

Litmus Test Results:

How the Economic Downturn is Impacting Consumer Payments

The economic downturn, coupled with the ongoing financial crisis, has impacted virtually every consumer in the United States. Many consumers have lost jobs or have seen the value of their homes or investments decline sharply (and in some cases, both). As a result, consumers are changing their spending behaviors — not just how much money they're spending, but the payment methods they're using to spend it.

This is a key finding from a study we recently conducted as a follow-on to our *2008 Study of Consumer Payment Preferences*. 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 that track consumer payment behaviors across the three primary payment venues: in stores, online, and bill paying. The Study shows the continuation of long-term changes we've seen take place in the payments landscape: the migration from paper to electronic payment methods; the rise of debit and online bill payment; consumers' preference for PIN debit over signature — all trends that continue to be relevant and applicable in today's environment.

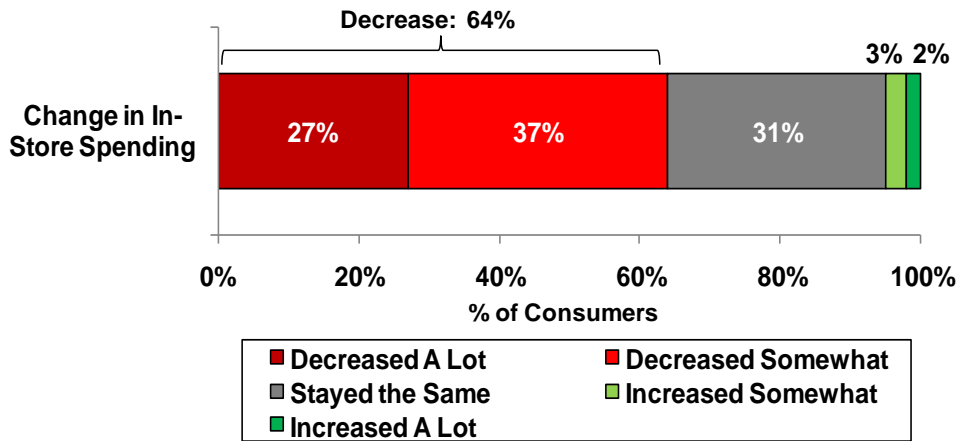
But that research was conducted in June 2008. Before the financial markets collapsed. Before the bankruptcy of Lehman Brothers. Before the federal takeover of Fannie Mae and Freddie Mac. Before the AIG bailout. Before things got so bad that the government introduced a Troubled Asset Relief Program.

Given the unprecedented events that took place in the latter half of 2008, we conducted a quick-turn "addendum" to the *2008 Study* in an effort to gain some insight into the impact that the economic environment might be having on consumers' payments behavior. In February of 2009 we surveyed a panel of 2,200 consumers to ask how their in-store spending behaviors had changed in the prior six months as a result of the economy and how it impacted their use of credit, debit, and prepaid cards, as well as cash and checks. It was designed to serve as a litmus test, if you will, to give us a directional indicator of how consumers' wallets were responding to the downturn.

Findings

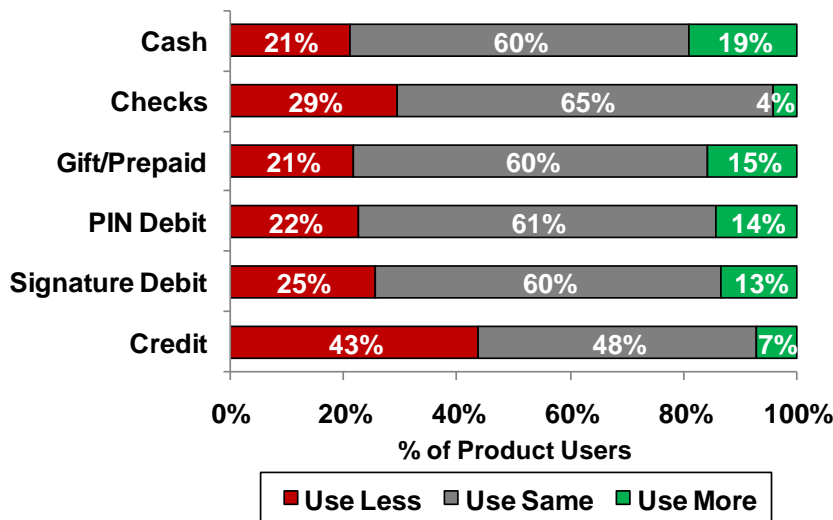
As it pertains to consumer spending, the results of our study addendum were not surprising. Nearly two-thirds of consumers indicated that they had decreased their spending over the previous six months.

