

**The Ongoing Evolution of Payments:
Implications of the 2007 Federal Reserve
Payments Study Results**

Ten short years ago, cell phones were just beginning to take off, the Internet was an exciting new phenomenon, and debit cards were exhibiting very strong growth rates, albeit off a relatively small base.

It's amazing what can happen in a decade. Today cell phones are everywhere, the Internet is an essential part of daily life, and debit cards are *still* exhibiting strong growth rates. Debit's growth is now being driven on a far larger base of transactions, however, and it does not show any signs of slowing down anytime soon.

It almost goes without saying that the payments landscape continues to evolve rapidly. Consider the following findings from the recently released *2007 Federal Reserve Payments Study*¹:

- Despite thoughts three years ago that debit growth would slow, it has continued at a torrid pace.
- Debit transactions now exceed credit transactions, although credit still exceeds debit in terms of total dollar volume spent;
- Debit transaction volume likely surpassed check transaction volume in 2007;
- Credit transaction volume continues to grow and to carry relatively high average ticket sizes;
- ACH payment volumes are growing even faster than debit volumes, and ACH transactions are moving downstream to capture higher volumes at smaller dollar values;
- Check volume is declining, but will certainly not disappear overnight.

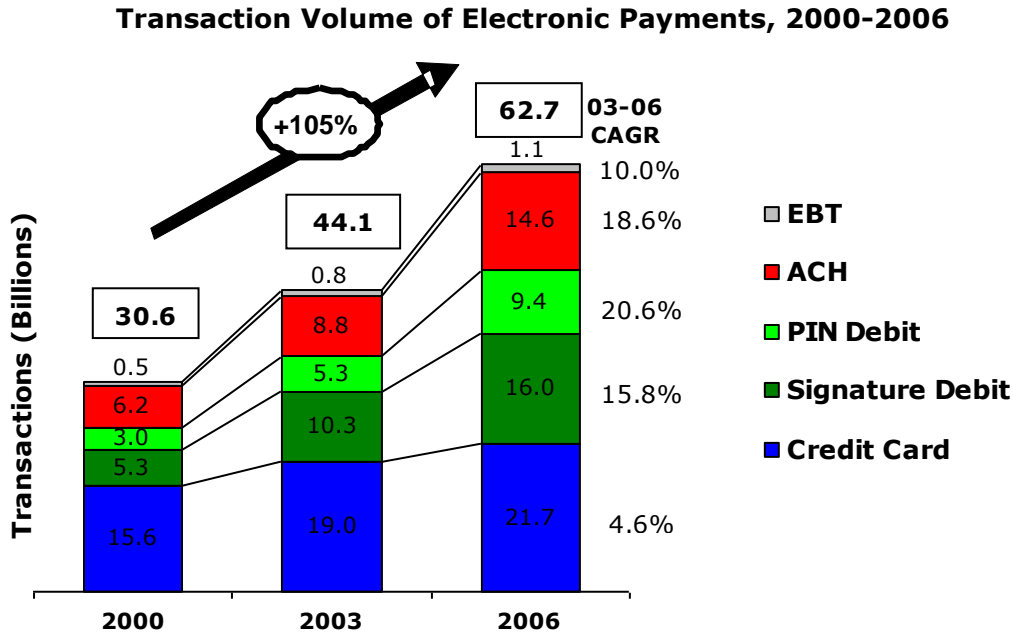
The *2007 Federal Reserve Payments Study* confirms what many people have long suspected: Electronic payments are replacing paper payments. However, it also confirms that there will very likely be a long tail when it comes to paper payments. The challenge is—and will be—managing a complex and expanding array of payment mechanisms, each of which offers a different value proposition for payors, payees, FIs, and payments providers.

¹ The *2007 Federal Reserve Payments Study* comprises the *2007 Electronic Payments Study*, which was conducted by Dove Consulting for the Federal Reserve Bank of Atlanta to determine the volume and dollar value of electronic payments. The *2007 Electronic Payments Study* documents the results of an industry-wide survey of EFT payment networks, organizations and processors; the full *2007 Federal Reserve Payments Study* also includes check volumes.

