

Fast & Without Cash—That's How She Pays¹ ***Highlights from the 2008 Study of Consumer Payment Preferences***

Most of us have fond memories of playing Monopoly®, gleefully organizing our money and counting out pink, green and yellow bills to buy Park Place or to pay rent to a mean landlord (a.k.a., our older brother) after landing on one of his properties. Today, however, the experience of playing Monopoly promises to be very different for many kids and adults, as they swipe their debit card through an electronic terminal to buy property or pay rent in the new Electronic Banking Edition of Monopoly that was introduced in the U.S. last year. According to Parker Brothers, the new version of the classic board game “reflects the changing nature of society and the advancement of technology.” And a recent study conducted by BAI and Hitachi Consulting suggests that Monopoly money may not be the only paper payments that are becoming obsolete.

Sponsored by First Data and its STAR Network, MasterCard, Metavante, and PULSE, the *2008 Study of Consumer Payment Preferences* is the fifth in a series of studies that have been conducted since 1999 designed to track consumer payment behavior across the three primary payment venues: in stores, online, and to pay bills. The research covers the full spectrum of consumer payment methods, including cash, checks, credit cards, debit cards, prepaid cards, automatic payments, online bill payment, and a number of emerging payment methods (e.g., contactless payments, Internet-only payment options, decoupled debit, and mobile payments).

The results of the *2008 Study* continue—and extend—a trend that has emerged over the past nine years: the way people pay for purchases has changed dramatically over the past decade, as consumers move away from paper-based payments such as checks or cash, and this continued change provides banks and other financial institutions with a whole new set of unique challenges and opportunities.

The Migration to Electronic Payments

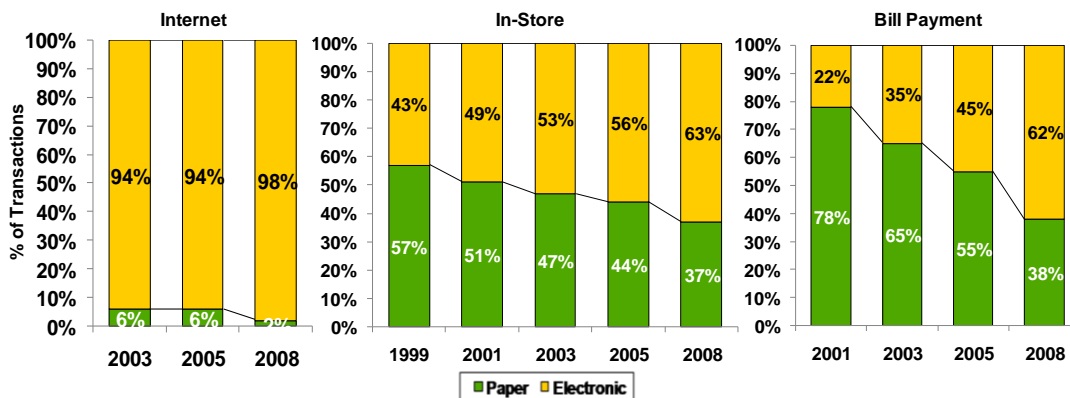
The *2008 Study of Consumer Payment Preferences* found that 63% of all consumers' purchases are made using electronic payment methods, and that electronic payments now account for the majority of payments across all three major payment venues—including bill payment.

Consumers have been migrating from paper to electronic payments across all three venues for several years—albeit at different rates. Internet payments have always been predominantly electronic, almost by default. For in-store payments, the balance between paper and electronic payments shifted in 2003, leaving bill payment as the last bastion of paper-based payments. This is no longer the

¹ To view Parker Brothers' advertisement for the Electronic Banking Edition of Monopoly®, visit http://www.youtube.com/watch?v=yS_APB09Ndc

case, however, as paper-based payments' share of bill payments shrank from 55% in 2005 to 38% in 2008.

