

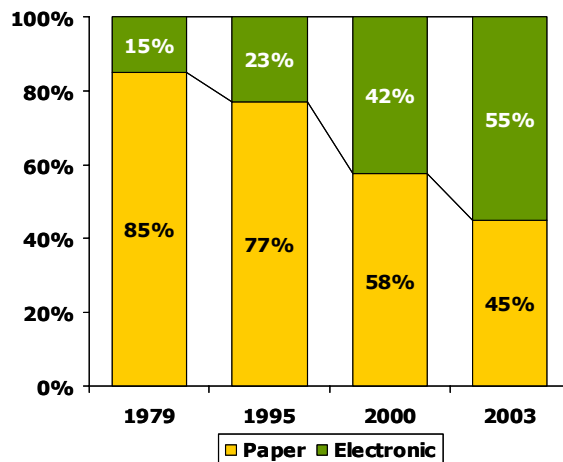
Consumer Payment Preferences *Understanding Choice*

Cash or credit. Check or debit. Enter a PIN or sign a receipt. In a country that prizes freedom of choice, consumers' ability to choose how, when, and where to pay for goods and services is at the heart of the U.S. payments system.

In the last 25 years, the range of choices consumers have for making payments has exploded. In 1979, consumers' options were limited: in stores, consumers could choose to pay using cash, checks, or credit cards; bills were paid primarily by mailing a check. Today, consumers can still choose to pay using cash, checks, or credit cards—or they can choose to use one of an increasing array of electronic payment options.

The growth of payment choices has dramatically altered the payments landscape. Traditional paper-based payments continue to be important, but consumers are migrating to electronic payments across all payments venues. In the last 25 years, electronic payment methods' share of wallet has increased, from 15% in 1979 to 23% in 1995 to 42% in 2000—most recently reaching 55% in 2004. And not only are consumers migrating from cash and checks to electronic payment methods, but the rate at which that change is occurring is accelerating.

Non-Cash Payments Mix, 1979–2003



**Electronic Payments:
Annualized Change in
Percentage Points**

1979–1995	+0.5
1995–2000	+3.8
2000–2003	+4.3

Source: Federal Reserve

Consumers are embracing new electronic payment methods, and are using them to make more and more purchases in stores and online and to pay their bills. Across each venue, electronic payments account for a significant—and increasing—share of the payments mix.

With the rate of change accelerating, it has never been more important to understand the drivers of consumers' payment choice.

About the Study

The *2005/2006 Study of Consumer Payment Preferences* is the fourth in a series of consumer research studies that tracks the evolution of the U.S. payments landscape. An updated and expanded follow-on to the *1999, 2001, and 2003/2004 Studies of*

Consumer Payment Preferences, the 2005/2006 Study is the definitive guide to how consumers pay in different venues, and why and how their payment habits are likely to change in the future.

Data were gathered using paper and Web-based surveys sent to consumers (18 years and older) across the United States. As of the response cut-off date, 3,008 completed surveys were received; of the completed surveys, 2,350 were submitted via the Web and 658 were submitted on paper. The demographics of the respondent base were compared with the national distributions as reported by the U.S. Census Bureau to ensure a representative survey sample.

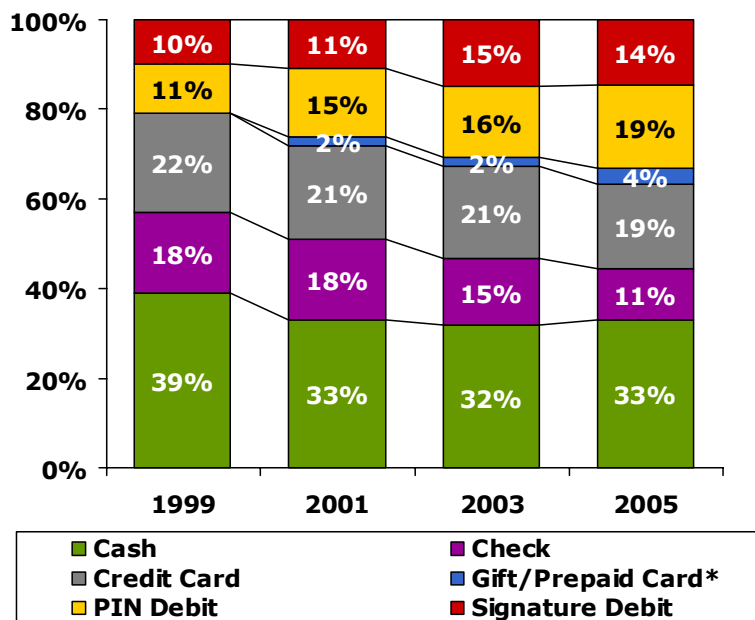
The *2005/2006 Study of Consumer Payment Preferences* is based on a large and balanced national sample of consumers, which provides a sound basis for analysis. This data are sufficient to draw meaningful inferences and conclusions about the overall U.S. payments industry.

