

Buyers who discount the prices they are willing to pay in high-risk transactions are willing to pay a premium for a low-risk transaction. That is why buyers are willing to pay a major online retailer 26.6%<sup>6</sup> more for a PDA than they are willing to pay a lesser-known Internet merchant. They will pay more for a transaction they trust, for the feeling of security, for the knowledge that the transaction will proceed as promised. For sellers of low-priced products with low gross profit margins, the increase in

profits from turning buyer discounts into trust premiums is significant. For a seller with a more typical gross profit margin of 25%, profits could increase by 30–85%.



Not only does an objective, trusted, third-party performance guarantee allow weakly branded online sellers to compete more effectively with other weakly branded online sellers, it also (and perhaps more importantly) becomes an effective substitute for a recognizable brand that will allow small online sellers to compete with their branded counterparts.

## What buyers are saying:

*"I am willing to pay more for an item if I know I am safe bidding on it."*

—Diana Moore

(From buySAFE's Online Buyer Survey, 2005)

# The buySAFE Solution: Bonded Shopping

**Bonded Shopping, created by buySAFE as a system for risk reduction, provides the means by which buyers can be confident that risk really is being reduced. It is the most comprehensive risk elimination solution available in online shopping.**



Because buySAFE's approach is comprehensive, it provides a very strong signal of credibility—and because it is backed up by a third-party guarantee of performance, it makes buyers confident that

they are well protected from transaction risks.

## **Bonding to Reduce Risk . . . and the Perception of Risk**

Research has shown that buySAFE can eliminate perceived risk by using a special credit-based performance guarantee called a surety bond. Surety bonds have been used for centuries to guarantee business transactions involving buyers and sellers who do not know each other. The bond provides the buyer with a guarantee that the seller will live up to the terms of sale, thereby protecting the buyer from nearly all transaction risk (such as fraud, misrepresentation, seller default, refund and guarantee failure, or transit problems, for example). For the online retail community, Bonded Shopping makes transactions safer for buyers, more profitable for sellers, and more efficient for marketplace sites—such as eBay and Overstock.com—benefiting all parties in the transaction.

buySAFE begins the risk-reduction process by pre-qualifying sellers, carefully evaluating a seller's experience, track record of success, reputation and financial strength and stability, as well as verifying identity. This comprehensive review process is called the buySAFE Business Inspection. buySAFE then provides qualified sellers—Bonded Sellers—with a surety program that they can use to guarantee their performance on all their transactions. This guarantee, backed by a trusted third-party financial

institution, Liberty Mutual, provides buyers with an assurance that they will be protected if there is a problem. Most importantly, the seller makes a financial commitment to the buyer and to an independent third party, thereby making a powerful statement of intent to perform as promised, and providing an equally powerful assurance that there won't be a problem in the first place.

## **Research Supports buySAFE's Value Proposition:**

According to results of a buySAFE proprietary test<sup>7</sup>:

- Bonded items had a sell-through rate more than 17% greater than non-bonded
- Bonded items had a final sales price more than 3% greater than non-bonded on average
- Total sales revenue for bonded items was nearly 15% greater than for non-bonded

A third-party performance guarantee provides the strongest possible signal to buyers about the professionalism and credibility of the seller, and that signal is backed up by the comprehensive financial protection of a surety bond. buySAFE Bonded Shopping is the only means currently available to reduce risk before, during, and after a transaction. It succeeds by employing the methods that shoppers themselves use to decrease risk and increase confidence: screening, branding, providing a safe haven, and providing a guarantee.

*buySAFE reduces buyers' risk and perception of risk through:*

**1) The buySAFE Business Inspection** - buySAFE screens sellers by requiring them to pass the comprehensive buySAFE Business Inspection. This secure online process confirms a seller's identity and evaluates the seller's experience, reputation, track record of honoring commitments, and financial stability. buySAFE is the only service that thoroughly pre-qualifies merchants to avoid problem transactions before they occur.

**2) The buySAFE Seal** - Approved sellers enjoy the benefits of a well-known brand when they join the select group of online merchants qualified to display the buySAFE Seal on their item listings. Having appeared in more than 10 million online listings with a total value of



more than \$4.5 billion, the buySAFE Seal has become the mark that shoppers look for before they buy. It gives them confidence that they are

buying from the best merchants anywhere. Displaying the buySAFE Seal on their item listings helps Bonded Sellers establish brand recognition that other sellers do not have.

**3) The buySAFE Bonded Shopping Network** - buySAFE provides shoppers the safe haven of a retail site where only a select group of online merchants are qualified to have their items listed. On the Bonded Shopping Network at [www.buySAFEshopping.com](http://www.buySAFEshopping.com), shoppers can easily search and browse all of the bonded listings on the Web. It is a place where shoppers feel free of the anxiety that keeps them from buying elsewhere.

