Buy Now Pay Later –

Does It Have a Future?

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In January 2022, Tony Craddock and Jay Bennett of The Payments Association, a highly successful UK-based organization empowering companies in the payment industry, held the Buy Now Pay Later CEO roundtable.

The consortium of CEOs from the European payment industry discussed the advantages and disadvantages of BNPL, which prompted a staggering yet potentially revolutionary question: does BNPL have **the power to replace credit cards?**

Considering credit cards have become a financial staple, it's hard to imagine a life without them. Of course, there *was* a time when we managed without them — and now we dare to ask if they might go extinct?

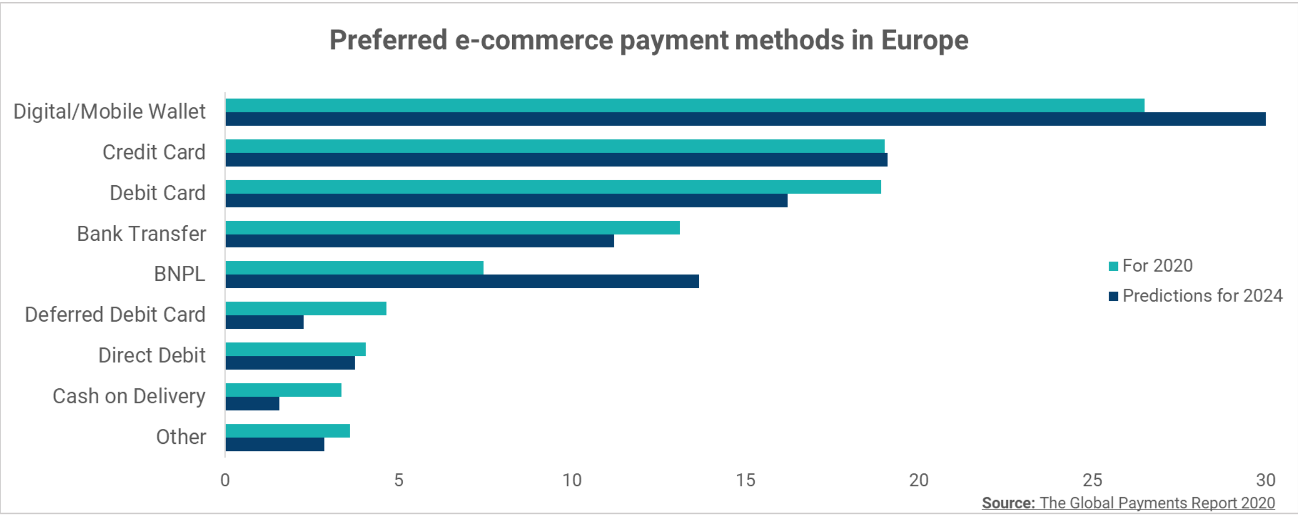
Then again, those thoughts are not so far-fetched. In an episode of the Business Daily podcast from BBC, Ed Butler from BBC interviews Nick Molnar, the CEO of Afterpay, an Australian BNPL giant.

Nick explained:

