Buy Now, Pay Later: Risks and Opportunities for Credit Card Issuers

BNPL is in the headlines as the format takes off globally. Accelerated by the global pandemic, consumers worldwide have adopted online shopping habits — with pay later a convenient, digital payment route for shoppers and retailers. Although instalment-based lending is not new, positioning at POS for smaller-ticket items on a three- and four-instalment basis is an innovation. Commonly known now as BNPL, it received a boost when cashless payment methods surged with Covid's onset.

In recent quarters, the market reached a turning point; tech giant Apple and traditional card issuers began rolling out instalment-based lending products. The first half of 2022 saw BNPL startups meeting serious economic headwinds for the first time, and investor perceptions of this sector shifted as they come to see the pioneers for what they are: consumer lenders rather than popular shopping apps.

> ***Instalment-based lending is here to stay***

Although the mood is shifting, consumer take-up shows that there's no doubt that instalment-based lending is here to stay.

This white paper examines:

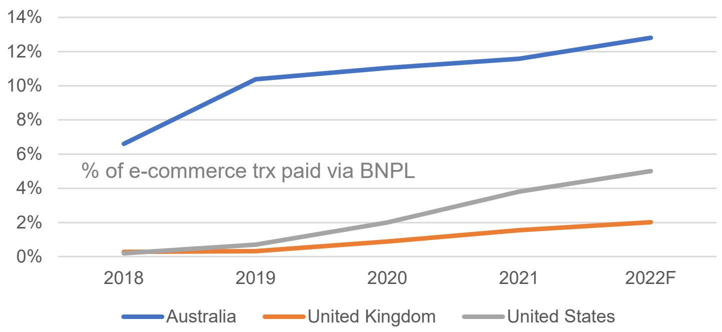
- What the pay later boom means for credit cards,
- What we can expect in coming quarters,
- The regulatory situation around the world,
- How incumbent consumer finance has been responding and
- The increasing move by leading challengers to provide a personal finance superapp (or faux-superapp) solution.

The paper also includes case studies of Australian BNPL and Apple Pay Later. We focus primarily on BNPL loans rather than the wider category of POS financing that includes larger amounts and generally involves terms of 12 months or longer and interest charges.

What does the growth of BNPL mean for the credit card industry?

Traditional credit card lenders are concerned about losing market share and customer relationships to BNPL providers, particularly among young people attracted by pay later's slick digital user experiences and put off by the notion of compound interest loans. Retailers too have been drawn to BNPL's ability to deliver new customers and bigger ticket sizes: this can lead to a dramatic uptick in sales, further intensifying the merchant-lender relationship. Merchants are also enthusiastic about new engagement possibilities as they can get more data on customers.

Australia stands apart for BNPL e-commerce



Source: Argus Advisory Research ©2022

With consumers used to the idea of digital instalments for lower-value, discretionary spend (for example, fast fashion), BNPL players are now looking to higher-value sectors, such as healthcare, where instalment programmes already exist but have yet to be digitised. However, it can be forgotten that credit cards, a well-tested form of payment with widespread acceptance, come with layers of anti-fraud protection not typically replicated in the BNPL sector.

Offline, BNPL has not yet made the same market-share inroads, as it lacks the same levels of acceptance, rewards incentives and anti-fraud measures.

That said, innovators in the sector have responded with virtual cards and complementary service offerings. Going further, Klarna launched a Visa-branded physical card in 2022 that gave holders the opportunity to delay payment by 30 days. There are limits to what such players can do as they haven't attained the depth and reach of established lenders. However, incumbents, often saddled with legacy systems and without fintechs' entrepreneurial, can-do culture, have generally struggled to score highly on user experience measures for their apps.

> ***"BNPL players are now looking to higher value sectors, such as healthcare, where instalment programmes already exist but have yet to be digitised"***

What's coming down the track in this space?

The first wave of BNPL pioneers is now running into headwinds on multiple fronts, from impending regulation and higher interest rates, to an inflationary hollowing out of disposable income and a rising level of delinquencies being reported in high-profile markets, such as Britain and Australia — all of which undercut confidence. Valuations in the sector have fallen as a result, with investors starting to look for profitability after a period where growth has been the priority. Market consolidation is now underway in response to these developments, and the high-profile launch of Apple Pay Later has only compounded the challenge for them.

