

## **The Evolution of Alternative Payments: *A Look Back, a Look Forward***

At one point, the need for a payment mechanism that would allow one person to pay another person for a Hello Kitty tote bag (\$7) or a pre-Columbian portrait burial mask (\$105,000) via the Internet would have seemed unnecessary—and yet PayPal processed \$48 billion in total payments value in 2007.<sup>1</sup> Similarly, the ability to pay for a can of soda by waving your cell phone in front of a vending machine or to receive checking account status alerts while waiting in line at the grocery store would have seemed superfluous—but today, leading banks, networks, phone companies, service providers, and vendors are working around the clock to develop these solutions.

Alternative payments are a hot topic: companies like BillMeLater, Obopay, Firethorn, Tempo, and Pay by Touch are headline news fixtures, and projections about the growth of alternative payments and the impact they will have on the payments industry abound.

The future is never certain, but lessons learned from the evolution of payments to date can provide some valuable insights into the future of alternative payments and the impact they will have—and will not have—on the established payments landscape.

Although today's alternative payment methods, which range from Internet payment services to decoupled debit and from deferred payment solutions to mobile commerce, account for just a small piece of the overall payments pie, they represent the next big opportunity. Some of these 'emerging' payment methods will eventually establish a foothold in the market, and as they gain traction, volumes will increase and providers will compete aggressively for scale and capital funding. The question is which ones.

The only thing that is guaranteed is that innovation in payments will continue—and as some of today's alternative payments become established payment methods, new alternative payment methods will emerge.

### ***A Historical Perspective***

Many people have speculated that cash and checks will eventually go the way of the dinosaur or the passenger pigeon: that is, at some point, they will cease to exist in the market, having been replaced by new emerging, electronic payment methods.

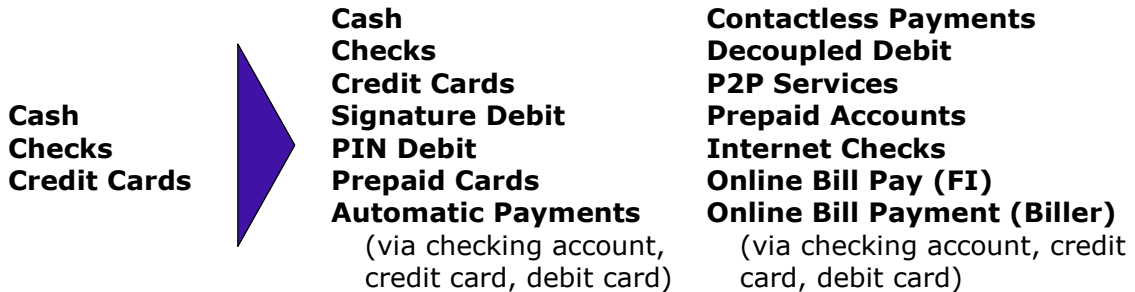
We respectfully disagree. The history of payments shows that consumers like to have choices—and these choices are additive; few, if any, disappear.

---

<sup>1</sup> EBay, 2007 10-K

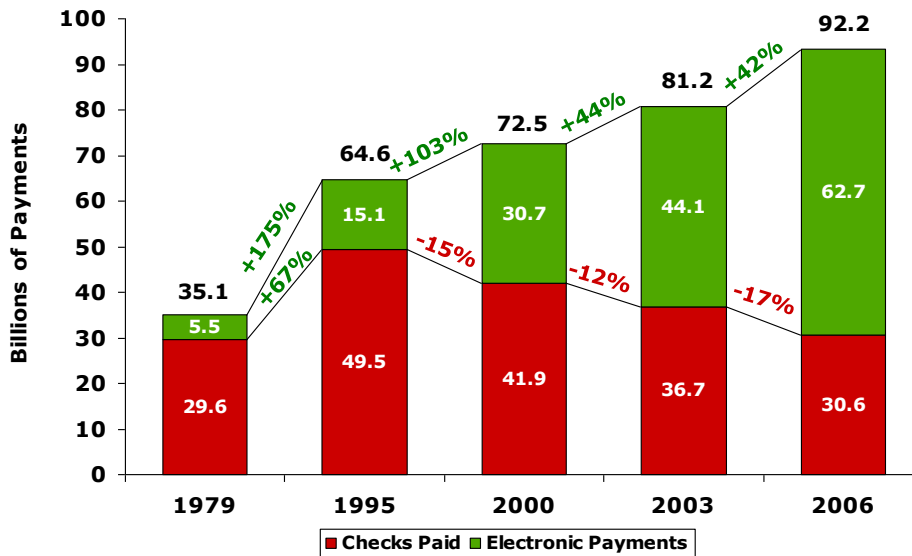
Over the last 25 years, the array of consumer payment options has exploded. In 1978, consumers' options were limited: in stores, consumers could choose to pay using cash, checks, or credit cards; bills were paid primarily by mailing a check. Today, consumers still choose to pay using cash, checks, or credit cards—or they choose to use one of an increasing array of electronic payment options.