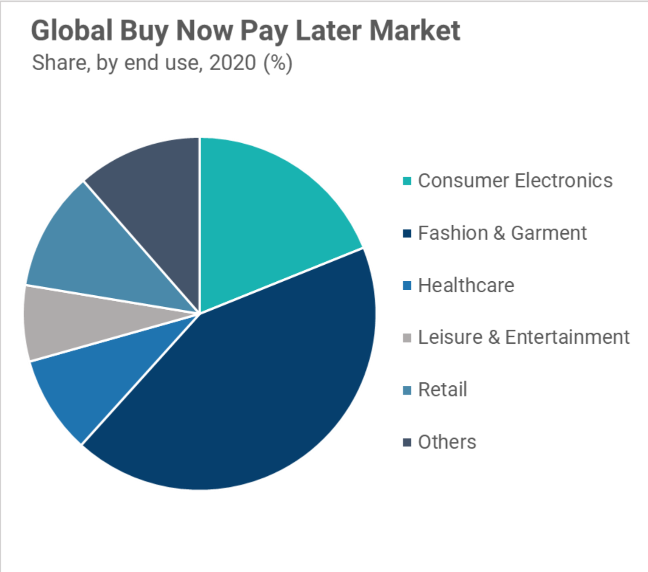
"I grew up during the 2008 financial crisis and that was where you saw the first wave of this shift away from credit cards to debit cards. Consumers are spending money differently. They're engaging with brands differently. As a result of the pandemic, you've seen a further acceleration away from credit cards to debit cards. If you look back in the middle of the pandemic in May, Visa had negative 21% year on year growth for credit cards, but actually positive 12% year on year growth for debit cards. So, there is this systemic shift and we're, you know, really excited to be part of the debit economy to take this forward and, engage with consumers in this new way."

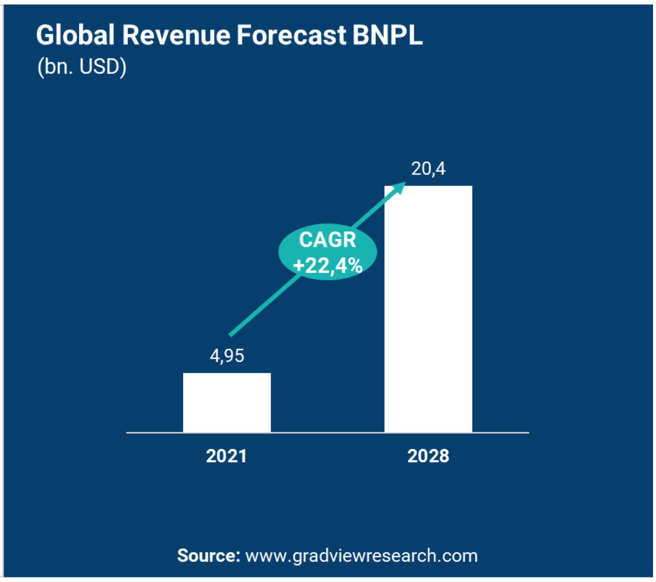
And the numbers seem to support his analysis, as BNPL is expected to seize significant market share in the payment space by 2024.

The Global Payments Report 2020 showed these trends in payment forms:



BNPL usage is expected to nearly double in size within four years. Moreover, the overall growth rate of BNPL is projected to be the fastest growing payment method in Europe. According to Grand View Research, the global BNPL market was valued in 2020 at $4.1 billion and is expected to continue to grow at a CAGR (Compound Annual Growth Rate) of 22.4% from 2021 to 2028:





The future seems bright. But how exactly does this budding payment method work? Why is it expected to grow stronger than all other forms of payment? And what's the catch — or is it truly as good as it sounds?

In 2021, Afterpay featured actress Rebel Wilson in an advertisement of the company's BNPL product. Despite the comedic intention, she gives an apt description of how this form of payment works.

A customer asks Rebel, who's posing as a store clerk, "What is Afterpay?" She answers: *"Wow — it's kind of like…having the abs NOW and getting six weeks to do the sit-ups. If credit cards and cash had a baby, you could pay over time without ever paying interest. If you could eat the whole tub of ice cream and spread the calories over 6 weeks."*

Her overview is both humorous and accurate. Buy Now Pay Later allows you to make purchases online and pay them off in weekly, bi-weekly, or monthly instalments. And when you go to check out, it's integrated seamlessly into the check-out process. With just a few clicks, you can buy goods at a fraction of the upfront cost. Of course, you have to pay the rest back later, but BNPL service providers say they're offering something very different from old fashioned credit cards. Here's more insight from Nick Molnar, co-founder of Afterpay:

"So, the way the product works is essentially if you're buying an item for round numbers, a hundred dollars, the consumer pays four payments of 25. Every two weeks. We pay the retail off the next day. And then we assume all of the risks. So, consumer gets the product up front and we recover the money on the due dates in the future. The first payment is made up front and then second payment, two weeks later, third payment, four weeks later, and fourth payment, six weeks later. … So, if the consumer goes late on one instalment payment, we actually disable their account until they pay that

late payment off. So, you can never revolve in debt. There is never interest. It's a trust-based model. It's not built by trying to maximize income from the consumer in revolving debt. So, if 100% of people pay us back on time, we're actually more profitable. So, we haven't built our model to be designed like a traditional finance product. There is a fundamentally different relationship that you can build with this millennial and gen Z customer. They're saying, you understand me. You understand that I prefer to use a debit card over a credit card that you've built this product to have the appropriate checks and balances. And it ultimately translates to better results for our retail partners. So, you know, we just stand really proud with what we've built and why we've done it. And you know, we're excited for the next few years."

To summarize, here are the benefits of BNPL for customers:

- Customers can buy goods straight away and spread the cost over multiple instalments.
- In many cases, customers aren't charged a premium for this service (i.e., 0% interest rates), so they don't pay any more than if they had paid for the goods or services immediately.
- BNPL providers aren't required to make hard credit inquiries, expediting the approval process compared to traditional credit products.
- In turn, customers get a flexible payment schedule, while keeping credit histories clean — provided they pay on time.

And here are the benefits of BNPL for merchants:

- Merchants can achieve higher sales by attracting customers who couldn't, or wouldn't, pay full prices for goods or services upfront — or simply don't want to use credit cards.
- Merchants can use BNPL as a sales promotion measure, potentially increasing the average shopping basket size without additional credit risk.
- In exchange for a small fee, merchants get their money in full right away from the BNPL companies.
- Merchants can fearlessly market to any customer segment as BNPL providers take over the payment default — in other words, unpaid receivables don't pose a risk to the merchant's balance sheet.

Data from the Buy Now Pay Later Tracker report of Afterpay and Klarna seems to support these benefits:

- Afterpay states that merchants increase their revenue when they offer BNPL credits. Buyers spend, on average, 55% more when they are offered the option to pay with BNPL instalments.
- Klarna states that retailers who offer BNPL options at checkout, both online and in-store, see an increase in average order value (AOV) of around 45%.
- With Afterpay, 87% of people between the ages of 22 and 44 are willing to pay for their larger purchases in monthly instalments.
- Millennials, reportedly, carry half the number of credit cards compared to the generation before them, which makes them the largest group using BNPL services.

But is BNPL really that good?

There's no doubt that consumers have embraced this budding payment method, but BNPL products also carry risks.

Unlike traditional credit issuers, BNPL companies often only do a soft credit check on the customer, as they are not required to perform anything more extensive. Also, there isn't a common pool of data where BNPL payments are recorded, so BNPL companies are limited in their understanding of a customer's credit situation. As a result, consumers may use multiple BNPL products — in addition to other credit products — and risk financial overextension.

A new study from consumer research firm Piplsay found that only 74% of BNPL customers make their BNPL payments on time. Consequently, 26% of customers miss at least one payment. As some BNPL providers do report to credit bureaus, late payments may affect an individual's credit scores.

Another potential risk for customers is that the BNPL can encourage impulse buying. The March 2021 Ascent survey found that 16% of BNPL users reported making five or more purchases with BNPL in an average month. Spaced out payments can still catch up to consumers.

Especially when several purchases are made from multiple providers, the customer may find it increasingly difficult to track their BNPL purchases. This could result in late and missed payment fees — plus, interest may accrue with some providers if a BNPL balance is not paid in accordance with the terms and conditions. Speaking of terms and conditions, customers may not even realize the consequences of a late payment due to (a) seamless integration in the purchasing process and (b) minimal credit evaluations upfront.

