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Buy Now, Pay Later … and Gear Up for More Regulation

Changes in the BNPL space are coming; learn how to navigate the opportunities and risks

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First there were layaways. Conjured during the Great Depression when people were struggling to make ends meet, layaways allowed people to buy big-ticket items and pay in instalments before walking away with their product. Layaways were especially popular around the holidays when many people reserved all their gifts in advance and started saving for them through a layaway program. Then came the retail and private-label instalment plans that let you take that large-screen TV or the fully adjustable mattress home and pay it off over time – interest free if you made the payments on schedule. Now it's *Buy Now, Pay Later* (BNPL), which has brought that same no-interest, post-purchase monthly instalment concept to all categories of products, small and large, and even services, fuelled by an easy, convenient and digitally enabled payments and credit value proposition provided primarily by fintech companies.

The business model behind these instalment plans has changed slightly over the decades though some elements have remained the same. Layaways were the sole responsibility of merchants, who bore the administrative costs of collecting the upfront payments but did not take any credit risk because the sale was completed once full payment was made. With post-sale instalment plans, a bank or a specialty lender was typically involved, taking the credit risk and getting some compensation from the merchant for that risk. Yet most of the bank's income came from the finance charges paid by customers who did not pay off the instalments on time. The BNPL provider also makes money from interest charges due to late or missed payments as well as receiving a fee from the merchant for taking on the credit risk. But unlike the banks and specialty lenders involved with private-label and retail credit instalment plans, the BNPL fintech companies have "softer" credit standards and could face large losses in the case of customer defaults.

Layaways are almost dead, hurt gravely by the emergence of credit cards that gave the consumer the ability to *buy now and pay later* early on. Private-label credit cards, specific to each merchant and accepted only at that merchant's stores, dealt a further blow to layaways. Old-fashioned instalment plans are still around, but they generally are centred on big-ticket items such as furniture, jewellery and appliances. BNPL, on the other hand, is expanding worldwide at high double-digit growth rates. The last deadly blow to layaways, in fact, came from the rising popularity of BNPL. Walmart, one of the last holdouts, removed seasonal layaway from most of its stores this year after teaming up with Affirm, one of the biggest BNPL fintech firms. As the

2021 holiday season approaches, other big retailers have jumped on the bandwagon, with Target and Amazon recently announcing BNPL partnerships.

While BNPL's appeal for retailers grows, it's also attracting the attention of payment companies and banks, leading to a series of acquisitions in recent months and similar services starting to be offered by other players. Square spent $29 billion to buy Afterpay; PayPal is paying $2.7 billion for Japanese upstart Paidy; Goldman Sachs bought GreenSky for $2.2 billion; Standard Chartered provided a $500 million loan to Singapore's Atome Financial; Discover invested $30 million in Sezzle. Visa and Mastercard recently started offering instalments on their networks in several markets, including the United States. JPMorgan Chase, American Express and Citi are providing their credit cardholders the ability to shift certain purchases to an instalment payment plan. In Canada, Scotiabank and CIBC are both offering card-linked instalments. Online banks in Hong Kong have been using BNPL to lure new customers without charging the consumer or the merchant.

As BNPL fintech companies garner huge valuations and add tens of millions of customers, banks need to decide whether they can afford to stay on the side-lines. Retailers that love the product because it brings new customers, generates higher sales and increases the ticket size need to do a more thorough cost-benefit analysis as BNPL becomes a bigger part of their payment mix. In this piece, we delve deeper into how BNPL is affecting the retail, banking and payments industries while also providing a global perspective on the regulatory issues.

Why retail loves BNPL

For retailers, BNPL is all about getting that incremental sale. And it appears to be helping with that goal. According to RBC Capital Markets, BNPL increases retail conversion rates – the measure of how often a shopper's desire to buy something results in an actual purchase – by 20% to 30%. People browse through shops online or in person and see things they like but do not always buy them, due to budget constraints or other reasons. Having BNPL as a payment option, however, seems to significantly increase the chances of a shopper actually completing the purchase. BNPL also lifts the average ticket size by 30% to 50%, RBC Capital estimates. Instead of buying a $200 kitchen robot, the shopper goes for the $300 one with more functionality because the interest-free instalment option makes the latter look more affordable.

Even though it was around for more than a decade in many emerging markets, BNPL took off in Australia, the United Kingdom, Europe and the United States during the pandemic. In Latin America and the Middle East, BNPL has been tied mostly to credit cards, administered by banks in those countries. At checkout, the credit cardholder is provided with the option to pay for a purchase in instalments along with a range of sales plans. In mature markets, BNPL started with e-commerce and with younger consumers, some of whom did not have credit cards and/or were averse to revolving credit. BNPL has especially resonated with millennials and Generation Z

individuals who distrust credit cards. BNPL grew in developed countries during the pandemic as people stuck at home shifted to online shopping in record numbers and discovered BNPL as a "new and convenient payment" option. Timing was opportune as the pandemic created a newfound appreciation for budgeting, and BNPL offered the ability to split up small ticket items – as low as $100 – and pay back in "affordable" instalments. The value proposition of digital credit and payments helped, as well.