In-Store Payments

Consumers make an average of 46 purchases in stores each month using cash, checks, credit cards, debit cards, and prepaid cards. As the most common venue for making payments, consumers' in-store purchasing habits tend to be the foundation for their overall usage and perceptions of different payment methods.

Consumer adoption and use of electronic payment methods is increasing, and looking at the mix of consumers' in-store payments mix—the relative "share of wallet" of each payment method—shows the extent to which that migration has occurred. As shown below, electronic payment methods—particularly debit—account for an increasing share of consumers' in-store payments. Their gain has come primarily at the expense of checks, while cash's share of transactions has remained relatively stable for the last four years.

In-Store Payment Mix, 1999–2005

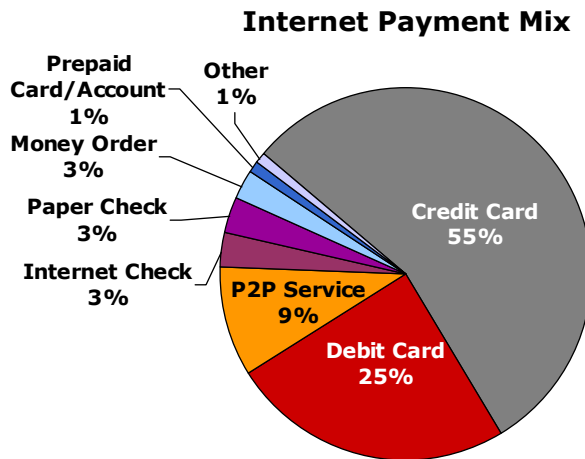


*In 1999 and 2001, consumers were not asked specifically about prepaid cards; in 2001, the 2% is "other."

Looking into the future, these trends are likely to continue. A net 23% of consumers plan to decrease their use of checks over the next two years, while a net 14% plan to increase their use of PIN debit, 13% plan to increase their use of signature debit, and 12% plan to increase their use of gift/prepaid cards.

Internet Payments

Consumers' use of the Internet, both in general and as a retail channel, continues to increase. Internet shoppers reported making an average of 6.1 online purchases over the last three months—most often using their credit card. Credit cards are the dominant payment method for Internet purchases, and debit cards are now firmly established as consumers' second most popular choice.

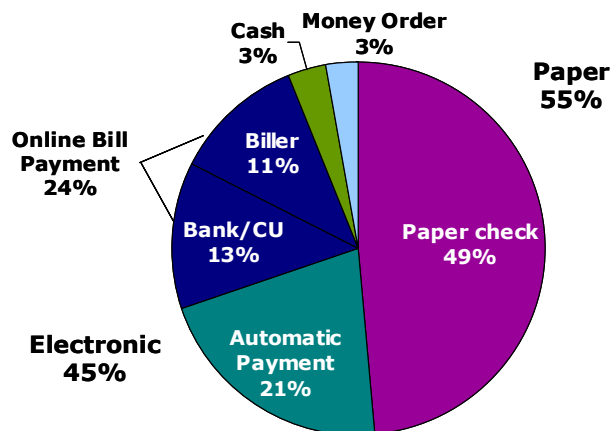


One of the biggest issues facing the Internet community today is consumers' concern regarding Internet fraud and identity theft, and this concern is impacting their use of the Internet as a retail channel: consumers who are not concerned about Internet fraud make 2.3 times the number of purchases as those who are extremely concerned. While it is unclear whether concern about fraud limits the number of purchases consumers make or if making more purchases increases customers' comfort and dispels concerns, consumer concern about fraud and identify theft seems to be a hurdle that must be overcome to maximize the growth of this channel.