**4) The buySAFE 10-Point Guarantee** - When shoppers see the buySAFE Seal, they know that the transaction is backed by a 10-point guarantee that includes a surety bond that protects the buyer's purchase up to \$25,000 in the unlikely event that anything should go wrong. The backing of a trusted third-party financial institution makes the guarantee a powerfully credible instrument of trust.

Bonded Sellers—those who pass the buySAFE Business Inspection—can use the buySAFE Seal as a trust mechanism to attract more buyers and higher prices wherever the retailer appears online. Sellers can either pay the buySAFE charges themselves or pass them on to the buyer via a separate charge similar to shipping costs. buySAFE gives Bonded Sellers a powerful competitive advantage versus other sellers.

#### According to buySAFE survey of over 1,500 buyers of Bonded Items:

- 91.6% feel safer seeing the buySAFE Seal in an online item listing
- 97% prefer to purchase an item from a Bonded Seller over a non-bonded seller with ten times as many positive feedback ratings, when terms of sale and price are the same
- 85.6% will be more likely to bid/buy an item if they see the buySAFE Seal in the online item listing

**One of the biggest challenges Internet merchants face today is the perception of risk that consumers associate with online marketplace sites.** Risk perceptions lead online shoppers to avoid buying from weakly branded merchants or to discount the prices they would otherwise be willing to pay. Every day, consumers are exposed to negative stories about eCommerce risks from media sources they know and trust. Consumer anxiety translates into fewer bids, lower sales prices, and fewer products being sold—costing professional online retailers millions of dollars each year. First, the perception of risk leads many online users to avoid buying online altogether. Second, it leads to reduced participation in online buying. Buyers discount the price they would otherwise be willing to pay to compensate for the assumed risk. Reduced participation leads to lost transactions for online retailers, and risk discounting leads to lower prices for online sellers. The evidence in support of these observations is substantial.

buySAFE can help increase a seller's revenue by closing this consumer confidence gap with a surety bond. Surety bonds have been used offline by merchants for almost 5,000 years. Today, buySAFE is the only company that enables Internet merchants to become Bonded Sellers, thereby benefiting and protecting their online retail businesses. Being a Bonded Seller is a point of distinction—a mark of trustworthiness—that helps Bonded Sellers turn more of their shoppers into buyers.

PROBLEM	NEED	SOLUTION
Consumers don't know which online merchants they can trust	A method of screening merchants.	The buySAFE Business Inspection
Small and midsize online retailers don't have the strength of a well-known brand.	A method to brand outstanding smaller merchants.	The buySAFE Seal
Consumers don't have a shopping channel where they know they are completely safe.	A channel where every merchant is reliable, every deal is guaranteed, and every transaction is bonded.	The buySAFE Bonded Shopping Network
Consumers want a strong guarantee of satisfaction, backed by a name they can trust.	A third-party institution-based trust mechanism.	A surety bond through buySAFE

## SELLER CASE HISTORIES

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### **Victoria and Addison Miller, eBay User ID: herbs-and-oils**

Victoria and Addison sell essential oils to consumers and to candle and perfume companies all over the world. They started using buySAFE to show their customers how much they care about customer service. To their surprise, buySAFE has positively affected their business in many more ways than they had originally thought.

**Results:** "buySAFE is the best single thing that has happened to our business. Since we became Bonded Sellers, we have tripled our sales...We use the Bonded Seller template on our storefront and listings. It has made a huge difference as far as standing out and attracting buyers...We are currently expanding into new markets. As a new merchant, you don't have a built-in trust factor. But we get that with buySAFE, because we're bonded."

"buySAFE paid for itself the first month...and the extra money we're making has allowed us to do many things we couldn't do before."—Victoria and Addison Miller

### **Jonathan Hilliard, eBay User ID: cellphonebrokers**

Jonathan Hilliard, founder and CEO of [www.used-cell-phones.com](http://www.used-cell-phones.com) has been selling used cell phones online since 2003. He has never seen final sale prices as high as those he is getting now that he is using buySAFE.

**Results:** "More people are buying multiple phones during a single transaction now, rather than just buying one. I've been getting record-high final sale prices since I started using buySAFE and I haven't done anything differently except add the buySAFE Seal to my listings. I've had items sell for twice the price I'd normally get for the same item since I started using buySAFE. Customers tell me they feel more comfortable bidding when they see the buySAFE Seal on my listings. That is a positive as far as getting higher selling prices." —Jonathan Hilliard

## BUYER RESPONSES

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**"This is a great idea! I got scammed for \$275 about 2 months ago...  
I still have not received the item or my money back."**

—Stacy Woodard, eBay User ID: ClaremorePrincess

**"Buying from a bonded seller greatly increases the buyer's confidence in the entire transaction. I will definitely buy from this seller again."**

—Avelina Monroy, eBay User ID: Rosebudelegance

**"In the future, I will look for the seller that is bonded."**

—Delila V. Robinson, eBay User ID: Delightfuldelila

## ADDITIONAL RESEARCH

Below is a brief overview of just some of the relevant academic studies performed in this area and their key findings.

