

Banking Strategies

WORLD OF CHOICE:
CONSUMER PAYMENT
PREFERENCES

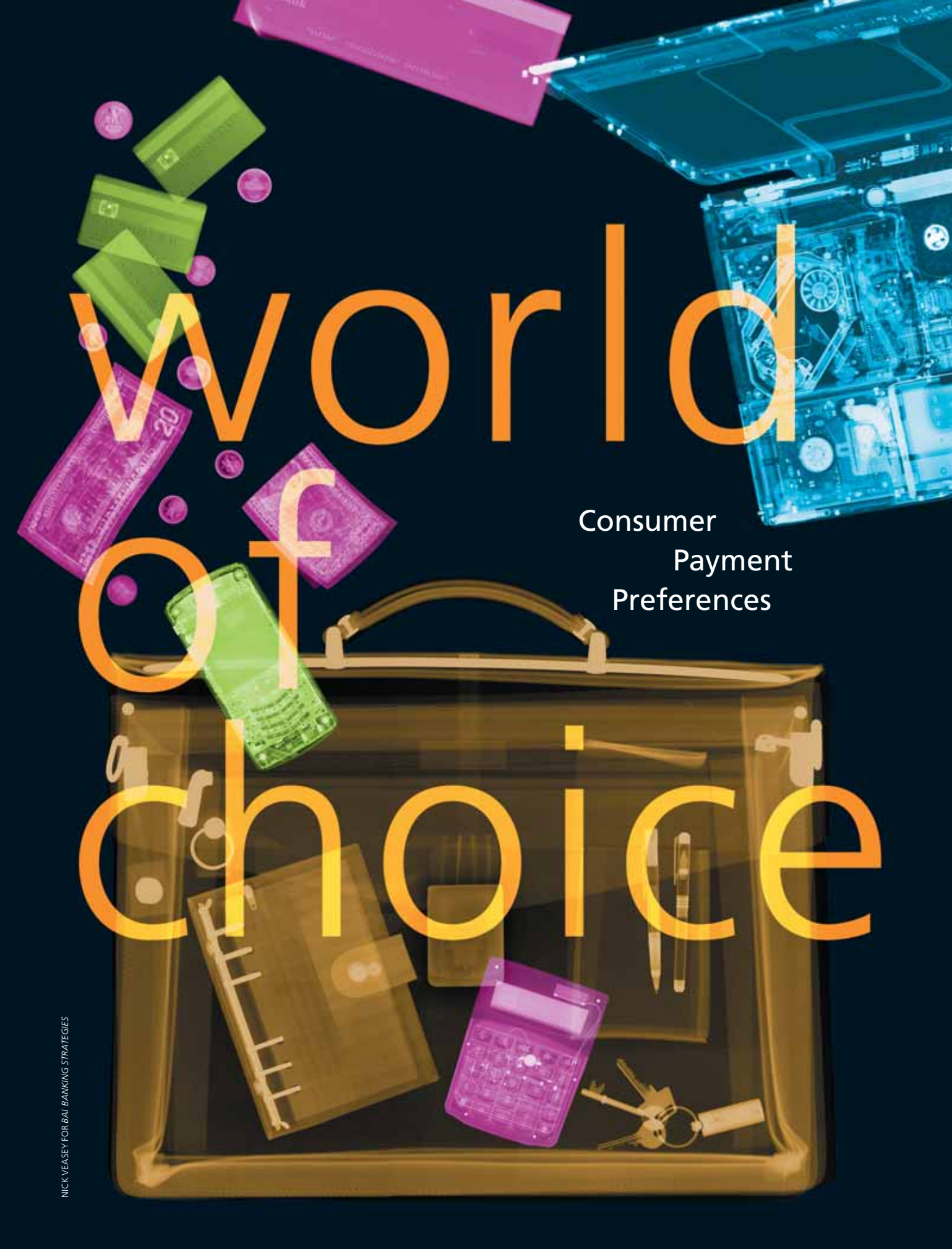
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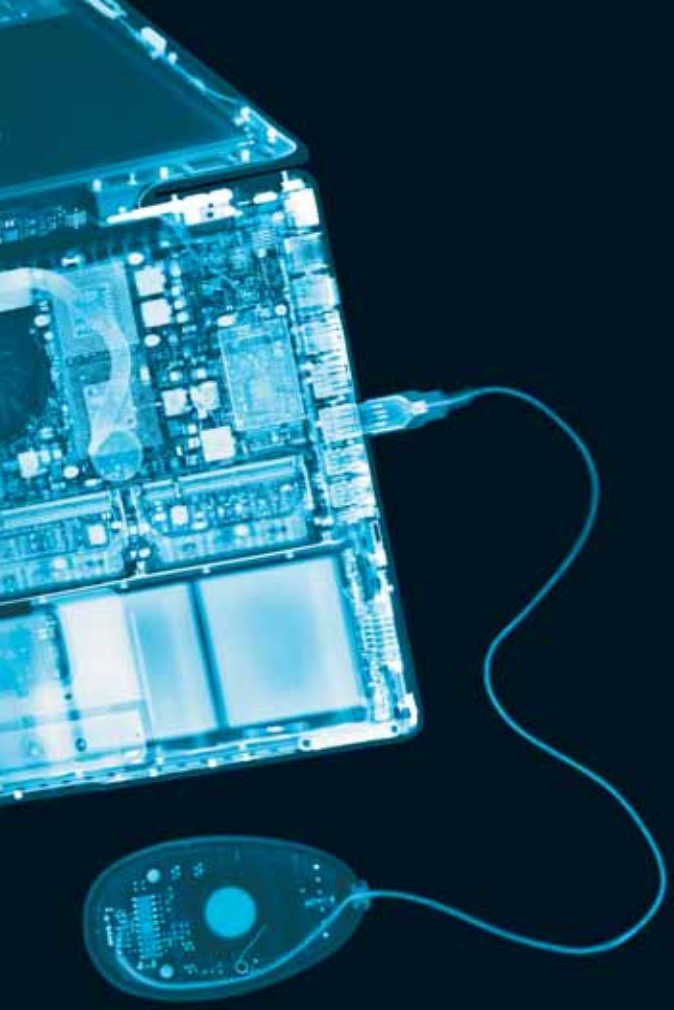
Cash Flow, Not Return