Bill Payments

Bill payment remains the last stronghold of paper-based payments—for the time being. Checks continue to be the most commonly used bill payment method, with 71% of consumers paying at least one recurring bill per month by writing a check. However, on a bill-by-bill basis, checks account for only 49% of consumers' recurring bill payments (down from 72% in 2001 and 60% in 2003).

Recurring Bill Payment Mix



In aggregate, just over half of all recurring bills are now paid with paper-based payment methods. Electronic payments account for 45% of all recurring bill payments—up from 35% in 2003, and 22% in 2001.

As the array of online bill payment and automatic payment options expand, consumers are increasingly able to pay bills using their credit or debit card. Some cardholders—particularly those who receive rewards—are making an increasing number of bills using their credit or debit card.

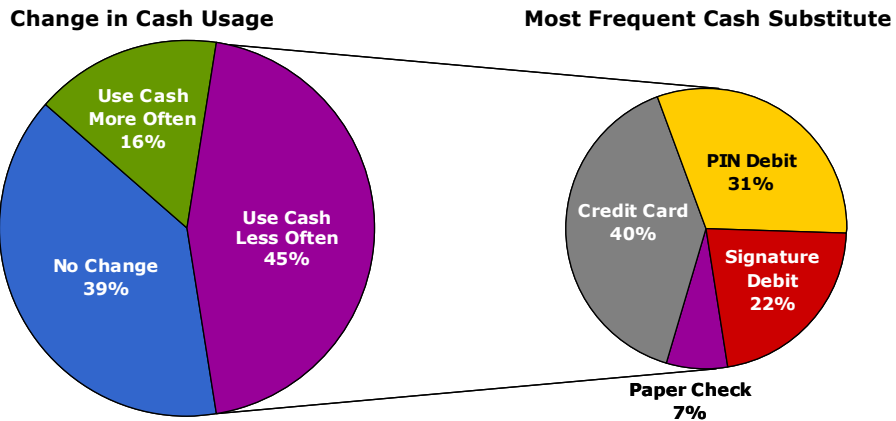
Looking at the future of bill payment, at least 20% of consumers predict that their use of each type of electronic payment will increase over the next two years; conversely, a net 19% of consumers predict that their check use will decrease and 1% predict that their use of cash for bill payment will decrease. Bill payment is still in a “wholesale adoption” phase of migration to electronic payments, and the rapid change in the mix between paper and electronic payments is likely to continue.

Cash

Cash is the universal medium of exchange. As an entrenched part of today’s society, virtually everyone knows, trusts, and accepts cash. In many respects, each new payment method developed and introduced has been forced to compete with cash for a share of transactions, raising the question of whether that payment method is better, faster, or cheaper than cash. As cash faces increasing competition from existing and emerging electronic payment methods, many participants in the payments arena are renewing their interest in understanding consumers’ use of cash—when, where, how often, why—and how that is likely to change in the future.

To date, cash has maintained its share of transactions, accounting for 33% of consumers’ in-store payments. However, when asked how their behavior has changed over the last two years, 45% of consumers report using cash less often than they used to. In place of cash, those consumers are primarily substituting card-based payment methods. Of consumers reporting lower cash usage, 40% reported using credit cards instead, 31% PIN debit, 22% signature debit, and 7% paper checks.

Change in Cash Usage and Cash Substitutes



Despite its position of strength, the dominance of cash is being challenged: nearly half of all consumers indicate that they have reduced their usage of cash over the past two years, and the data suggest that additional erosion will occur, with a net 5% of consumers projecting a reduction in cash use over the next two years. However, the primary reasons consumers use cash rather than alternatives center on its ease of use, its speed, and its appeal for small-value purchases. These reasons are not likely to change overnight, and none of the currently well-established payment alternatives has challenged cash's strength in these areas. As such, cash will remain an important element of the payments landscape going forward.

