

Consumer Payment Preferences **The Paper Trail is Getting Colder**

The payments industry is undergoing major structural changes. The number of payments made in the U.S. has seen significant growth, nearly doubling in size over the last 30 years. More importantly, radical shifts are altering *where* and *how* payments are made.

Moreover, several recent events — the passage of the Check Clearing Act of the 21st Century (Check 21), the proposed merger between First Data Corp. and Concord EFS, and the lawsuit settlement between the retailers and Visa/MasterCard — will further shape the payments system.

While these developments will no doubt produce major change, the consumer will remain the ultimate arbiter of the fate of the payments industry.

To this end, the **2003/2004 Study of Consumer Payment Preferences** is designed to understand consumers' payment habits and preferences. The study profiles the payments landscape from the perspective of consumers, providing key insights into what payment methods they use, how they perceive payment methods, and how their behavior will change in the future.

About the Study

The *2003/2004 Study of Consumer Payment Preferences* is the third in a series of consumer research studies conducted by Dove Consulting in conjunction with the American Bankers Association to track the evolution of the U.S. payments landscape from the consumer perspective.

Across three venues (in stores, on the Internet and for bill payments), the study addresses:

- Payment methods currently used by consumers
- Consumer perceptions of these payment methods
- Influential factors that determine how consumers pay in stores, on the Internet, and for bills
- Consumer use, preference, and understanding of debit cards
- Expected future use of different payment mechanisms
- Penetration and usage (current and planned) of emerging payment technologies

A nationally representative sample of consumers was surveyed for this research. In total, 2,008 responses were received, and the data set was tested to verify its validity based on geography, gender, income, education, age, and race. Based on these tests, the data in the study are sufficient to draw meaningful inferences and conclusions about the overall state of the U.S. payments industry.

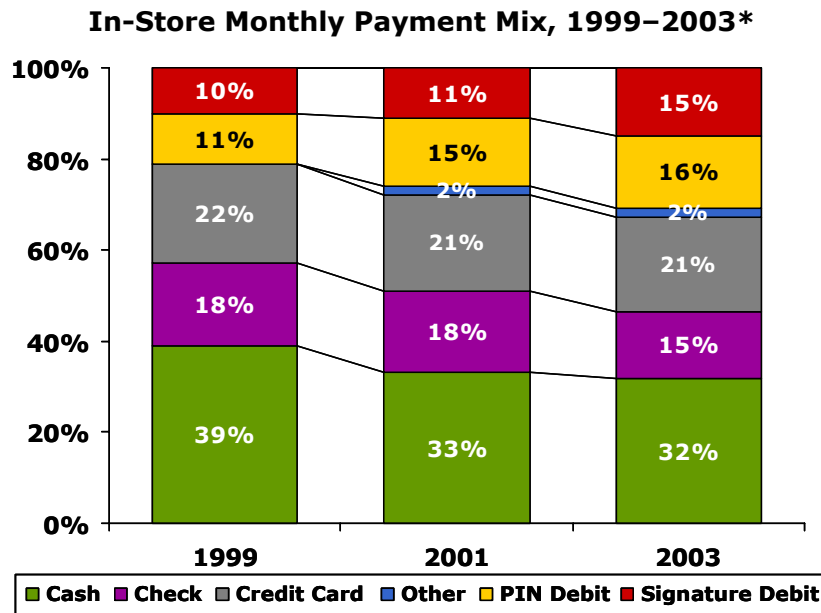
Across all payment venues (in-store payments, Internet payments, and bill payments), consumers are continuing to migrate toward electronic payment

methods. This evolution is driven primarily by the fact that consumers are writing fewer checks and using debit cards more frequently.

In-Store Payments

For the first time, electronic payments have surpassed cash and checks as the preferred payment method for in-store purchases. This year, cash and checks account for 47% of in-store purchases, as compared to 51% in 2001 and 57% in 1999. By contrast, 53% of in-store payments in 2003 were made (on a self-reported basis by consumers) using some kind of payment card, up from 49% in 2001 and 43% in 1999.

As shown in the chart below, the primary driver of this growth is debit. Four years ago, debit represented approximately one out of every five in-store transactions; today consumers report that nearly one of three in-store purchases are made with a debit card.



*Note: "Other" includes check truncation and prepaid cards for the 2001 data and prepaid cards for the 2003 data.

Cash has experienced the greatest decline in relative share of transactions, falling from 39% in 1999 to 32% in 2003. Checks have also experienced a decline, while credit card use has remained relatively stable.