Paper vs. Electronic Payments by Venue, 1999-2008

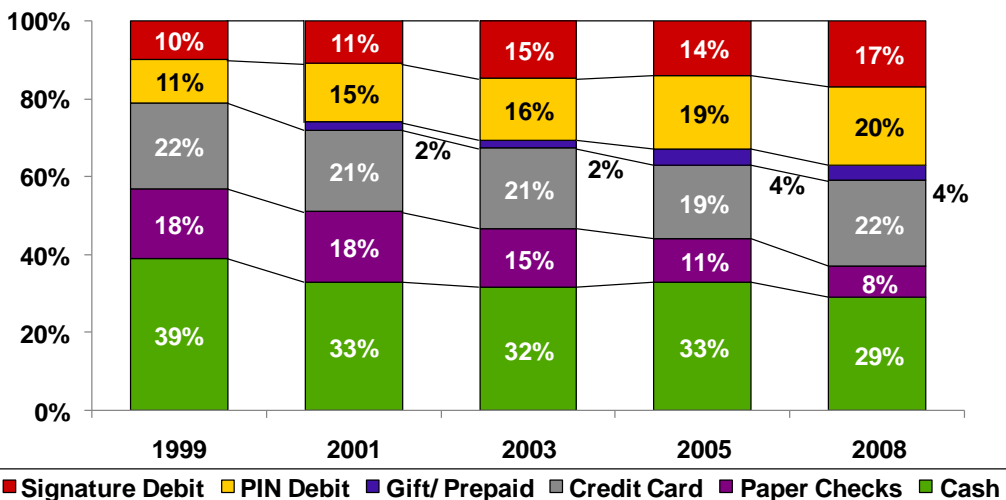


Cash No Longer King?

To see just how dramatic the decline of paper payment methods has been, we need only look back to the initial 1999 *Study of Consumer Payment Preferences*, where paper payments accounted for more than half of consumers' in-store purchases (57%). Cash accounted for 39%, and checks 18%.

Fast forward to 2008, where a consistent, nine-year trend of declining paper payment usage continues, and just a third (37%) of all purchases made in stores were completed using cash (29%) or a check (8%).

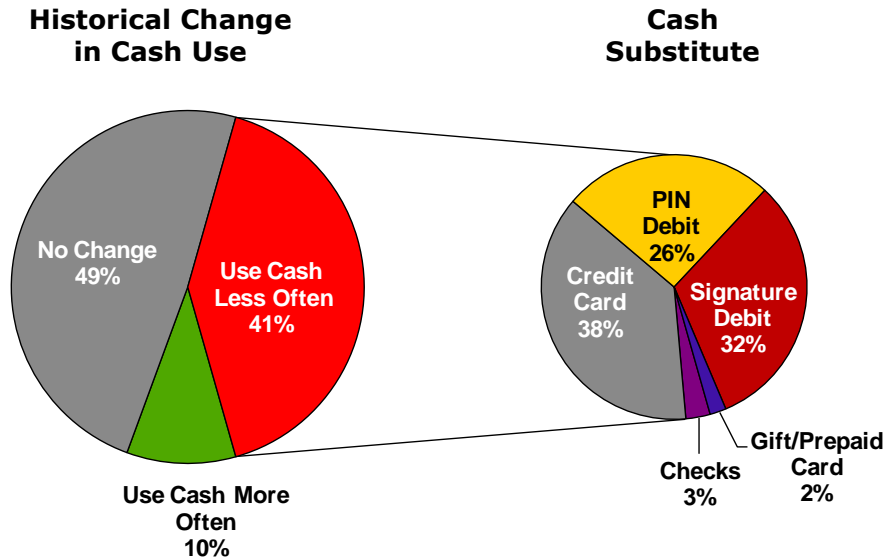
In-Store Transaction Mix, 1999-2008*



* In 1999 and 2001, consumers were not asked specifically about gift/prepaid cards; in 2001, the 2% is "other"

The decline in checks has been tracked and measured for years, but few studies have been able to track the decline in cash. Starting in 2005, this study began exploring how and why consumers' use of cash is changing.