Retailers whose client base is especially young have benefited from BNPL's appeal among that demographic. The instalment option has made it easier for younger customers to pay for their purchases at such retailers. According to a study by Klarna, one of the largest BNPL providers, average order volume is 73% higher with BNPL compared to other payment methods for the customers of Rue21, an apparel retailer targeting young people. Rue21 shoppers using BNPL also come back more often, according to Klarna's study. Making the customer sticky is another important goal for retailers, which BNPL seems to help – at least with some segments.

BNPL has caught on with older, middle income, and wealthier clients as well. The $2,000-Peloton bike becomes more affordable with instalments even for the middle-class shopper. Of note, Peloton products accounted for almost 30% of Affirm's sales in 2020. After being available solely for e-commerce, BNPL has also moved to the in-store point of sale (POS), with big retailers teaming up with the major BNPL providers so customers can use the payment option at the checkout counter in their stores. Despite its rapid growth, BNPL still represents a small share of total sales. In 2020, according to industry reports, it accounted for about 2% of global e-commerce transactions and will likely double by 2024.

BNPL is not cheap for retailers. They pay between 3% and 7% of the purchase price to their BNPL provider. These fees are much higher than interchange fees retailers typically pay – and which they have long bemoaned. In the United States, the industry pressured Congress to add a section to the 2010 Dodd-Frank Act limiting interchange fees on debit card transactions. In Canada, pressure from the industry has resulted in successive government interventions to get the payment networks to reduce interchange fees. Retailer-driven interchange regulation continues to be an issue in Australia, the United Kingdom and the European Union. Even though retailers haven't complained about the BNPL fees so far, that doesn't mean they will not in the future. As BNPL becomes a larger part of the payments mix, cost will become a bigger consideration for retailers. As they did with free shipping, which was all the rage for a short while until the companies felt the cost pressure, retailers may soon push back against BNPL fees.

One of the attributes that has made BNPL so popular, particularly among younger consumers, is the ease of the approval process. BNPL providers' softer credit checks lead to more approvals compared to bank and private label credit cards and pre-BNPL retail instalment plans. Another factor driving approvals is the lack of credit bureau reporting. Many BNPL providers do not

report new accounts to the credit bureaus, which in turn makes it difficult to assess a consumer's overall credit exposure and is becoming a particularly vexing issue as BNPL expands. The credit aspects of BNPL are proving to be a double-edged sword. While easy credit has allowed for the growth of BNPL, it also poses considerable risks. As regulatory concerns grow worldwide over consumer indebtedness that BNPL may cause, the retail industry could find itself blamed for enabling it along with the BNPL providers. If some of the BNPL firms fail in an economic downturn under the weight of surging credit losses, retailers may find themselves in the political crossfire.

Why banks need to love BNPL

Banks have generally viewed BNPL as a competitive force threatening their credit card business. During the COVID-19 pandemic, credit card spending did decrease in the United States, the United Kingdom and other countries while BNPL saw fast growth. Yet the drop in credit card volumes was more impacted by the pandemic lockdowns, a lack of opportunity for discretionary spend, fiscal conservatism, a shift to debit, and improved consumer liquidity as a function of government stimulus payments. As the pandemic eased in recent months and borrowing started to recover, credit card volumes have been on an upward trajectory, signalling that consumer debt aversion was temporary and that BNPL and credit cards can coexist. The availability of the interest-free instalments can expand overall consumer credit instead of cannibalising revolving credit.

Consumers without a credit card constitute a new segment that banks can target. This would be a broader play within the unbanked and underbanked segments and could help drive financial inclusion. Additionally, banks can incorporate BNPL offerings into their credit card products, as has been done in many emerging markets for years. Some have already done that. JPMorgan Chase, American Express and Citi are offering instalments as an option while Commerce Bank is working with Visa Installments. But without the BNPL model fully in place and no agreements with merchants to pay for the service, they are charging a fee to the cardholders. Citizens Bank, a regional lender in the United States, and Barclays, the United Kingdom's second-largest bank, are providing financing and the ability for merchants to construct their own BNPL program. First National Bank of Omaha is the latest entrant in this space. Barclays already provides BNPL services on Amazon's German website and is moving to expand that to the online retailer's U.K. site.

Banks worldwide can adopt a model similar to the BNPL fintech firms by getting retailers to pay the fees. Visa and Mastercard may help the banks connect with retailers. The two card payment providers are working with the banks and the payments ecosystem to facilitate BNPL on their respective products and rails.

While the younger generation is a new segment banks can tap into by offering their own BNPL products, the older, middle income and wealthier consumers also using BNPL comprise a group the industry cannot afford to lose to its fintech rivals. Goldman Sachs, the largest U.S. investment bank trying to expand its retail banking footprint, is counting on GreenSky's

network of 10,000 merchants to beef up its consumer-lending business. GreenSky, unlike typical BNPL fintech companies, provides instalment loans for big ticket items, with a strong focus on the home improvement vertical, or home improvements.