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Electronic Payments Doubled 2000-2006

The rise of electronic payments has been nothing short of phenomenal. The *2007 Federal Reserve Payments Study* documents that in just six years, from 2000 to 2006, electronic payment transaction volume has more than doubled, rising from 30.6 billion to 62.7 billion transactions. Electronic payments continue to grow at a rapid, double-digit annual rate. The significant growth of debit card and ACH transactions in part reflects a continuing trend of substituting cash and checks with electronic payments.



One key driver of electronic payments' success is card acceptance. Card acceptance continues to move into new channels, such as quick-service restaurants. Customer adoption and usage of cards are now firmly mainstream – with check usage at the point-of-sale now the exception rather than the rule – while ACH payments have experienced strong growth as online bill pay and ACH eCheck conversion continue to increase. As new opportunities to use electronic payments have opened up, consumers have shown a strong willingness to use them.

The Rise of Debit

Debit, which eschews credit cards' debt-based spending by instead providing direct access to a checking account, has been growing steadily over the past several years. From 2000 to 2006, debit transactions have more than tripled, from 8.3 billion to 25.4 billion. Although credit card volume has also increased over this time period, it has been no match for the rapid rise of debit.

Why has debit become so popular so quickly? Several reasons:

- It's easy to use. Just pull out your card, hand it to the cashier or swipe it at the counter, sign or enter your PIN, and be on your way.

- It's convenient. The card is linked directly to your DDA, so it is just like using cash, but without the trip to the ATM. Plus it is accepted nearly everywhere.
- It's secure. Even taking into account the highly-publicized recent string of data breaches, debit is still safer than writing a check or carrying cash.
- It's not credit. Credit is borrowed money, and most consumers are acutely aware of that. But since debit links directly to your bank account, you are unable to spend more than you have. Research has shown that consumers are more likely to associate credit with an infrequent big-ticket purchase than with a trip to the grocery store or the gas station.
- It's rewarding. Reward programs for debit card purchases are increasingly common, with over 37% of issuers—and 68% of large banks—offering debit rewards.²

Although credit and debit have many similarities, millions of consumers have indicated with their actions that beyond just the speed, convenience, and security of paying with plastic, access to a checking account rather than a line of credit tips their preference in favor of debit over credit. In 2000, credit transaction volume was nearly double debit's volume, but even though credit has continued to grow, debit has already closed the gap and is poised to begin leaving credit even further behind.

Rapid debit growth has provided direct economic benefit to financial institutions. Banks' main source of revenue from debit is interchange, which averages ~\$0.52 per signature debit transaction and ~\$0.23 per PIN debit transaction.³ As transaction volumes have increased, this relatively new source of revenue continues to have an increasingly favorable impact on issuing banks' bottom lines.

Importantly, unlike with credit cards where a handful of large issuers dominate the market and many banks no longer even have a credit card portfolio, debit cards are issued by—and generate revenue for—just about every single financial institution that offers a checking account.

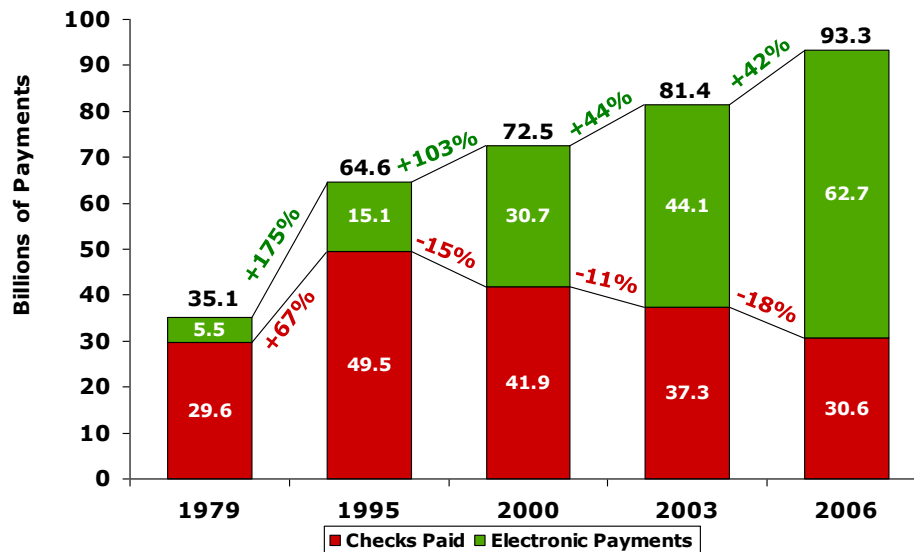
The Displacement of Checks

The *2007 Federal Reserve Payments Study* also documents that in 2006 the number of electronic payments was more than double the number of paper checks paid in the United States—62.7 billion electronic payments vs. 30.6 billion checks paid. Electronic payments accounted for a 67% share of non-cash payments in 2006, up from a 54% share in the year 2003. Importantly, the data shows that between 2003 and 2006, electronic payment volume increased by 42% while check volumes decreased by 18%.