What will the next phase of BNPL development look like? Certainly, through consolidation and market exits, there will be fewer players and less room for new challengers in developed markets where leaders have established a strong foothold. The tight conditions in one of the format's key markets, Britain (where APRs are not being charged on BNPL loans), led to Openpay's exit from that country, the latest in a procession of withdrawing fintechs. (In July 2022, it decided to pause its US operations.)

The consolidation process has begun in this market as well, with Zip, for example, acquiring a number of players in overseas markets. However, in a time of unpredictable market conditions, potential parties to such deals are becoming increasingly cautious: Zip's acquisition of Sezzle, and Latitude's plan to buy Humm's consumer lending operations for 335 million Australian dollars ($240m), fell through as this white paper was being prepared.

Increasingly, funding challenges are reshaping the operating environment for non-bank BNPL lenders. Heavily reliant on institutional funding rather than deposits, these firms may be stifled in their growth plans and need to put greater focus on profitability.

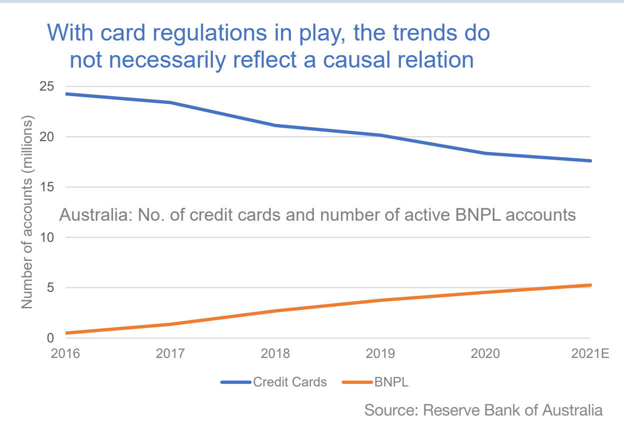
Nonetheless, it is without doubt that BNPL has been transformative in the unsecured lending space: one clear indication of this was the recent decision by TransUnion to incorporate BNPL data in its credit reports in the UK, the US and India. As noted by TransUnion UK's chief executive, Satrajit Saha, "Consumers are seeking alternative ways to pay as they address the cost of living crisis". TransUnion is in discussions to facilitate reporting in the United States and other markets.

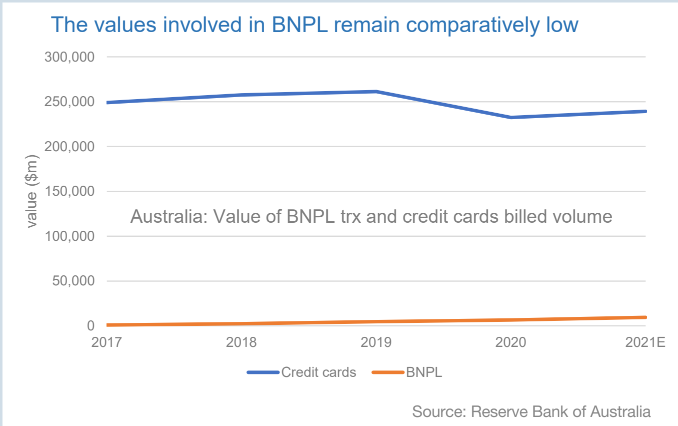
> ***"Consumers are seeking alternative ways to pay as they address the cost of living crisis"***
> ***–Satrajit Saha, TransUnion UK CEO***

In late 2021 JPMorgan Chase chief Jamie Dimon promised, that "we will spend whatever we have to spend to compete" in BNPL. Apple too can be counted upon to put considerable resources behind their instalment lending effort. Whatever recent headlines may suggest, pay later remains an enticing opportunity for lenders with deep pockets. Both Apple and Chase are now well advanced in their campaigns to win the business of young consumers. These two US titans have the resources to not only heavily advertise their digital-based consumer-credit operations but run them at a loss for as long as it takes to dominate the market.