BNPL products also have longer-term risks. Users of BNPL products tend to skew younger, so any financial trouble could hinder their ability to access credit in the future or even obtain certain types of employment. Moreover, some merchants have eliminated layaway services in favour of BNPL options, so some consumers may feel nudged into using a credit product they cannot effectively manage.

Identity fraud is also possible. In instances where BNPL loans are not reported to credit bureaus, an individual may be unaware that BNPL credit has been fraudulently established and used in their name. Alert and monitoring services would have no insight.

It is not that the information is unavailable — just looking at the websites of the main BNPL providers shows the following terms — but the customers aren't being made aware of it:

Buy Now Pay Later Services	Interest Rate / Finance Rate	Late Fees
Klarna Pay Later in 4	0%	Up to $7 (per payment)
PayPal Pay in 4	0%	Not listed on website, may vary between states
Affirm	Up to 30% depending on creditworthiness and / or the type of product offered (0% APR may only be offered at selected merchants)	None
Afterpay	0%	Up to $17 per late payment, capped at up to 25% of initial order value or $68, whichever is less (per purchase)
Sezzle	0%	$10 per payment
Splitit	0%	None (although credit card will charge late fees)
Future Pay	$1.50 for every $50 unpaid balance	Up to $38 (per payment)
QuadPay	0%	Up to $21 per purchase

Source: T&C pages of the BNPL providers

However, most of the BNPL users are Millennials and GenZ, who may not have sufficient experience with credit products to fully understand what they're agreeing to. In turn, it's possible that many customers don't recognize this payment method as credit or debt, as seamless integration and minimal credit hurdles give the illusion that BNPL is simply a convenient service without repercussions.

In our CEO roundtable Andrea Dunlop, Managing Director at [TheAccessGroup Paysuite] confirmed this out of personal experience, and added:

"…when we think of consumer harms, one of the things that stands out is consumer understanding of the product. Does the frictionless experience increase the risk of getting into debt more quickly? I think we talked about sometimes a bit of friction is good. The relationship between the lender and the retailer, I feel, is a potential conflict of interest."

And isn't she right?

How should we deal with this situation?

In the BBC podcast "Business Daily" on BNPL, Alice Tapper of personal finance forum Go Fund Yourself explained it like this:

"We need better information at the point at which people are using these products. We need protection. So, access to the financial ombudsman, good affordability checks, just to make sure that people aren't kind of racking up huge amounts of debt across multiple BNPL platforms, which is happening currently. And then finally to that point around marketing at the moment, any other credit product, like a credit card, there are certain kind of rules around how they should be promoted on social media and traditional media. And so on, those rules should probably apply.

So, we're not saying scary regulation, which would put these companies out of business, at all. It's simply about providing that counterbalance so they can exist in the market, be useful for those that need them, but also add a layer of protection for people, particularly young people, so that they are aware of how to use these products."