² Dove Consulting, *2007 Debit Issuer Study*

³ Ibid.

Growth of Non-Cash Payments in the U.S., 1979-2006



Electronic payments are clearly eating away at check volumes. However, it is also interesting to note that in terms of dollar value, the amount of money paid via checks actually increased between 2003 and 2006, from \$39.3 trillion to \$41.7 trillion. This indicates that the average check size is increasing; this makes logical sense because most corporate payments are still paper-based, but many consumers now pay their bills online via ACH payments and many billers are ARC'ing paper checks at the lockbox.

Another important implication of this trend is that although check volume is clearly on the decline, it will also likely have a long tail and need to be supported for many years to come. As the number of checks paid continues to decrease, FIs will be faced with an expensive fixed cost infrastructure that cannot be fully dismantled, but must be managed carefully in order to keep expenses under control.

What About Cash?

When it comes to paper payments, cash remains the big unknown. Although cash is certainly widely used and accepted, no study has yet been able to provide a comprehensive, consistent metric for how many transactions are conducted with cash each year, and attempting to track cash payments has proven to be notoriously difficult.

Nonetheless, it appears that electronic transactions are displacing not only checks, but cash transactions as well. The incremental 18.6 billion electronic payments from 2003 to 2006 can be partially explained as transactions replacing checks. However, paid check volume declined by only 6.7 billion transactions. Therefore, even when organic growth is taken into consideration—real Personal Consumption Expenditures (PCE) grew at an annual rate of 3.3% from 2003 to 2006—it is logical to assume that some portion of the growth in electronic payments can also be explained by displaced cash transactions.

Since the total number of cash transactions occurring in the United States remains unknown, it is challenging to determine whether cash volumes are increasing, decreasing, or flat. Based on our analysis of the little data available, we believe that overall cash transaction volume may indeed still be growing, but at a much slower rate than in the past.

Since the actual number of cash transactions is unknown, it is not possible to determine how quickly—or slowly—the growth in electronic payments is actually displacing cash transactions. Yet cash is a crucial component of the payments industry that cannot be ignored when evaluating potential payments strategies, since cash impacts a wide variety of factors ranging from currency handling costs to ATM usage to the deployment of cash recyclers in bank branches.

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In the midst of these dramatic shifts in payments behavior, what are financial institutions to do? Financial institutions, if they are not today, should consider organizing their various payment products under a more holistic umbrella. Despite the importance of payments and the need to adapt quickly to industry developments, our experience has been that decisions about payments at most FIs remain fragmented. Given the rise of electronic payments and the displacement—but long tail—of paper payments, it is more crucial now than ever that financial institutions begin looking at payments as a whole rather than in product silos. FIs need to establish a mechanism for addressing their payment strategies holistically.

Such an approach becomes even more important as new payment methods are introduced and take root. Recent innovations such as open loop prepaid cards, mobile payments, and contactless payments—just to name a few—are each at various stages of maturation and acceptance, and the jury is still out regarding which offerings will imitate debit's strong growth in the coming decade, and which payment methods will go the way of the smart card in the U.S. (that is, initially promising with a lot of hype, but ultimately disappointing).

Those institutions that are able to truly address payments in a system-wide, holistic manner will end up being those institutions that are best poised to react quickly to these ongoing changes in the payments industry, and in turn they will be the institutions most likely to capitalize on the revenue and customer servicing opportunities that these changes offer.

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Founded in 1981, Dove Consulting, a division of Hitachi Consulting, is a Boston-based consulting firm specializing in financial services, with a particular focus on payments strategy and payments compliance. 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 financial institutions, networks, processors, and other providers all over the world.

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