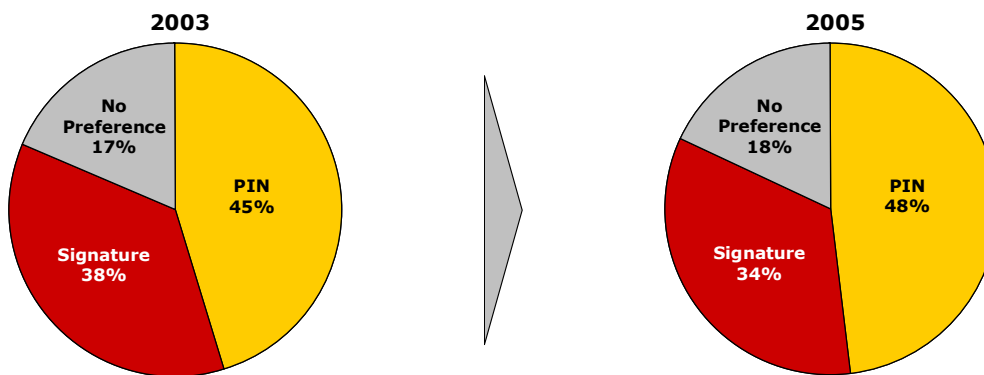
Debit Cards

Debit is a payment phenomenon. Since 1998, debit volume has increased at an annual rate of 23%, and has become the preferred method of payment for many consumers.

Today, most consumers (83%) own a debit card, and the majority of those cards (95%) can be used to make both PIN and signature debit purchases. Combined, debit represents 33% of consumers' in-store payments mix, and is tied with cash as the payment method consumers use most often to make in-store purchases.

With one debit card, consumers have a choice between two different types of debit transactions: PIN debit or signature debit. Increasingly, consumers prefer to select "debit" at the point-of-sale and enter their PIN to authorize a debit card purchase.

Consumer Preference between PIN and Signature Debit



As debit card issuers start to shift their focus toward driving incremental debit card use, some have begun offering debit rewards programs—many within the last year. From 2003 to 2005, the number of consumers enrolled in debit rewards programs has increased from 8% to 13%—an increase of more than 60%. And debit rewards programs appear to influence consumer use of debit cards, and particularly of signature debit. Of cardholders currently enrolled in a rewards program, 46% plan to use signature debit more often because of rewards; for PIN debit, 16% plan to use it more often as a result of rewards.

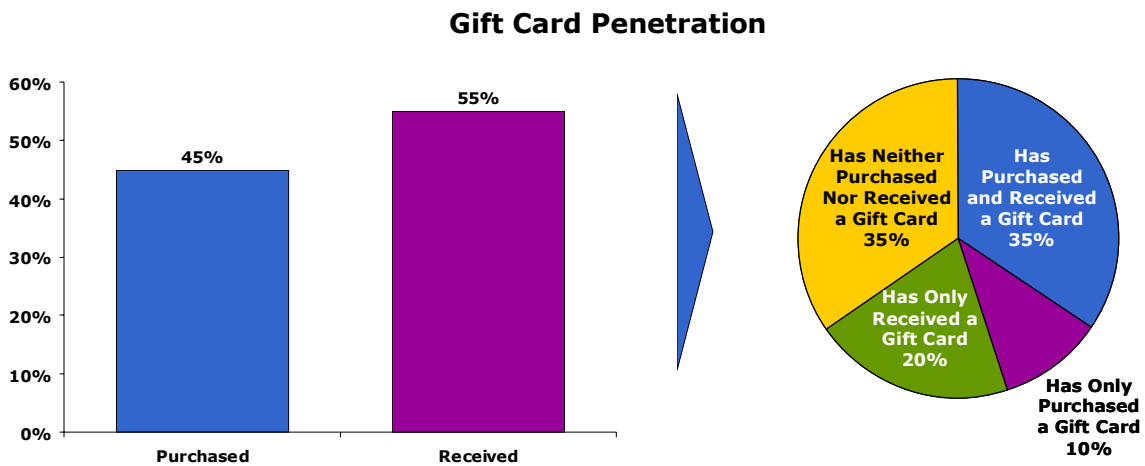
Fueled by consumer demand, debit volume has grown at double-digit rates. As debit’s share of wallet continues to rise for many consumers, issuers anticipate that this strong growth will go on for the foreseeable future—debit is likely to continue to be a payments phenomenon.