World of choice

Consumer
Payment
Preferences



A decisive shift in consumer payment preferences from paper and cash to electronics poses customer relationship and cost control challenges for banks.

BY DANIEL HOUGH, MARK RIDDLE,
CHRIS ALLEN AND MELISSA FOX

| SYNOPSIS | The inevitable and ongoing march from paper to electronic retail payments has become a full-on run, according to a recent consumer payment study conducted by BAI and Hitachi Consulting. Consumers are using debit cards more aggressively, particularly PIN debit, instead of cash or checks, even for small-value purchases in stores, while increasingly using electronic bill pay for recurring payments. This rise in the use of plastic and automated payment vehicles is putting greater pressure on banks to find new ways to reward and retain customers for their electronic payments. Bankers also need to find an appropriate balance managing cash and checks, as those become a smaller part of the payments mix.

It's not surprising that electronic payment — by credit, debit and automated clearing house (ACH) transactions — has outpaced paper. What is surprising is how quickly and aggressively consumers have embraced these forms of payment and how pervasive they have become.

This ongoing sea change in retail payments is documented in the 2008 Study of Consumer Payment Preferences, jointly conducted by BAI and Dallas-based Hitachi Consulting (see “About the Survey,” page 23). Our in-depth consumer survey offers insights into the key trends in consumer payments, the underlying factors that impact customer behaviors when it comes to paying for goods and services and what it means for the banks that provide, process and support traditional and emerging payment options. The 2008 results build on previous waves of the same study conducted in 1999, 2001, 2003 and 2005. We subsequently interviewed a number of top payments experts in banking to solicit their perspectives on our findings and asked how the identified payment preferences and trends affect their payments business strategies.

We were particularly intrigued by the study data and industry feedback we received surrounding the use of debit cards. In less than a decade, the in-store use of debit has increased to 37% of the payments mix, from 21% in 1999. And while banks have historically promoted signature debit — on which they receive a higher interchange fee — consumers in our study expressed a distinct preference for PIN-based debit payment.

Overall, consumers have become increasingly comfortable forking over their plastic in place of cash to pay for a wider variety of items — even purchases of a few dollars or less, like a latte or lunch at a fast-food restaurant. This is dramatically changing how banks must operate their physical channels while cash and checks are rapidly being displaced. In our 1999 study, cash accounted for 39% of consumers' in-store payments. Last year, cash payments made up just 29% of the payments mix — a dramatic shift for a country where cash has long remained king, even in the face of alternative payment options and emerging electronic channels (see chart, "Plastic Rules at Retail Point-of-Sale," page 17).