KEY FINDING	TITLE	AUTHOR(S)
<ul style="list-style-type: none"> <li>eBay seller reputation differences account for 7.6% of the final differences in price on auctions in the vintage post-card product category.</li> </ul>	<i>The Value of Reputation on eBay: A Controlled Experiment</i>	Resnick, Zeckhauser, Swanson & Lockwood (2002)
<ul style="list-style-type: none"> <li>eBay seller reputation differences account for 6.8% of the final differences in price on auctions in the collector coins product category</li> </ul>	<i>What Factors Drive Final Price in Internet Auctions? An Empirical Assessment of Coin Transactions on eBay</i>	Kauffman & Wood (2001)
<ul style="list-style-type: none"> <li>Positive feedback increases price; negative feedback reduces price for Palm Pilot PDAs</li> <li>eBay seller reputation differences account for 12.6% of the final differences in price on Palm Pilot PDAs auctions</li> </ul>	<i>Return on Reputation in Online Markets</i>	Kalyanam & McIntyre (2001)
<ul style="list-style-type: none"> <li>Price discounts and premiums based on perceived trust in online auctions range from as low as -62% to as high as +12%</li> <li>Price premiums and discounts are more pronounced for expensive items than inexpensive</li> </ul>	<i>Trust Building Technology in Electronic Markets</i>	Ba & Pavlou (2002)
<ul style="list-style-type: none"> <li>Both positive and negative feedback affect the probability of sale for MP3 players and Beanie Babies</li> </ul>	<i>Trust Among Strangers in Internet Transactions: Empirical Analysis of eBay's Reputation System</i>	Resnick & Zeckhauser (2001)
<ul style="list-style-type: none"> <li>Sellers with stellar reputations receive price premiums for coins</li> <li>Negative feedback impacts price more than positive</li> </ul>	<i>Pennies from eBay: the Determinants of Price in Online Auctions</i>	Lucking-Reiley, et al (2000)
<ul style="list-style-type: none"> <li>Positive feedback increases price; negative feedback reduces price for Pentium chips</li> </ul>	<i>Reputation in Auctions: Theory and Evidence from eBay</i>	Houser & Wooders (2000)
<ul style="list-style-type: none"> <li>Higher net feedback score (positives less negatives) increases price for dolls</li> </ul>	<i>Reputation in an Internet Auction Market</i>	McDonald & Slawson (2000)

## ABOUT BUYSAFE

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buySAFE, Inc. creates a safe and stress-free online shopping environment through Bonded Shopping—the only program that uses surety bonds to provide protection for individual buyers from online transaction risks. buySAFE reduces risks for buyers and increases profit opportunities for sellers by comprehensively qualifying online sellers and providing the buySAFE Seal to approved sellers for display on their item listings. Online transactions are further protected with surety bonds issued by buySAFE's trusted financial institution partners. buySAFE is headquartered in Arlington, Virginia.

## ABOUT THE AUTHOR

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Steven L. Woda is buySAFE's founder and its current Chairman and Senior Vice President of Strategy & Business Development. Mr. Woda brings more than 14 years of financial services experience to buySAFE, with significant expertise in surety bonds, financial risk management, strategic planning, and commerce. As buySAFE's founder, he created the company's original vision, concept, and business plan, and he continues to lead the strategic development of buySAFE's business to fulfill the vision of making eCommerce safer for both shoppers and merchants. Mr. Woda has a Masters of Business Administration from The Wharton School, University of Pennsylvania with specialized studies in eCommerce entrepreneurship, operations, and information management.

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## FOOTNOTES

<sup>1</sup> Gartner Research Survey, July 24, 2005

<sup>2</sup> Dr. Robert Kauffman, University of Minnesota & Dr. Chuck Wood, University of Notre Dame

<sup>3</sup> "The Value of Reputation on eBay: A Controlled Experiment," Resnick, Zeckhauser, Swanson & Lockwood, June 21, 2002

<sup>4</sup> "Return on Reputation in Online Markets," Kalyanam & McIntyre (2001)

<sup>5</sup> "Company Note: eBay, Inc., Market Perform," Safa Rashtchy and Aaron M. Kessler, June 27, 2005

<sup>6</sup> Average price difference observed during buySAFE's market research, February 2003

<sup>7</sup> Details about buySAFE's proprietary test:

buySAFE's proprietary test was conducted on eBay from August through October, 2004. Using two eBay User ID's with comparable feedback, we tested over 275 item pairs across 7 categories, including art & antiques, jewelry & watches, clothing, shoes & accessories, toys, computers & electronics, cameras & photos, and home & garden. The price range of items listed was \$5 - \$200. Each eBay User ID listed over 275 identical items, with title and description exactly the same on both ID's with few exceptions. The differences between the listings of the two eBay User ID's are as follows:

- The keyword buySAFE was used in the title of the Bonded User ID
- The buySAFE Seal was displayed in the listings of the Bonded User ID
- The listings and the About Me Page of the Bonded User ID had a paragraph of copy describing buySAFE and how it benefits buyers

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