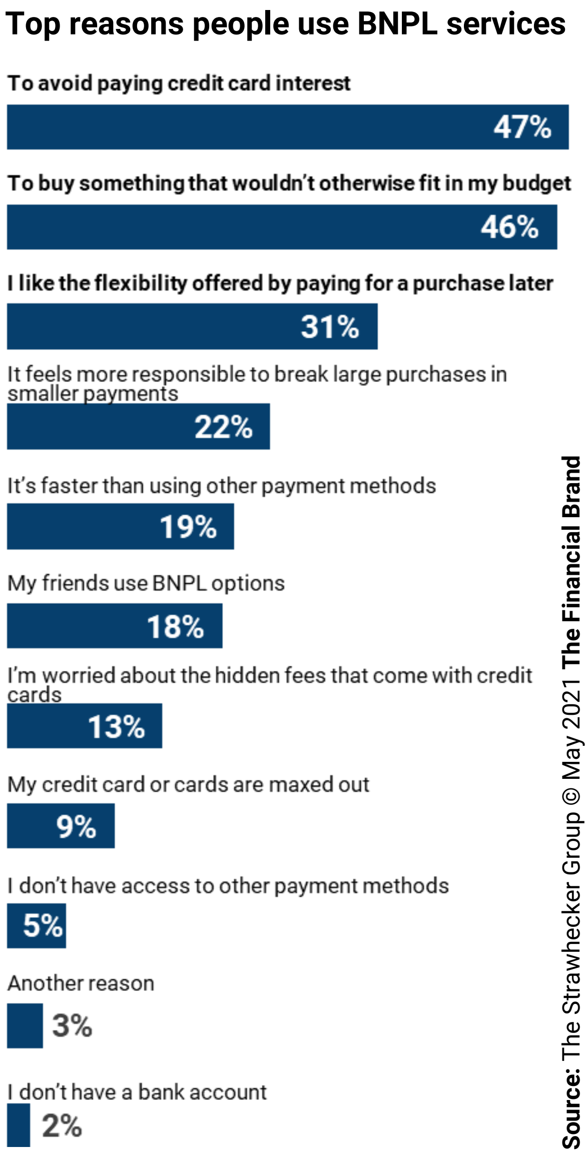
The regulation of BNPL was an intensely discussed topic in our CEO roundtable. The consensus seemed to be that regulations are needed to protect the consumers — but within limits. At this point in time, BNPL payments aren't concerningly high. The majority of BNPL customers spend less than $250 a month on payments according to the Ascent study:

Average monthly BNPL payment	Percentage of respondents who spend this much on a monthly basis
$50 or less	24.82%
$51 to $100	23.92%
$101 to $250	20.43%
$251 to $500	15.14%
$501 to $1,000	8.60%
Over $1,000	7.08%

Source: The Ascent survey of 2,000 American adults, conducted March 10, 2021.

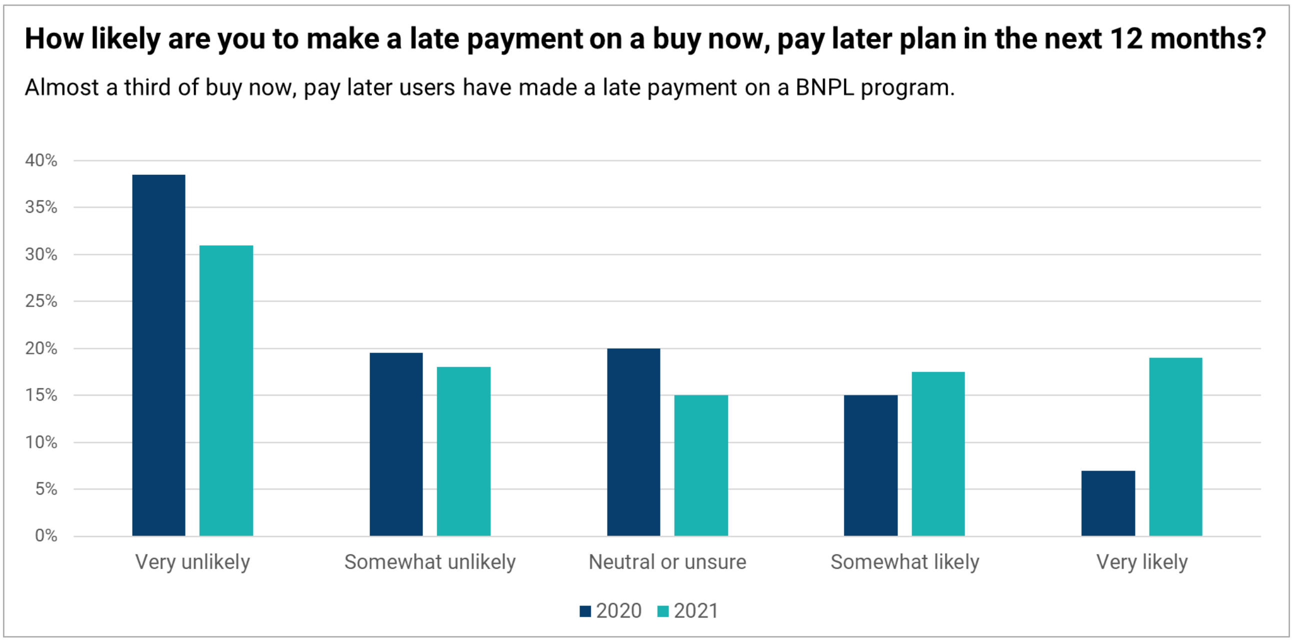
These conclusions also aligned with The Payment Association's response to the Regulation of Buy-Now-Pay-Later Consultation of HM Treasury (which can be downloaded here), which is summarized below:

- Affordability checks during the checkout process
- Appropriate marketing including a proper explanation of the BNPL service
- Sharing of BNPL usage amongst BNPL providers to ensure the financial wellbeing of the users



The results of the Ascent Study as well as the Financial Brand Report 2021 confirm that additional precautions are necessary. For instance, over 40% of respondents to the latter study indicated they use BNPL to buy things they couldn't afford otherwise. In other words, consumers are using this new payment method to justify questionable financial decisions.

And the Ascent study found that 31% of BNPL users have made a late payment or incurred a late fee. Moreover, 36% of BNPL users say they are at least somewhat likely to make a late payment within the next year.



Klarna's Sebastian Siemiatkowski, the cofounder and CEO of Klarna, the Swedish based firm that's now the world's biggest BNPL provider, is also a supporter of a proportionate approach:

"I'm not one of those companies that are gonna tell you that like, oh, free markets is gonna solve everything. …. If we wanna have a functioning society, we need some rules. So some rules make sense. The question is just, how do you create rules that at the same point of time protect consumers but also protect competition and doesn't handicap competition too much, because then unfortunately you may have the opposite results which is that everyone will pay too much for these services for any credit services."

So, with all the logical reasons for appropriate regulatory measures — why has BNPL not been regulated yet?

The UK's existing regulations were put in place in the 1970s and have not been adequately adjusted since then to our modern payment world.

In the UK, any unsecured consumer credit (e.g., a cash loan) is regulated under the Consumer Credit Act 1974 (CCA) and the Financial Services and Markets Act 2000 (FSMA). As is the activity of 'credit broking' (i.e., introducing customers to lenders or other credit brokers).

All companies that offer or invest in regulated credit agreements therefore must be authorised by the FCA (Financial Conduct Authority) and must comply with relevant FCA rules and CCA obligations.

However, this does not apply for BNPL companies as there is an 'interest-free credit' exemption so long as:

- the agreement is a borrower-lender-supplier agreement for a fixed sum with no more than 12 payments to be made by the borrower;
- payments are to be made within 12 months or earlier; and
- the credit is not conditional on interest or other fees (although fees might arise after the agreement is made, e.g., for missing or late payments).

Hence most BNPL providers offer products that take advantage of this exemption. Their products tend to either (a) split the cost of a purchase into several equal amounts, which are then paid at regular intervals or (b) defer payment ('try before you buy') until a specific time after the purchase so long as the purchased item is not returned by the customer. Other models are also emerging, for example, where a third-party lender legally purchases the item and then resells it to the customer.

This is a typical example of any European or US legislative status. Credits for small amounts, without interest and a short payback time are usually left out of the regulatory framework.

Many authorities are currently reviewing the options for regulating the BNPL market. However, there is risk of a disproportionate response in that regulators could enforce overly restrictive policies that would likely kill the BNPL market (i.e., by making it too difficult for the merchants to offer BNPL services). For example, merchants could be seen as performing credit brokering; regulators could require them to apply for an FCA license to offer BNPL. Or regulators could make it too difficult to provide the service for the BNPL providers. For example, BNPL providers could be held liable for any breach of contract or misrepresentation of merchants using their BNPL service.