Moreover, bank customers are not going to the ATM or the bank branch to obtain cash as frequently as they used to. Instead, they're choosing to get cash-back at the point-of-sale when using their ubiquitous debit cards. This is forcing banks to rethink the way they manage cash, particularly how they stock ATMs, and is driving more banks to find ways of streamlining their paper processes.

Even when it comes to paying their regular bills, consumers are steadily decamping from paper to electronic. According to our findings, 62% of recurring consumer bills are paid electronically, up from 45% three years ago. Given the cost savings bill payment affords banks — not to mention the well-established "stickiness" it creates with customers — banks are actively encouraging this trend by offering bill payment for free and by marketing this feature more regularly and aggressively to online banking customers. They're also trying to win over new converts by underscoring the "green" aspect of going paperless.

DEBIT COMES OF AGE

The replacement of paper with electronically processed payments has long been heralded in the banking industry. But according to the BAI/Hitachi Consulting study, credit, ACH and particularly debit payments are gaining ground faster than ever among Americans who are using these non-paper forms of payment for a wider array of purposes. In 2008, 63% of consumers' in-store purchases were paid electronically, using signature or PIN debit card, credit

card, or gift or prepaid card, up from 43% at the beginning of the decade.

"The time has come in the mind of consumers to use debit," says Ron Lewis, senior vice president of emerging technology and payment services for Dallas-based Comerica Inc. "It was largely ignored by consumers up until the late 1990s and banks didn't heavily promote it." Now, with consumers' new-found and widespread embrace of debit in recent years, "banks have just been trying to keep up," Lewis says. According to our survey, more consumers prefer using a debit card (37%) than using a credit card (25%) or even cash (32%).

Kerry Brashears, group vice president of card and loyalty products for Atlanta-based SunTrust Banks Inc., says he's noticed debit use "almost doubling" in the past few years. "Consumers see electronic payment now as more convenient, giving them a better paper trail," he says, noting that debit card usage enables consumers to track incidental purchases online as well as on their bank statement.

Lewis also attributes this shift to banks' efforts to seed the market and encourage debit usage. Over the course of the last decade, he points out, bankers have done a great deal of work to educate customers, particularly during the new account enrollment process, about upgrading from an

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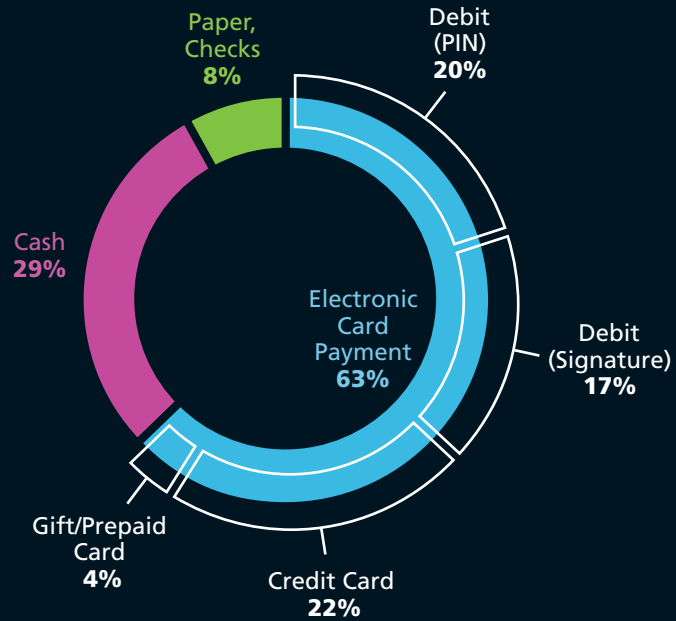




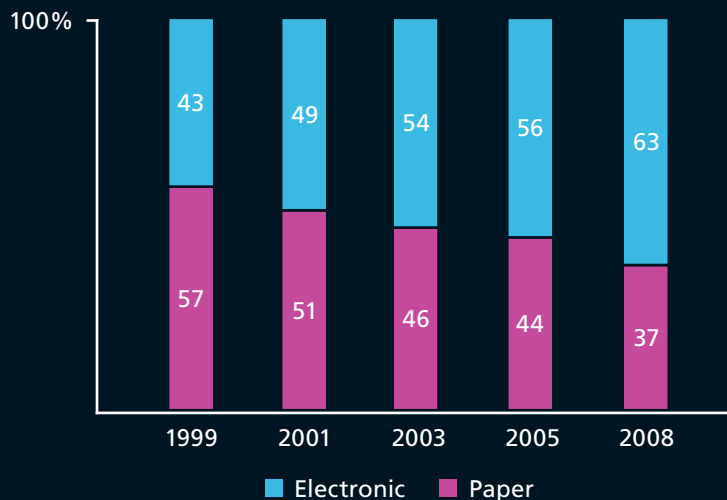
PLASTIC RULES AT RETAIL POINT-OF-SALE

In 2008, nearly two-thirds of consumers' in-store purchases were paid electronically with debit or credit cards, up from 43% at the beginning of the decade.