How has the downturn in the economy impacted your spending in stores now versus six months ago?



As it pertains to consumers' use of individual payment methods, the findings are more interesting. As expected, consumers reported declining use of payment products across the board. Many, however, also indicated that they had increased their uses of particular payment products. Given that very few consumers reported a corresponding increase in spending, we can presume that these increases came from substitution as consumers replaced one or more payment methods with others they perceived to provide greater advantages in the current market.

How has your use of payment products changed compared to six months ago?



Credit cards in particular appear to have taken a hit. Nearly half (43 percent) of consumers indicated they had decreased their use of credit cards over the prior six months. Presumably this stems from consumers' desire to avoid interest payments and increasing their debt — or simply to help them resist the temptation to overspend.

On the opposite end, a higher percentage of consumers (nearly one in five) indicated they had increased their use of cash; a relatively high percentage also indicated they had increased use of gift/prepaid cards. From the *2008 Study of Consumer Payment Preferences* we know that cash, in particular, is associated with budgeting and control, which may account for some of the shift.

Implications

Based on this data, it appears the economic downturn has had some impact on consumers' payment preferences — at least in the short-term. But what do these changes mean for FIs?

On the paper front, there may be very little change. There may be a temporary up-tick in consumers' use of cash, but the overall migration to electronic payments is likely to continue. (And there is nothing in the data to suggest that the decline in check volumes will slow; if anything, it may accelerate further).

On the card front, changes in consumers' payment use may have a direct impact on issuers' top-line revenue. Reduced spending and lower transaction volumes will affect all categories of card issuers. In addition:

- **Credit card issuers** are likely to be negatively impacted by a number of factors. First, consumers are spending less, which translates into lower transaction revenues and lower interest income. Second, delinquencies and charge-offs are continuing to rise. The result is lower revenues and higher losses, with good credit-risk customers pulling back at the same time higher-risk consumers are defaulting. This dynamic can lead to significant portfolio losses. Based on media reports, this is already beginning to manifest in the marketplace.
- For **debit issuers**, we believe the heady days of 20 percent annual growth are clearly over. Some FIs may even experience a decline in debit transactions. Although debit may pick up some transactions that would otherwise have been put on credit cards, overall growth will be slower than in years past. Additionally, the retailers that are focused on everyday spend (e.g., Wal-Mart) have not experienced the degree of sales-growth declines other retailers have. This may portend a shift toward PIN debit as these retailers all have 'prompt for PIN' type programs in place. The combination of slower growth and a potential shift in the mix between PIN and signature suggests that debit issuers will see lower revenue growth from interchange than they have historically enjoyed, at least in the short-term.
- For **prepaid issuers**, the outlook is somewhat mixed. Many issuers are already struggling to manage portfolio profitability, and logic dictates that less gift giving will take place in the current recession, although, to some extent, that remains to be seen. Issuers may also stand to benefit from an increase in consumers using prepaid cards as a budgeting tool to help them manage their money. But again, that remains to be seen.

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While it is no stretch to say that FI income from payments will be challenged in the current environment, especially those with credit card portfolios, what (if any) long-term impact the economic downturn will have on consumers' payment

behavior is not yet known. Stay tuned for the results of the *2010 Study of Consumer Payment Preferences*.

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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, Hitachi Consulting acquired Dove Consulting, a Boston-based strategy and organization consulting firm specializing in payments strategy and research. In March 2008, Hitachi Consulting 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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