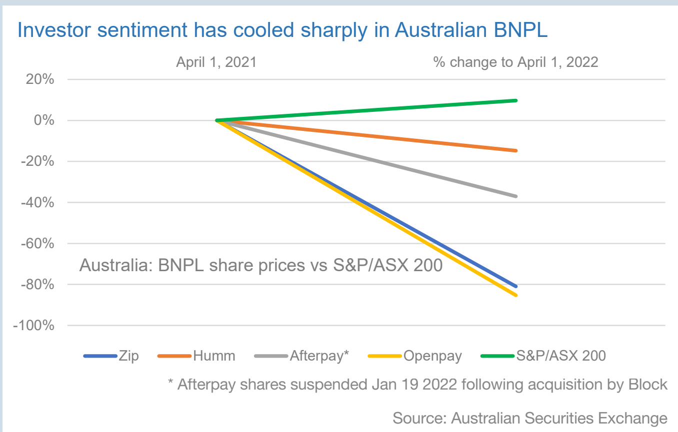
Australia: a bellwether for the global BNPL sector?

With a well-developed and rapidly growing BNPL industry, Australia has been the focus of attention from players in markets around the world looking for business lessons and a guide to the sector's direction of travel. Stories about Australian consumers cutting up their credit cards in favour of the new providers have played well in the press, but the reality is that falling numbers of credit card accounts in recent years have been driven primarily by diminished rewards offerings (in turn, caused by tightening interchange rules that have curbed rewards funding). In addition, spend on credit cards is growing again post pandemic and, at $239bn as of the end of 2021, it still dwarfs BNPL's total transactions value, which stands at an estimated $9.5bn.





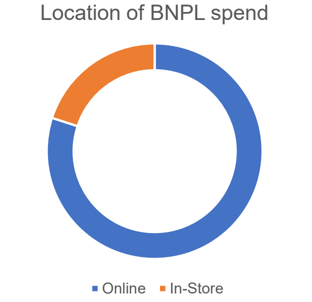
With its own changing market environment to contend with, the country's BNPL sector has started to experience headwinds. A worsening consumer economy has brought mounting credit losses, while a long period of climbing interest rates should prove challenging for a business model that needs to fund users' purchases without the same capital pools that traditional lenders can rely on. In addition, new competitors are squeezing merchant rates while, perhaps most importantly of all, long-awaited consumer protection rules are guaranteed to transform this previously unregulated lending niche. Public equity markets have already turned against the sector; some players' shares are down by more than 80% from the peaks seen in early 2021.

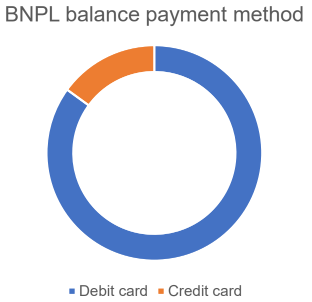


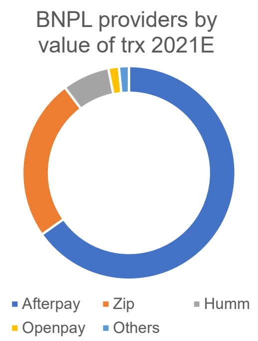
A maturing market and more challenging economic conditions have moved the Australian BNPL sector into a period of consolidation — with some players exiting the market:

- **Afterpay** (65% of market share by transaction value), was acquired by Block (formerly Square) for some $29bn. It posted a 1Q22 loss of $177 million (up by 145% year on year) as bad debts on its books soared.
- Another major player in this space, **Zip** (25% of overall transaction value) saw its debts climb beyond its own target limit in the first quarter of 2022. Its merger talks with rival Sezzle looked to have been terminated in July of this year, bringing to a close an acquisition spree that included South Africa's Payflex, UAE-based Spotii, US-based QuadPay and Czechia's Twisto.
- **Openpay**, responsible for one in every fifty dollars transacted by BNPL in Australia, saw the most extreme market share fall from peak of the new breed of instalment lenders here. It exited the UK market in March of 2022 and left the US three months later.