2008 IN-STORE TRANSACTION MIX



IN-STORE TRANSACTION MIX



Source: BAI and Hitachi Consulting

ATM card to a debit card, its range of acceptance and the security implicit in the system. “It was something of a wake-up call for consumers,” Lewis says. “This piece of plastic works the same way as a check, plus it lets them get cash back.”

Mike Marzec, senior vice president and manager for electronic banking at First Tennessee Bank, a unit of Memphis-based First Horizon National Corp., says his bank has done its part to increase the acceptance of debit by including store coupons in mailers that enable consumers to get discounts when using their debit card. Other banks have also instituted rewards programs where debit cardholders are allotted points or cash-back for certain debit transactions — as has long been the case with credit card usage. Marzec says that First Tennessee is in the process of revamping its debit rewards program to be more appealing to customers.

However, while debit acceptance by consumers has grown rapidly, the change has not occurred swiftly enough for some executives. “It’s taken longer for us to get from checks to debit than expected,” says Mitch Christensen, executive vice president of enterprise payment strategies for San Francisco’s Wells Fargo & Co.

In tandem with a growing preference for debit payment, consumers are also demonstrating a slight but decided predilection for PIN-authorized debit over signature debit, according to the BAI/Hitachi Consulting study. In 2008, 20% of in-store purchases were made using PIN debit versus 17% by signature debit. This trend has occurred despite banks’ efforts to influence customers to select signature debit at the point of sale (POS) through education, rewards, and other perks for signing their receipt.

Banks have long promoted signature over PIN because signature debit earns higher interchange for card issuers than does PIN debit: approximately \$0.51 per signature debit transaction, compared to \$0.22 for PIN debit.

For this reason, some banks have opted to charge customers for using their debit card for a PIN-authenticated transaction. As recently as last year, U.S. Bancorp was reportedly charging cardholders in Colorado, Indiana, Kentucky and Ohio \$0.25 for each PIN debit transaction. At the same time, Wells Fargo was charging \$1 per month to some customers who used PIN debit at least once a month. Neither bank charged for signature debits.

Christensen of Wells Fargo and Lewis of Comerica both attribute consumer preference for PIN to a belief that those transactions are more secure than signature transactions (since it would presumably be easier to forge a signature than to gain a consumer’s protected PIN). Marzec estimates



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— MIKE MARZEC

that use of PIN debit by First Tennessee cardholders has increased as much as 10% in the last few years, although signature debit still accounts for about 60% of the bank’s debit card transactions.

Marzec attributes at least some of this eager adoption of PIN debit to the merchants and the PIN debit networks, which are increasingly emphasizing PIN to consumers who are indifferent as to how their transaction is authenticated. Lewis also notes that PIN-based point-of-sale terminals have come down in price over the last three years and become more available at merchant locations.

“What’s driving this is that merchants are steering the cardholders to PIN debit transactions because of the interchange difference,” Marzec says. “Most consumers don’t truly have a preference.”

But one factor that could keep PIN from outpacing signature debit is the fact that most debit-oriented reward programs only offer incentives such as points, airline miles or cash-back for signature debit, not PIN. SunTrust’s SunPoints program, for example, is in that category, according to Brashears. Wells Fargo likewise rewards customers with one point for every \$4 they spend on their signature debit, but not for PIN.

“It’s no secret that a lot of debit rewards programs are different based on whether a consumer signs or PINs,” Lewis says.

CASH NO LONGER KING; CHECK NO LONGER IN THE MAIL

Whether it’s PIN debit or signature debit, or credit card or gift card, it’s become clear that consumers are much more accustomed to handing over their plastic than a wad of bills when it comes time to pay.