### Consumer Payment Options



Electronic payment infrastructures have provided increasingly easy pathways for the introduction of new consumer choices—and the increased share of electronic consumer payments reflects the value of choice and convenience.

### U.S. Non-Cash Payments Volume & Growth



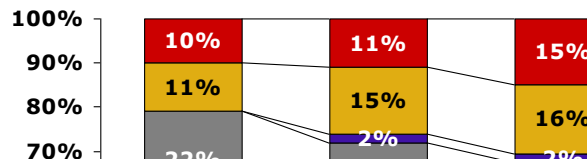
Source: Federal Reserve, 2007 *Electronic Payments Study*

Debit cards, prepaid cards, online bill payment, automatic bill payment, P2P services—each has expanded the array of choices consumers have for making payments in different venues. These payment methods have increased the range of payment applications, filling a different niche or meeting a particular need—and in some cases, creating a new 'need' we hadn't realized we had. Each has provided distinct advantages over existing payment options, and as a result, consumers' adoption and use of these payments have increased significantly over time, often at the expense of other payment methods.

Although credit and debit cards are now well-established payment methods, they were once considered emerging payments—and they have done much to reshape

the payments space over the last thirty years (and even over the last ten years). Cards' share of consumers' in-store purchases increased from 43% in 1999 to 56% in 2005, and cards now dominate the payment landscape.

### Consumers' In-Store Payment Mix, 1999-2005



Source: ABA/Dove Consulting, 2005/2006 Study of Consumer Payment Preferences

Despite the growth of card payments, however, cash—the original 'alternative payment method' to traditional bartering—continues to be a primary payment vehicle. Although cash use has declined in recent years, it remains the most frequently used payment method for 33% of consumers, the highest share of any payment method. And although checks have been largely displaced for point of sale purchases, they still play an important role in business transactions, person to person payments, and consumer bill payments. Despite the rapid growth of online bill payment and automatic payments, 71% of consumers use checks to pay at least one bill per month.<sup>2</sup>

What does this mean for the future of alternative payments? It means that alternative payments that provide unique advantages will likely gain traction and see their volumes increase—and in doing so, they will further expand the range of payment applications and the spectrum of consumers' 'needs'. It means that alternative payments will replace traditional payment methods for certain constituents and/or in certain niches, but legacy payment methods will continue to be important. Most importantly, it means that competition for transactions and share of wallet is only going to intensify over time as more and more payment options vie for a piece of the overall payments pie.

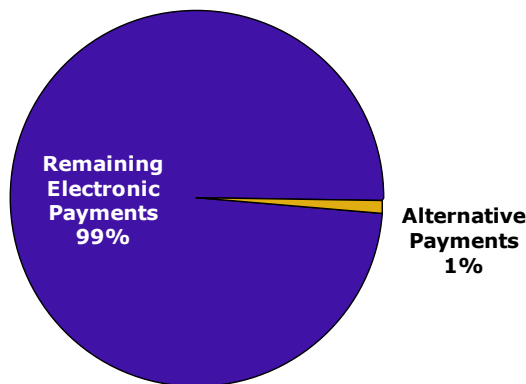
### Alternative Payments Today

Today's alternative payment methods include a wide variety of applications: Internet payment services, decoupled debit/ACH cards, mobile payments, deferred payments, etc. Some of them are new, while others ride the rails of existing payment methods.