BNPL certainly has a right for existence as it provides both customers as well as merchants with a win-win relationship. As Guy Raymond El Khoury, CEO of Accomplish Financial, so eloquently puts it:

"BNPL is another credit option and having more options is a good thing for consumers, as long as it is provided in a responsible way."

But assuming policymakers institute appropriate measures, is BNPL even a viable business model?

Each of the top BNPL companies — Klarna, Affirm and Afterpay — are, at the moment, reporting sizable losses ($408m, $379m and $123m, respectively). Based on those figures, one could make an argument that BNPL isn't long for this world.

However, investors think differently — at least in the present environment. Meteoric growth and customer acquisition typically come at a price in the short-term. Longer-term outlooks are another story. Of course, without complementary and profitable products to at least partially offset losses, it could be a short-lived journey. According to Redburn, a UK equity research house, this will make it difficult for pure BNPL companies, as they have only one product to share, whereas other players like PayPal or Square are well-positioned since they offer a wide array of monetized products. Also contributing to the fast success in customer acquisition is the fact that the BNPL market is currently unregulated, leaving a big question mark for pure BNPL players in the event of policy changes. With regulation bringing in tougher rules, the costs for BNPL providers would likely grow and apply pressure to already slim profit margins available today with the BNPL model.

Under the typical BNPL business model, the BNPL provider charges the merchant a 4% fee on average. When deducting costs like interchange fees, card scheme fees, issuer processor fees, the cost of credits, marketing and funding costs, there is only 0.2% – 0.4% margin leftover on average.

Market leaders appear to understand the financial viability of pure BNPL offerings (or lack thereof), as they are buying other companies to provide different products and services. Klarna, for example, is focusing outside of BNPL on the development of super apps and has acquired multiple businesses providing services for banks and retailers.

Afterpay joined forces with Block, strengthening Block's strategic priorities for its existing Square and Cash App ecosystems. Together, Square and Afterpay intend to (1) enable sellers of all sizes to offer BNPL at checkout, (2) give Afterpay consumers the ability to manage their instalment payments directly in Cash App and (3) give Cash App customers the ability to discover sellers and BNPL offers directly within the app.

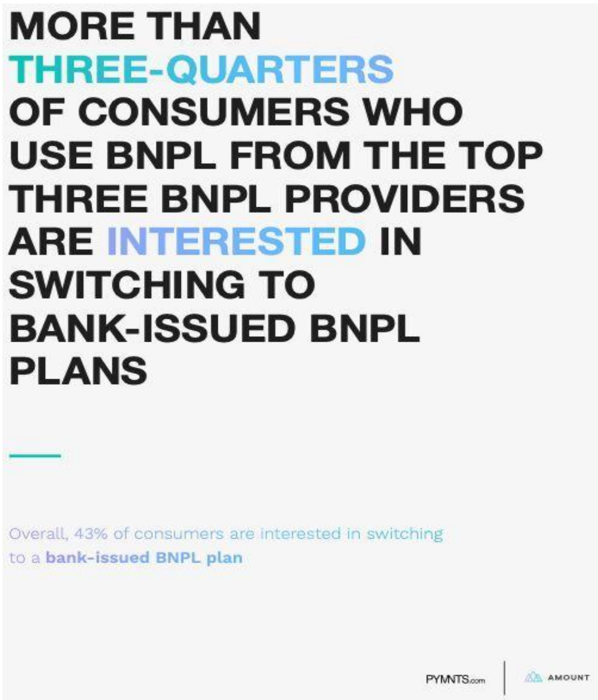
Other BNPL companies also understand that new revenue streams are needed. For example, Merchants are willing to pay more for customer acquisition than for providing a payment form. Hence a good number of successful BNPL companies have started to develop their own marketing programs, getting nearer to the consumer and bring the customer to the merchant, rather than the merchant driving its customers to the BNPL provider.

Loyalty schemes, in which customers are rewarded by the BNPL provider based on the money they spend, have emerged as well.