According to our study, the use of cash has declined in less than a decade to just 29% of the in-store payments mix, from a full 39% in 1999. Cash is getting forced out of both the high end and the low end of the payments spectrum, as consumers are increasingly viewing their debit card as more convenient for small dollar payments. Consumers inter-

viewed for our study say that they would spend about \$30 on a cash transaction at most. By contrast, their maximum purchase on a debit card averages about \$100. Meanwhile, bolstered by speed-centric, contactless NFC technology and a push by terminal makers and card associations into new markets, cards are becoming more broadly accepted in quick-serve restaurants, coffee shops and convenience stores, where transaction amounts tend to be smaller.

“Handling cash is expensive and risky for merchants,” Christensen says. He adds that the card networks and merchant acquirers have been more aggressively working with big fast-food companies like McDonald’s to discount interchange rates and make card acceptance worthwhile. This, in turn, has a domino effect on other merchants and consumers, driving cards in place of cash, he says.

CONSUMER PAYMENTS CHOICE: WHAT SHOULD BANKS DO?

History has shown us that new payments technologies tend to be additive — new payment methods are added to the mix, but the old ones continue to provide unique value. This introduction of new options and the changing use of mature ones pose significant implications for banks and other financial institutions (FIs):

Managing a payments business has become a more complex task.

FIs need to have a holistic, global payments strategy that enables them to proactively manage their business and take advantage of the benefits payments provide in terms of revenue potential, cross-sell opportunities, customer retention and brand equity.

The consumer payments market has become more specialized.

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. Therefore, differentiation and consumer education, whether it is by payment method or by brand, will be increasingly important to providers.

The decline of cash use will increase a bank’s per-unit cash handling costs

and negatively affect the economics of its ATM channel. Similar to the decline in checks, the unit cost of handling cash is likely to increase over time as volume declines, prompting more banks to evaluate outsourced cash solutions. ATM deployers have already seen declines in their average number of monthly transactions per machine and we expect that trend to continue. Fee-free ATM access will continue to be important to bank customers, so banks may need to reevaluate how they measure ATM performance and investment.

The decline in check volume is accelerating, which has implications for bank risk management strategies, technology investments and product positioning. The migration to electronic payments heightens the need for risk management and fraud mitigation. As reliable customers migrate to debit, the percentage of “bad” checks is increasing, and banks need to have tools in place to mitigate their risk. Some banks are struggling to justify investment in a declining payment method and need to evaluate their investments in remote deposit capture technology and other electronic forms of check capture carefully. Long term, as checks and check writing become obsolete, the term “checking account” is likely to become less relevant. We expect to see more banks packaging and promoting free electronic banking accounts with alternative branding and labels, as opposed to free checking accounts.

Credit card issuers are going to need more sophisticated and targeted segmentation strategies to identify quality acquisition targets. While consumer use of credit cards has remained relatively stable over the past several years, 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. The sub-prime mortgage credit crunch has also impacted the credit quality of credit card portfolios with large issuers reporting higher loss rates. Growth in this space will require careful analysis to differentiate between those consumers who will be profitable and those who pose a risk to the issuer.

Cash is getting forced out of both the high end and the low end of the payments spectrum, as consumers are increasingly viewing their debit card as more convenient for small dollar payments.



While debit use continues to grow at double-digit rates, we are beginning to see early signs that it will begin slowing down.

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.” Since the economics of debit are less robust than for credit and the business case for rewards can be harder to justify, many issuers are exploring innovative options such as merchant-funded rewards that allow them to offer incentives for a lower cost or relationship rewards that spread the cost of rewards over multiple banking products. Issuers would also be wise to evaluate additional costs carefully. Interchange rates are under scrutiny in the U.S. and around the world. And, although the outcome and

Customers not only have less of a need to get cash, but when they do retrieve cash from their account, they are increasingly likely to get it at the merchant POS, bankers say. This, in turn, puts more pressure on banks — already trying to cut costs around their declining and expensive check infrastructure — to become more efficient in how they manage their retail cash reserves, particularly at their ATMs.

“ATM activity is kind of stagnant this year,” Marzec says, noting ATM usage at First Tennessee decreased 2% in 2008. He speculated that this decrease could derive from the difficult economy as well as the growing usage of cash-back at the merchant POS. In any case, banks such as First Tennessee are tracking their vault cash by region, neighborhood and even machine more carefully, trying to drive down the cost of replenishing the vault cash.

timing of litigation is uncertain, issuers should be careful to ensure that the business case for enhancements to their debit card program does not rely solely on today’s interchange rates, which may not hold in the long term.