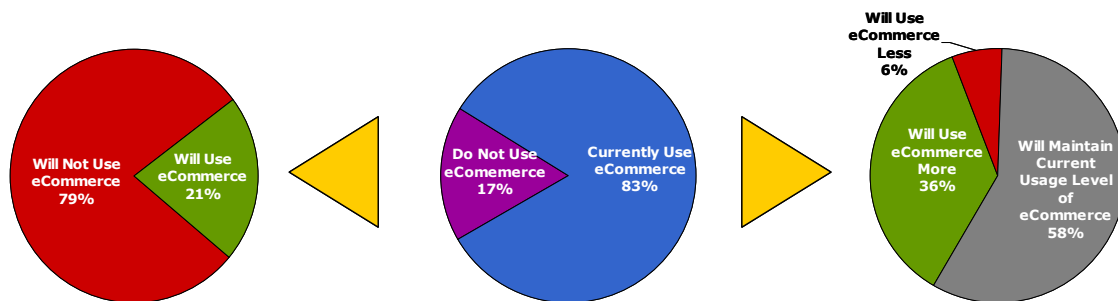
The trend away from paper-based payments is projected to continue for in-store purchases. While 24% of consumers anticipate they will decrease their use of checks for in-store purchases in the next two years, 25% of consumers plan to increase their usage of PIN debit. Usage of signature debit and prepaid cards will also increase, with 22% of consumers expecting to increase their use of each payment method in this time period.

Internet Payments

Credit cards remain the predominant payment method for Internet purchases. However, consistent with in-store purchases, debit is growing in popularity and taking share of wallet for Internet purchases from credit cards.

Despite some residual reservations about e-commerce security, consumers expect their use of the Internet for shopping to increase over the next two years. Of those currently shopping online, 36% expect to increase their Internet purchases while only 6% anticipate decreasing their Internet shopping. Equally important, of those consumers who do not currently shop online, approximately one-fifth plan to start shopping online within the next two years.

Future Change in Internet Shopping



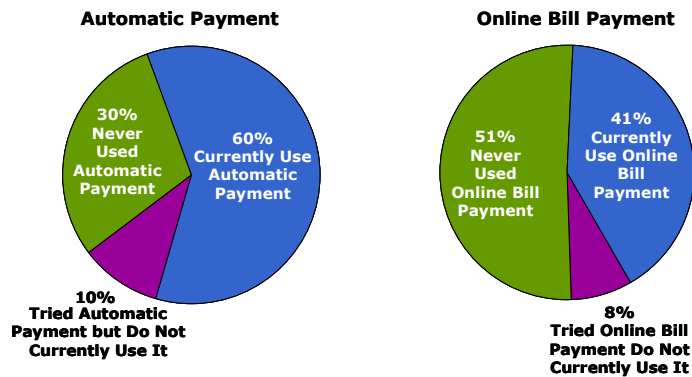
Bill Payment

Bill payment remains the last bastion of paper-based payments—at least for the time being.

In 2001, 72% of recurring bill payments were made with a check. In 2003, this percentage fell to 60%. Increased use of automatic payment and online bill payment poses the greatest threat to the dominant position of checks. Automatic payments and online bill payments represent 29% of consumers bill payment mix—up from 17% in 2001.

Currently, 60% of consumers pay at least one recurring bill with automatic payment, while only 30% of consumers have never tried automatic payment. While adoption of online bill payment is lower than automatic payment — 41% of consumers currently use online bill payment — it represents one of the fastest growing payment methods.

Use of Automatic Payment and Online Bill Payment



Financial institutions have also looked to online bill payment as a revenue-generating feature of online account management. However, of the 41% of consumers who currently pay bills online, 56% pay bills exclusively at a biller Web site, compared with 44% who pay bills through a bank or credit union Web site.

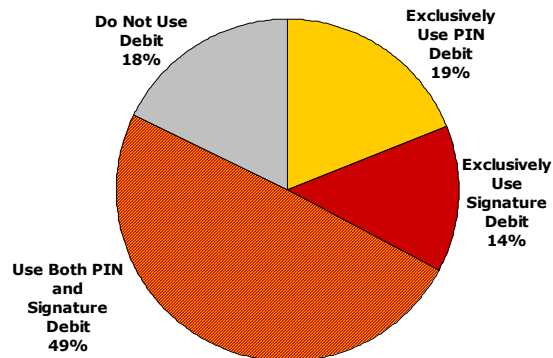
Consumers are moving toward biller direct payments because billers often provide bill presentment (giving consumers the ability to view details of the bill they are paying), which financial institutions usually do not; and because many billers offer online bill payment free of charge.