According to the 2008 Study, 41% of consumers have decreased their use of cash over the past two years, replacing cash with electronic payment methods that they perceive to be faster, easier, and more convenient. For the consumers who indicated that their use of cash has decreased in the past two years, the vast majority (97%) are migrating to card-based payments. More than half (58%) are substituting debit, while 38% are using credit cards in lieu of cash, and 2% are shifting to prepaid cards.



In addition to declining usage, cash is no longer ranked as consumers' most preferred payment method—that title now goes to debit. When asked what payment they would most prefer to use (assuming all payment options were available), 37% of consumers indicated a preference for debit, while 32% said they preferred cash, 25% credit cards, and 4% checks.

For those who prefer debit, the reasons they cited focused on speed, convenience, and security. As one consumer noted, "[Debit] is quick and easy and I know I am not racking up debt because it's coming out of my checking account. I also feel like it is more secure than carrying cash." Another consumer explained their preference for debit saying "it's easy, quick, and I can get cash back."

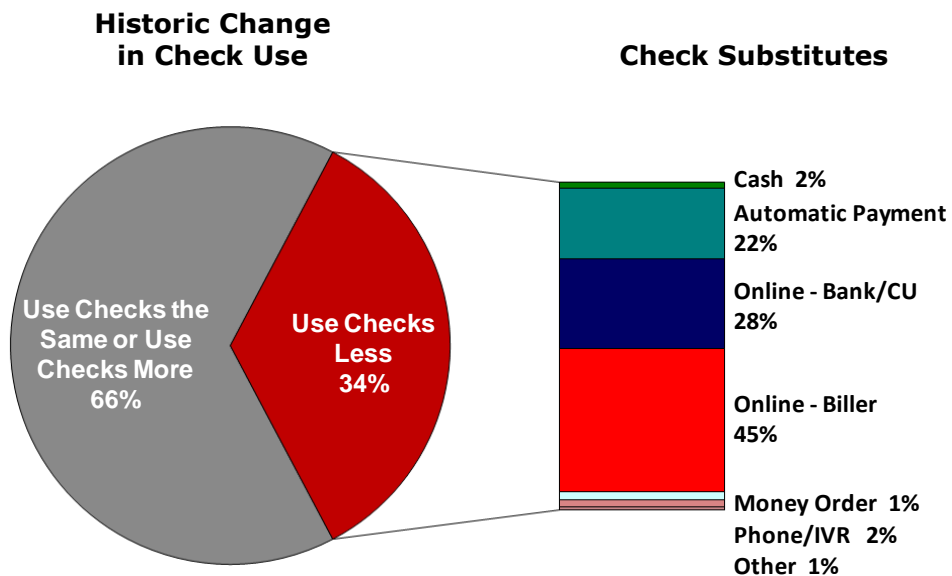
Cash may no longer be king, but it still has a place as payment option, and the size of the transaction has a lot to do with whether or not cash is used. Asked how much they would spend using different payment options, consumers say that on average, the most they would spend using cash is \$30 per transaction while the maximum they would spend using a debit card averages around \$100 and \$250 when using a credit card. Cash is typically used for small value payments—but even that niche is being contested as networks and banks promote the use of contactless payments designed to provide the same benefits of speed and ease of use that cash can under certain circumstances. Currently, 11% of consumers have a contactless card, and 58% of them have used it by waving it or tapping it at the point of sale, primarily in gas stations and grocery

stores. Those in-roads may provide a foundation down the road for other emerging payment technologies, such as mobile payments.

Rise of Electronic Bill Payments

One of this year’s study highlights was the tipping of the balance of bill payments between paper and electronic payments. Historically a stronghold for paper checks, bill payment is becoming increasingly dominated by electronic bill payment methods as consumers’ increasing use of automatic payments and online bill payment replaces paper check volume.