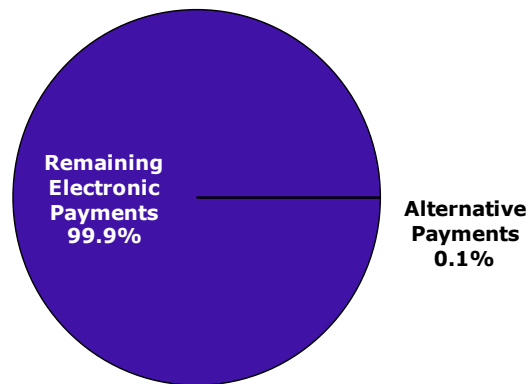
<sup>2</sup> ABA/Dove Consulting, 2005/2006 Study of Consumer Payment Preferences

Alternative payments are hip and cool, and they generate a lot of interest—but they currently account for a tiny share of electronic payment volume and value.

**Electronic Payments Transaction Volume**



**Electronic Payments Transaction Value**



Source: Federal Reserve, 2007 Electronic Payments Study

In many ways, alternative payments play larger than they are, with more hype than substance. But these payment methods represent the next horizon, and many companies, from entrepreneurial start-ups to industry giants, are wading into the mix.

**Examples of Alternative Payment Providers**

**Internet Payment Services**



**Decoupled Debit/ACH Cards**



**Deferred Payments**



**Mobile Payments**



Monitise



And many more...

These and countless other providers have entered the market, with mobile commerce dominating the pool of new entrants and garnering the most interest of venture capitalists. These companies are agile, innovative, and looking to push the envelope of the payments industry. Many of them are small, niche players struggling to gain a foothold and vying for venture capital funding, and only time will tell which ones will survive the growth curve.

These providers will face challenges gaining share and competing against both established players and other new entrants, and eventual consolidation is almost inevitable. Examining past trends suggests that although new payment technologies are additive, the same is not true of new payment vendors. Payments is a scale business, and over the years the payments industry become increasingly consolidated along multiple dimensions—and the ability to drive down unit costs based on volume increases has been the single most important driver of consolidation.

As alternative payment methods gain traction, the provider landscape is likely to pattern itself after the PIN debit networks. In the early 1980s, when debit was still an 'emerging' payment method and the network market in the U.S. was highly fragmented, there were almost 200 EFT networks facilitating transactions between merchants and financial institutions. By 1997, there were only 41 networks, and the top 5 networks—which had consolidated to become large regional players—accounted for 70% of network switch volume.<sup>3</sup> Since then, the leading networks have continued to increase their scale: the top 5 players now have national footprints, and together they account for 96% of PIN debit transaction volume.<sup>4</sup> Similarly, it is unlikely that there will be 20+ mobile payments providers ten years from now. History has shown that there will be winners, and, unfortunately, there will also be losers.

### ***What the Future Might Hold***

No one knows what the future may hold for alternative payments—or for payments more broadly—but we have five predictions:

1. We will continue to see new ideas in the payments space addressing smaller and smaller niches. These innovations will come both at the point of consumer contact (what we might use and how we might pay) and behind the scenes in the form of new infrastructures to facilitate transactions.
2. Most of these ideas will be brought to market by new companies; some, although very few, will be established players. Large, established players have little incentive to displace what they have already constructed; more likely, they will likely use small companies as their 'skunk works.'
3. We will see consolidation at the same time that we see expansion. Small players will merge to enhance their competitiveness, and longer-term, vertical integration with large-scale providers is likely.
4. We will see migration of players from one space to another. Scale advantages will require it, and consumers will welcome it.

---

<sup>3</sup> ATM & Debit News, 1998 EFT Databook

<sup>4</sup> ATM & Debit news, 2008 EFT Databook

5. We will be surprised both by new payment devices—and by payment mechanisms that just never go away.

---

*Melissa Fox is a Senior Manager in the Financial Services Practice at Hitachi Consulting (formerly with Dove Consulting, a division of Hitachi Consulting); she can be reached at 617-753-9205 or [mfox@hitachiconsulting.com](mailto:mfox@hitachiconsulting.com).*

*Hitachi Consulting, a global consulting company with operations in the United States, Europe and Asia, is a recognized leader in delivering proven business and IT strategies and solutions to Global 2000 companies across many industries. With a balanced view of strategy, people, process, and technology, we work with companies to understand their unique business needs, and to develop and implement practical business and technology solutions.*

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

*For more information, the firm can be reached at [www.hitachiconsulting.com](http://www.hitachiconsulting.com).*