Humm Group's BNPL unit was set to be bought by **Latitude** in 2022, but the deal was called off in June in light of the buyer's financial position following a run of declining stock values.







Source: Argus Advisory Research's Australia Country Report

Changing ground rules

The firms that remain in contention for instalment-lending business will also have to play the game differently as the ground rules change: in the UK, market leaders Clearpay, Klarna and Laybuy are bracing themselves for new regulations from the Financial Conduct Authority, which has already required them to rewrite their terms and conditions on the grounds of clarity and fairness.

It's not just London that is taking a closer look: rulemakers in several countries are preparing to reform the regulatory environment. In Washington, a newly reinvigorated and legally empowered Consumer Financial Protection Bureau (CFPB), the country's consumer credit watchdog, has been signalling a revolution in its approach: "The consumer gets the product immediately but gets the debt immediately too," the bureau's director, Rohit Chopra, recently said, while his team cited concerns around "accumulating debt, regulatory arbitrage and data harvesting".

The cost of living crisis, growing particularly acute in Britain, is only intensifying such concerns. Regulators and lawmakers in London may have believed that the hostile environment they created in the middle of the last decade for payday lenders like Wonga had put an end to risky borrowing in underprivileged cohorts.

However, the rush to instalment-based credit in recent years indicates that the need for low-interest loans (a segment underserved by the high street banks) has persisted. The government is now subsidising a no-interest alternative through the credit union network, currently in the midst of a pilot on Manchester.

> ***Rulemakers in several countries are preparing to reform the regulatory environment***

Going by the findings of the UK review of unsecured credit that preceded the BNPL regulations currently being crafted, it is all but certain that clear and transparent credit information will be central: at all points in the consumer journey, consumers need to understand what they're getting into and what their protections and obligations are, while providers must ply their wares in a way that respects consumer well-being. Another intervention could be adding a step in the checkout process that clearly explains what choosing BNPL to complete the transaction means and how it differs from the immediate settlement more familiar to online shoppers.

Any friction added to the customer journey — for example, credit-checking or explanations — will impact usage with a consequent change in customer perception of these services. An uptick in abandoned shopping carts would seem inevitable, which will have a material effect on the online pay later business model. Incorporating efficient and effective credit checking will be essential to prospering in the new, regulated era.

Both Affirm and Klarna are seeking to differentiate their approach from some of their competitors' business models and practices (eg, unexpected late fees). These prominent fintechs are mindful of consumer rights campaigns and stories in the media, particularly in Britain and Australia, which have focused on a lack of consumer understanding of BNPL as a form of credit. Klarna, as we have seen, would prefer to be known as a unified financial services app that runs the gamut from e-commerce to digital banking. Affirm, created and run by PayPal co-founder Max Levchin, is actively encouraging tighter regulation in its home market of the United States, a sign of confidence in his firm's business model.

Focus: Apple Pay Later

Apple's pay-in-four product, Apple Pay Later, was launched in the US in June 2022. This entrance represents a serious challenge not only to high-profile players, such as Klarna and Affirm, but also traditional consumer lenders that have been making their debuts in the pay later arena in recent quarters that currently lack the clout of Apple Pay at the digital point of sale.

The company, in a break from tradition, is handling underwriting and lending for its BNPL; it had been expected that Goldman Sachs, issuer of the Apple Card, would provide these services.

The product promise of Apple Pay Later contrasts sharply with the BNPL pioneers (whose main concern is driving sales for their merchants) as it is interconnected with a dashboard view in the Apple Wallet app to help purchasers gauge their repayment obligations and match them to their budgets for upcoming periods.

Counting iPhone owners alone, at least 113 million people in the United States have the Apple Wallet app – through which all of the company's financial products work. In addition, the brand has a particular attraction for the young (a key BNPL demographic) with some nine out of every ten Gen Z Americans owning an iPhone and naming Apple Pay as their favourite payments solution according to a Piper Sandler survey of over 7,000 American teens (average age: 16).

Starting in the second half of 2022, Apple could quickly convert tens of millions of its payments customers into borrowers, a live possibility given consumer enthusiasm for BNPL generally and the compelling proposition now formed by Apple's suite of products. Any significant gain of this sort could quickly take the Big Tech champion into the level of customer base that is currently served by America's biggest consumer bank: JPMorgan Chase, which has 60 million customers.