When asked how their use of checks for bill payment has changed over the last two years, one in three consumers indicate that their use of checks to pay bills has declined. Online bill payment has been the most popular check substitute, cited by 73% of consumers who have decreased check use (45% biller and 28% FI). Another 22% have moved to automatic payments.



Electronic payment methods are now the preferred bill payment method of 62% of consumers—and only 25% indicate that checks are their favorite bill payment method. Much of consumers’ bill payment preferences are based on habit, and paper checks continue to provide benefits to consumers who have built their monthly bill payment “system” and “processes” around paper checks.

For other consumers, however, technology is providing benefits in the form of speed, convenience, and security with which checks cannot compete:

- “[Automatic payments] are quick and easy. I don't have to keep entering my information over the Internet every month, so I feel a little safer with it. It also helps me pay bills on time, so I don't forget to send out a payment.”
- “I trust my bank's web site, and online bill pay is all I've ever used before, so I'm familiar with it. I can check account balances, including when payroll is deposited, as well as make payments from one place.”

- *"Online bill pay is easy, convenient, and secure. I know it's going directly to my biller and pretty much can't get lost in cyberspace or in the postal mail. Plus, if I am running behind on paying something I can pay it and not worry about the time it will take to get there."*

Electronic bill payments are now very much a part of the mainstream—and for consumers who are coming of age today, many of them are likely write few, if any, checks to pay bills. Their bill payment habits and systems will develop around today's electronic bill payment technologies and those that emerge in the future.

The End of Paper-Based Payments?

People often ask "are we heading for a paper-free future, where cash and checks will cease to exist?" The short answer is no. Although Parker Brothers has introduced an electronic banking version of Monopoly®, they continue to offer the original cash edition as well, because some people prefer the old version. And so it is with payments as well.

Debit cards, prepaid cards, online bill payment, automatic bill payment, and Internet payment services have each expanded the array of choices consumers have for making payments in different venues. These payment methods have increased the range of payment applications, filling a different niche or meeting a particular need—and in some cases, creating a new "need" we hadn't realized we had. Each has provided distinct advantages over existing payment options, and as a result, consumers' adoption and use of these payments have increased significantly over time, often at the expense of other payment methods. And yet cash, and even checks, continue to play an important role in the payments environment—and we expect that to be the case for a long time to come. We expect the use of cash to decline in the future, but are we nearing a cash-free future? No. Just ask the nearly one-third of all consumers who say cash is their most preferred method of payment for in-store purchases.

Implication for Financial Institutions

History has shown us that new payments technologies tend to be additive—like new versions of Monopoly®, new payment methods are added to the mix, but the old ones continue to provide unique value.

Over time, the consumer payments market will become more and more specialized: as new individual payment products are added, many will address the needs of smaller and smaller niches of consumers and/or merchants. Competition for share of consumers' wallets will only increase as more and more payment products (and more and more providers) compete for pieces of the transaction pie. In this environment, differentiation and consumer education will be increasingly important.

Managing a payments business is becoming increasingly complex as the options and alternatives available to consumers continue to proliferate. Financial institutions need to have a holistic, global payments strategy that enables them to proactively manage their business, prioritize opportunities, and mitigate risk.