Prepaid Cards

Credit cards allow consumers to pay later; debit cards allow consumers to pay now; and prepaid cards allow consumers to pay before. The spectrum of card-based payments is now complete.

Any discussion of “prepaid cards,” however, is likely to be misleading. In reality, there is no such thing as “prepaid”; rather there is a broad and growing array of prepaid applications. In the current market, however, there are—by size—essentially two categories of prepaid cards: gift cards and everything else.

While the number of prepaid applications has increased in recent years, gift cards are the only ones that have attained widespread consumer adoption to date. As shown below, 45% of consumers have purchased a gift card within the last 12 months, while 55% have received a gift card. The majority of consumers (65%) have purchased or received a gift card: 35% have both purchased and received a gift card, 10% have only purchased a gift card, and 20% have only received one. The remaining 35% of consumers have neither purchased nor received a gift card within the last year.



There are two primary, interrelated reasons why consumers choose to give gift cards, as opposed to cash or paper checks. First, gift cards are perceived to be more personal than cash or paper checks, as cited by 57% of consumers. Second, a gift card designates where the recipient can redeem the value of the card. Given these preferences, it is not surprising that 87% of gift card purchasers have given retailer-specific gift cards, compared with 10% who have given bank-issued gift cards, which tend to be more direct cash substitutes.

In addition to gift cards, a variety of prepaid applications are still emerging. Most of these applications are bank-issued open-system cards designed to occupy specific niches. Most of these non-gift prepaid cards—check cashing cards, payroll cards, healthcare savings cards, etc.—currently have low levels of penetration among consumers (less than 5%).

Of the different prepaid card applications, retailer-specific gift cards are the only well-established prepaid card in consumers' wallets. However, with the transition from gift certificates to gift cards largely complete, and retailer gift cards now well-established, future growth of the prepaid market depends on the success of these various non-gift applications.

Conclusion

Since 2001, this *Study* has documented the shift in consumer payment behavior across multiple payment venues. In 2001, paper-based payments represented 57% of consumers' payments. By 2003, that share had decreased to 49%—a major milestone for electronic payments, which accounted for the majority of consumer transactions for the first time ever. Between 2003 and 2005, the shift toward electronic payments continued, with paper payments decreasing to 45% of all in-store payments.

Although consumer adoption of electronic payments is increasing across the board, the speed of migration to electronic payments is not consistent across payment venues. The different migration patterns reflect fundamental differences in the dynamics of in-store payments, Internet payments, and bill payments—and yet across all three, debit is emerging as the clear winner.

- Debit is now tied with cash for the highest share of consumers' in-store purchases, and 33% of consumers cite debit as the payment method they use most often in stores. Over the next two years, a net 14% and 13% of consumers plan to increase their use of PIN debit and signature debit, respectively.
- Between 2003 and 2005, debit's share of Internet purchases increased from 20% to 25%. Since 2001, consumers' comfort with debit cards for Internet shopping has increased significantly, from 2.4 to 3.3, crossing the line from "not comfortable" to "comfortable."
- An increasing number of consumers are using their debit card for bill payment, to make either automatic payments or online bill payments. As more and more consumers earn rewards for using their debit cards, their use of debit for recurring bill payment is likely to increase.

If debit is the clear winner as consumers' payment habits evolve, checks are the clear loser. Consumers' use of checks in stores and for bill payments is deteriorating rapidly, and the future outlook is bleak. The outlook for credit cards and cash is less clear-cut. Credit cards are maintaining their relative share of the payments' wallet, although, in some cases, debit card use is cannibalizing the use of credit cards. Cash has also held its own but is starting to show signs of erosion. Although cash continues to offer unique benefits, it may lose some of its distinctiveness as the array of electronic payment options proliferates.

In the final analysis, as electronic payment options expand, the real winner is not debit, or credit, or cash. The real winner is the consumer.

The *2005/2006 Study of Consumer Payment Preferences* is available for purchase online at http://www.aba.com/Surveys+and+Statistics/SS_CPPS_05.htm (\$500 for ABA members/\$2,000 for non-members).

About the American Bankers Association

The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership — which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks makes ABA the largest banking trade association in the country. To reach ABA, visit www.aba.com.

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