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 at all. Unlike merchants’ gift cards, whose business case is based on store sales and loyalty, banks are trying to generate revenue from card issuance and usage. Many of the revenue levers for prepaid cards are being legislated away as consumer advocate groups have raised concerns about some issuer practices and fees. This 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 Flex Spending Account and Health Savings Account 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 will need to evaluate the different prepaid options — each of which have their own technical requirements, economic drivers, and market niches — to determine which, if any, prepaid products make sense for them and their customers.

| DANIEL HOUGH, MARK RIDDLE, CHRIS ALLEN AND MELISSA FOX

“Our operations and technology units are trying to forecast how quickly they need to shrink the existing infrastructure.”

— MITCH CHRISTENSEN



“If an ATM had previously been replenished weekly, now we might be able to keep the same amount of cash in there for longer, maybe 10 days or two weeks,” Marzec says, adding that this could lessen the costs involved with having bank staff or third parties handle that service.

Comerica is also analyzing how it can better “manage the supply chain around ATMs,” Lewis says. Because the machines require more infrequent fulfillment, he sees the decline of cash having a “favorable impact on the economics of cash handling.” Christensen of Wells Fargo predicts that, as with checks, banks will see a “stair-step approach” downward in reducing the cost of handling cash, with costs coming out of the environment as the payment type hits certain thresholds.

Christensen says that Wells Fargo has long been “forecasting that cash utilization is going down.” Although he points out that cash, given its anonymity and lack of an audit trail, is notoriously difficult to track and is still the favored payment of the unbanked population, he adds, “Our operations and technology units are trying to forecast how

quickly they need to shrink the existing infrastructure.”

One payments area that banks are *not* looking to shrink is electronic bill payment. Indeed, consumers are actually more apt to dash off an automated or card payment than to put a check in the mail, our study finds. Sixty-two percent of recurring bills were paid electronically, up from 45% in 2005. Bankers say this tremendous jump could be attributed to a number of factors, including the emergence of tech-friendly (and now, bill-paying) younger consumers. Also, banks that often reward consumers for using electronic bill payment and billers who offer perks to consumers for setting up regular automated payment have added to its appeal.

“Online bill pay is extraordinarily important when opening new accounts,” Lewis says. While he would not disclose the number of Comerica customers paying bills online, he says the service is used by roughly half of the bank’s online customers. He adds that the bank has recently been revamping its online bill pay product to simplify the user interface and improve security by adding out-of-band authentication and challenge questions to access accounts. As recently as 2007, Comerica was offering a cash bonus of up to \$100 for customers who signed up for electronic bill payment (along with opening a new checking account with direct deposit and overdraft protection).

“Certainly, consumers have discovered online bill payment for recurring payment for a number of factors,” Marzec says, citing both reward perks and a number of financially related “green” initiatives that encourage consumers to pay bills electronically. In 2007, for example, several banks including Charlotte-based Bank of America Corp. joined major billers to form the Pay It Green Alliance to boost support for electronic bill payment and presentment. Also, according to Marzec, consumers are being wooed by the increasing ease of linking the electronic payment of bills with online or mobile alerts that will notify them if their payment is due or if it has been debited from an account.

Overall, Marzec says, the banking industry needs to continue to stay alert to the growing pervasiveness of electronic payment and its impact on banks. “It’s kind of a watch-and-see time,” he says. “The banking industry needs to take a long hard look as to how we respond.” ⊕

Mr. Hough and Mr. Riddle are both directors of research content delivery at BAI. Mr. Allen is a director and Ms. Fox is a senior manager in the financial services practice at Hitachi Consulting.





THE 2008 STUDY OF CONSUMER PAYMENT PREFERENCES

About the Survey

The 2008 Study of Consumer Payment Preferences, a primary research project conducted by BAI Research and Hitachi Consulting, with sponsorship support from First Data, Mastercard, Metavante and PULSE, is based on a survey completed by a nationally representative sample of 3,308 U.S. consumers in June 2008. The survey was fielded to the Harris Poll OnlineSM panel, a consumer panel comprised of 6 million members managed by Harris Interactive, and was completed by adults 18 years of age or older. The sampling error for the national sample was +/- 1.7% at a 95% confidence interval.

The research represents the fifth in a series of studies conducted in 1999, 2001, 2003, 2005 and 2008 designed to track the evolution of the consumer payments landscape and to monitor and understand consumer payments behavior

across three primary payment venues: In-Store, Internet and Bill Payment. The insights and information generated by *The 2008 Study of Consumer Payment Preferences* was designed to help banks develop and market payment solutions for consumers, as well as enable them to maximize the opportunities payments provide in strengthening customer relationships, forging new ones, and building brand equity among consumers.



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