Along with a need to take a more holistic approach to their payments business, FIs will need to carefully monitor and manage the trends impacting individual payment methods:

- The decline of **cash** use will have an impact on a bank's cash handling costs and also on the economics of their ATM channel. Similar to the decline in checks, the unit cost of handling cash is likely to increase over time as volume declines and prompt more banks to evaluate outsourced cash solutions.
- The decline in **paper check** volume is accelerating, which has implications for bank's risk management strategies as fraud levels increase, their technology investments in the wake of Check 21 legislation, and product positioning as checks—and the term 'checking account' become less relevant.
- The **credit card** market is mature and highly consolidated, and issuers are going to need more sophisticated and targeted segmentation strategies to identify quality acquisition targets. Consumer use of credit cards has remained relatively stable over the past several years, and the space is dominated by large issuers who can afford to invest in innovative rewards and perks to differentiate their cards and achieve the coveted "top of wallet" status. Smaller issuers are struggling to compete, and many have opted to sell their portfolios in the past several years.
- **Debit** has been a payment phenomenon for the past decade, but as it matures, issuers will be challenged to find ways to promote usage. While debit use continues to grow at double-digit rates, we are beginning to see early signs that it will begin slowing down.

As the organic growth runway nears an end, many issuers have followed in the footsteps of credit card issuers and begun offering rewards and incentives for debit card use, which has pushed penetration and usage rate to near maximum. This is particularly true for the most sophisticated issuers, and has reduced the opportunity to seize 'low-hanging fruit'. Issuers have to be careful of making investments in debit program enhancements based on the assumption that current interchange rates will continue—the economics of debit are less robust than credit, and interchange is under pressure in both the U.S. and around the world.

- Building the business case for bank-issued **prepaid cards** has been a challenge, and actual use has yet to meet forecasts and projections. FIs continue to report very modest profits with their prepaid programs—if any at all.

The lack of profitability has given rise to disparate strategies: some FIs are focusing solely on payroll and related cards to generate higher spend and support commercial business; some are focusing on FSA/HSA cards, which are reported to have higher average balances; others are testing the prepaid market with gift cards or general purpose reloadable cards as a defensive play and do not expect to derive significant returns. Still others are choosing to remain on the sidelines, leery of thin margins and potential risk. Banks need to evaluate the different prepaid options to determine which, if any, prepaid product(s) is best for them and their customers.

- **Automatic payments** are correlated with account stickiness and customer retention—but different types of automatic payment have different

cost/revenue implications for FIs. ACH direct payments, for example, are a low cost payment option—but they are also a low revenue option. To the extent that ACH direct payments replace cash and check payments, consumer migration will produce positive benefits. To the extent that they replace credit or debit card transactions, however, it may have a negative impact on FIs' bottom lines. More and more FIs are promoting recurring card payments—which both produce customer retention benefits and generate additional interchange income.

- Online banking is one of the fastest growing retail banking delivery channels, and now that most FIs have eliminated fees for **online bill payment**, FIs have seen significant adoption of their bill pay services over the past few years. Many consumers, particularly those who pay only a handful of bills online, continue to go directly to the biller website; an increasing number, however, appreciate the convenience of paying all their bills in one place. As with most online services—particularly financial services—ensuring the security of online banking and bill services is and will be critical. FIs need to work to balance the need/desire for increased security with customer convenience.

Conclusion

It is difficult to predict the future of the payments business—and even more difficult to predict how consumer preferences will evolve. How our children will pay for hotels on Boardwalk is unknown: maybe they may use brightly colored bills or swipe a fake plastic card through a miniature reader; maybe they will use toy cell phones to transfer imaginary funds; or maybe they will use something we haven't seen yet. Whatever the future holds, those financial institutions that are proactive in developing a strategic approach to the payments challenge, and that are creative in leveraging the opportunities payments provide in terms of revenue potential, cross sell opportunities, customer retention, and brand equity, will be paid back many times over.

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Our Financial Services practice is the product of significant investments the firm has made in this space over the past few years. In August 2005, we acquired Dove Consulting, a Boston-based strategy and organization consulting firm specializing in payments strategy and research. In March 2008, we acquired JMN Associates, a leading provider of consulting services to the financial services, real

estate and insurance industries based in San Francisco. Together, our team brings valuable expertise and practical, proven solutions to clients in the areas of business and technology strategy, process improvement, market research, project management, and industry and regulatory compliance.

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