BNPL providers have also branched out to traditional banking services like bank accounts and credit cards, whereas banks seem to be reluctant to offer their own BNPL services. According to a Gain The Lead study of payment trends in the banking industry of Central and Eastern Europe, providing BNPL services was the fifth highest priority among Central and Eastern European banks:

Rank	Demand	Score
1	SoftPOS	6
2	Platform Business	5
3	Digital Onboarding	4
4	Local Schemes	3
	Instant Payments	3
	Data Analytics	3
5	BNPL	2
	Smart Terminals	2
	Value-Added Services	2

This seems to be a missed opportunity, as 43% of consumers are interested in using BNPL plans offered by their banks rather than FinTechs according to a study from PYMNTS & Amount (download here).



However, banks are often inhibited by slow development and integration timelines as well as stringent compliance standards — not to mention multiple legacy systems that still lack modern digitalization in many cases.

There are technical solutions in the market that could assist banks in taking advantage of BNPL services — as Katrina Beckwith, VP Sales and Business Development at Episode Six, a next generation payment processing technology provider, points out:

"Now Issuers at banks are able to make decisions as fast as a fintech with the BNPL service, whilst still complying with responsible banking and lending regulations of a bank. The E6 platform enables issuers to configure the options based on specific consumer profiles, and not just a one size fits all. Suitability of the service can be pre-screened at customer onboarding, and instalment payment plans can be offered either at the point of spend, or post transaction once a payment has been authorised to see if the customer would prefer to defer the payment into instalments. Banks can easily get back in this game and recapture a younger market segment they are apparently losing."

Other BNPL trends:

- Another trend is getting BNPL to the physical Point of Sale – which is still a challenge at the moment due to the needed technical integration to the POS system.
- Rent-a-product models are evolving in which the product remains a legal possession of the BNPL provider and, therefore, is returned to the BNPL provider at the end of the usage term.
- We also see the usage of BNPL models for perishable goods like foods and drinks evolving — however, due to the small relative value of these products and the debate as to whether necessary items for the daily life should be bought on credit, it will be difficult to see how this can be made profitable.
- Another trend with promising revenue potential is the usage of BNPL for B2B payments. Compared to already existing trade credits and invoice financing, BNPL can bring automation and expedited payments to the table.
- Last but not least, we also see developments in the direction of Smart Contracts and the usage of Distributed Ledger technology in combination with BNPL.

During our CEO roundtable, Jack Nicogosian, CEO of Aryze and a living legend in the area of distributed ledger technologies and Bitcoin, presented his view on the potential use of smart contracts for BNPL consumer protection. We discussed the following question:

Question: *"When you (Jack) spoke about the possibility to use smart contracts for BNPL consumer protection, it made perfect sense. What I am wondering is if smart contracts — where you need to have assets that you then "borrow" against — would be making BNPL not so popular, as currently over 40% of the users say that the reason they use it is that otherwise the article they want to buy does not fit their budget."*

Jack: "I agree that BNPL would be less popular if you had to provide collateral of sorts, compared to how it is today. That's because what you basically collateralize when you take out a credit, loan or a BNPL payments is yourself. Basically, you collateralize your future *ability to pay the goods that you can't pay for today.*

I think that we will see a merger of the two concepts in the future. I can imagine a liquidity pool where users lock up their assets, so that others can loan, and if you provide collateral, you get a better price than if you don't. We can easily imagine a system where you can take out a collateral free loan if you are willing to sell yourself, but you can get a better deal if you have assets to collateralize.

Going forward, we are also going to see various forms of digital identity, and we will have systems in place where you are required to connect a KYC'ed wallet to the lending platform, and if you don't pay the loan back, you get banned (like on lendingclub). That would also prevent the fragmented BNPL loans that people take with different providers."

A combination of BNPL and Smart Contracts certainly has its advantages.

One thing is certain: The Buy Now Pay Later payment method is here to stay. The BNPL companies, however, must evolve to claim their space in the future of the payment ecosystem.

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