Debit

Consumer adoption and usage of debit has been growing steadily. Between 1998 and 2002, signature debit transactions increased at an annual growth rate of 28%, while PIN debit increased at 26%. All trends indicate that debit is an increasingly popular form of payment at the point-of-sale: 80% of consumers have a debit card, and of those who have a card, 79% use it.

Within the overall category of debit, some cardholders are exclusively PIN debit users (19%) and others are exclusively signature debit users (14%). As shown in the chart below, the majority of debit cardholders, however, use a combination of the two (49%).

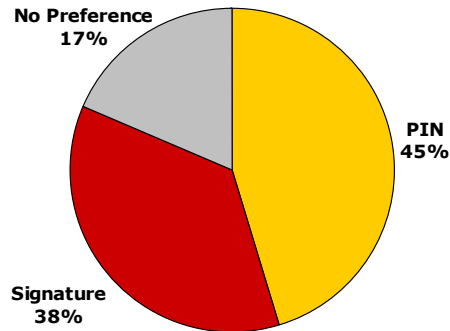
Usage of PIN vs. Signature Debit*



*Note: Does not include consumers who do not have debit cards.

In the battle between PIN and signature debit, both sides have strong support from consumers: 45% of debit cardholders prefer to enter their PIN at the point-of-sale, compared with 38% who prefer to sign a receipt.

Consumer Preference between PIN and Signature Debit



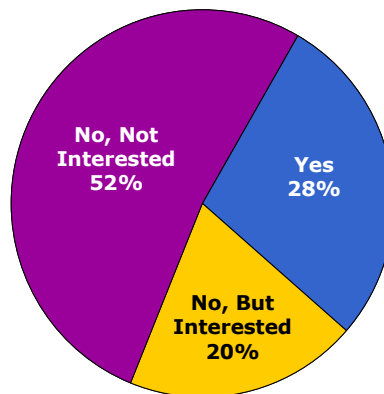
Emerging Payments

Emerging payment technologies will accelerate the rate of change between paper and electronic payment methods. This study explored consumer usage and perceptions of five new payment methods: transponders, wireless payment devices, cross-border money transfers, check conversion, and stored value cards.

One of the most discussed new payment methods is check truncation. With the recent passage of Check 21, both merchants and financial institutions are hopeful that implementing check conversion at the point-of-sale will reduce the cost of handling checks and encourage residual check writers to use more efficient forms of payment.

28% of consumers have had a check truncated at the point-of-sale, and an additional 20% of consumers expressed interest in this payment technology.

Check Truncation at the Point-of-Sale



Conclusion

Based on our primary research, the direction of overall payments is clear—consumers will continue to migrate toward electronic forms of payment.

Card-based payments stand out as the overall beneficiary of this migration. In particular, debit will gain the largest share across in-store, Internet, and bill payment venues. As issuers of debit cards, financial institutions should be well-positioned to take advantage of this trend in consumer payment preferences. Consumers are more comfortable using debit and have a greater understanding of debit than ever before; however, more education is needed.

The success of debit cards comes at the expense of other payment methods, namely checks. Financial institutions must prepare, not only operationally but also strategically, for declining check volume. As consumers turn to checks less frequently across all venues, it is in the best interests of financial institutions to play an active role in influencing what payment methods are used in their place.

In particular, financial institutions should consider:

- Developing a coordinated debit campaign to promote the features of both PIN and signature debit: *Educating consumers on the dual-capabilities of debit cards will increase usage of debit across all venues.*
- Implementing a check migration strategy to encourage alternative forms of payment: *This strategy will benefit consumers who prefer to write checks and want to continue doing so, but face declining acceptance of their preferred payment method.*
- Investing in emerging payment methods that meet the specific needs of a particular venue or market segment: *Success in a niche market can drive adoption in the short term and pave the way for expanded use in the mass market.*
- Explore ways of establishing new kinds of horizontal cooperatives that can gain check processing efficiencies in a declining volume world: *Success in managing the payments migration will depend not only on how growth segments are captured, but also on how declining segments are managed from a unit cost perspective.*

Financial institutions that recognize the changing payment patterns of their customers and plan accordingly will be well positioned for success in the coming years.

Dove Consulting is a Boston-based consulting firm specializing in strategy and organizational effectiveness. Dove's value proposition—deep expertise for immediate value, sincere collaboration with clients, and the delivery of clear results—has enabled the firm to become a highly valued and trusted advisor to leading companies and their executive teams all over the world. Founded in 1981, Dove offers deep expertise in four industry areas: financial services, consumer broadband, consumer packaged goods, and government.

For more information, the firm can be reached at www.doveconsulting.com or 617-482-2100.