As other banks ponder how to get into the race, the industry may take heart in the prospect of regulation soon to come. One of the reasons behind the breath-taking growth of BNPL has been lack of regulation. While banks worldwide must contend with a consumer's creditworthiness and ability to pay – for purposes of risk management and to meet regulatory requirements – BNPL providers have flown under the radar, making their acquisition of new customers seamless and less costly. But that may change soon, which will be beneficial to banks.

"It's going to get more regulated, and it should be more regulated," Mark Barnett, Mastercard's president for Europe, told the *Financial Times* recently. "Nobody wants over-indebted consumers. The people who are best able to make sure consumers are able to repay are banks."

Regulation on the doorstep

In Europe and Australia, BNPL has managed to avoid consumer credit regulation by not charging interest when consumers fail to pay their instalments on time. The industry has argued that the late fees charged in those cases are not interest and thus they are not in the business of consumer lending. Regulators however are taking note that BNPL is consumer credit after all and are moving toward regulating the industry as such. A February 2021 review of unregulated consumer credit carried out for the United Kingdom's Financial Conduct Authority (FCA) highlighted the BNPL industry's exponential growth as posing harm to consumers and recommended regulatory oversight urgently.

The review by Christopher Woolard, a former head of the FCA, pointed out that the exemption from consumer credit that the BNPL industry has relied on, which is based on a 1974 law, was never intended for such products but only for short-term invoice deferral. Many consumers do not realise the payment option is credit, Woolard's review said, increasing the risk that they will not apply the same level of scrutiny to their decision-making as they would when borrowing money. BNPL also poses risks to vulnerable customers because it does not check for affordability, with most providers doing only soft credit checks, the review found. The U.K. Treasury has indicated its intention to regulate the market following the Woolard report. Proposals of such regulation are likely to come in 2022 and be finalised in 2023. In anticipation of impending regulation, Klarna has modified its BNPL product set to include a "pay now" option and will move to strengthen credit and affordability checks as well as improving consumer disclosures.

Meanwhile the European Commission, the legislative arm of the European Union, put forth a proposal in June 2021 to revise the region's Consumer Credit Directive. The proposal would widen the scope of the directive to bring BNPL and other currently unregulated consumer credit businesses into its purview. The revisions would also require credit checks and affordability assessments more widely, trying to prevent dangerous debt build-up by vulnerable customers.

Australian regulators, even though they were probably the first to notice the potential risks in BNPL products, have been slower than others to move toward regulation. A 2018 report on the industry by the Australian Securities and Investments Commission (ASIC) concluded that BNPL could create risks for consumers taking on debt they cannot afford. In its 2020 update, ASIC said it had power to regulate the industry under new regulatory tools focused on consumer outcomes and harms. Following ASIC's 2020 report, the BNPL firms active in Australia published a voluntary code of conduct, pledging to increase transparency and provide suitable products for the consumer. The industry also volunteered to pass customer complaints to the government ombudsman as other financial institutions are already required to do. ASIC seems to be giving the industry a chance first with self-regulation before it moves to enact hard and fast rules itself around BNPL.

In the United States, regulation is likely to come from the Consumer Financial Protection Bureau (CFPB). In a July 2021 blog post, the agency warned consumers against overextending their finances even if the interest-free instalment plans look attractive. Rohit Chopra, who was confirmed as the head of the CFPB in September 2021, has pledged to protect consumers with financial vulnerabilities. Chopra was involved in the establishment of the agency, whose mission from the start included taking on non-bank financial companies and fighting predatory lending. In addition, in November 2021, the U.S. House Committee on Financial Services conducted hearings related to BNPL.[1]

In China, the BNPL services of Ant Group and Tencent Holdings have faced intense scrutiny from the country's crackdown on online lending to the young, which has slowed the growth of BNPL there. The Monetary Authority of Singapore is reviewing whether BNPL needs a regulatory framework, its chairman told the country's parliament in October 2021.

Regulation will likely slow down the breath-taking growth of BNPL worldwide as providers are forced to assess affordability and do more comprehensive credit and identity checks. That will protect vulnerable customers from overextending themselves. It will also help level the playing field for banks and enable them to compete on more equal terms.

[1] https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408594.

In closing

BNPL has spread like wildfire worldwide in the last few years. It offers consumers an alternative way to pay for their purchases, potentially helping them budget their spending better. But it also poses the risk of consumers spending beyond their means by making it too easy to select the "pay later" option too many times. Here is what we see for the future of the BNPL industry:

- BNPL products coexisting with other forms of credit and serving as a new payment option
- The expansion of BNPL to the in-store POS, services, travel and entertainment, healthcare, pet care, and B2B segments
- Consolidation within existing BNPL fintech providers
- Banks playing a larger role in the BNPL sector
- BNPL features being integrated into credit cards and banks re-tooling their payments operations, servicing and technology infrastructure to support new requirements
- Lower fees paid by retailers due to increased competition among BNPL providers
- Retailers modernising their payments acceptance and management technology
- More robust identity management, security, fraud and risk management requirements
- Regulatory oversight and new rules for the industry (including pricing, credit management and disclosures)

Decreases in merchant fees due to competition and consolidation will make the math work better for retailers. Regulation will make it work better for banks. Both sectors have opportunities to leverage BNPL for new revenue capture.

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