Incumbent response

Traditional lenders have long had grounds for concern over the ease with which BNPL players built up formidable user numbers through eyecatching propositions executed via simple and intuitive interfaces. The target audience is clear: approximately 62% of POS financing applicants being below 40 years of age according to TransUnion's US consumer credit database.

In some cases, incumbent issuers are taking a twin-pronged approach: lobbying hard against the new breed — as a highly publicised Barclays survey indicating widespread buyer's remorse among young adults — while simultaneously imitating them. NatWest, for example, has recently launched a BNPL solution, available to its cardholders at any merchant (other than gambling companies) offering Mastercard. As mentioned above, JPMorgan Chase too is committed to the model, if that's where the customer wants to be. Even Capital One, which famously banned BNPL from its systems in 2020, took a U-turn less than a year later in piloting its own instalment-based product.

> ***"JPMorgan Chase is committed to the model, if that is where the customer wants to be."***

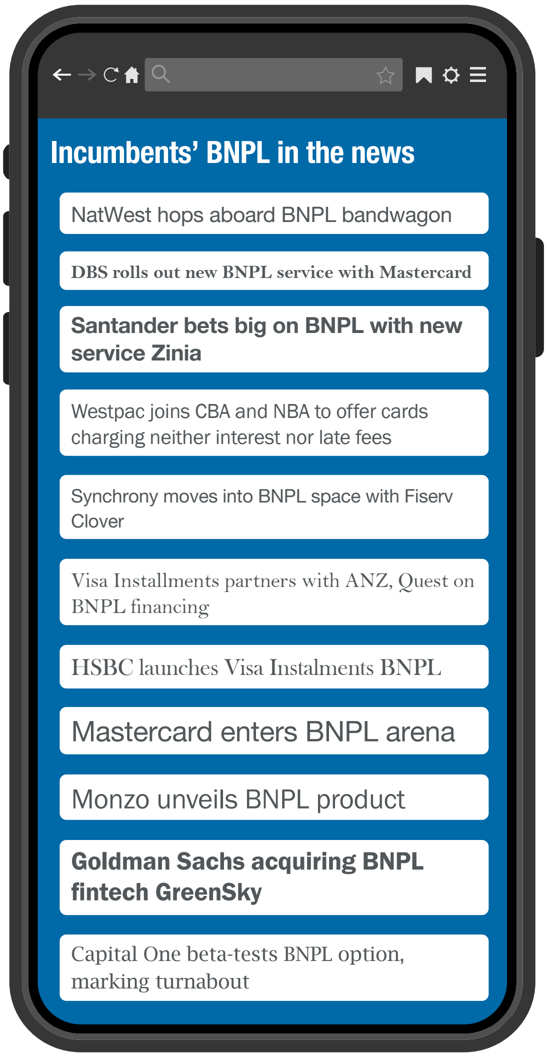
In keeping with its ongoing interest in the payments space, Big Tech too has been watching closely as the market evolves, particularly attractive given the intrinsically digital nature of an arrangement that sits well in the mobile-first environment in which they specialise. However, the first move by a Big Tech firm proved to be public-relations mis-step: Microsoft received criticism after inserting a BNPL payment option within its Edge browser such that the method appeared, injected into the web interface, alongside card icons on checkout screens. Apple's more considered entrance enjoyed a contrasting reception: see the inset box on previous page.

Other factors are also in play, such as the fact that the leading credit reporting agencies are now including BNPL data in markets like the UK and India and increasing competition for merchants is driving down the discount rates. Delinquency concerns too are also increasing in banner pay later markets such as Australia and Britain as borrowers find themselves repaying in a very different economic environment than the one that existed when they first discovered BNPL.

However, incumbents should take note of lessons from TransUnion data, such as the consistent increase in POS financing over recent years — with sharp spikes during peak shopping weekends. POS lender loyalty is notably high too, according to the same source: consumers with multiple inquiries are very likely to choose the same lender for all of their applications, a stickiness that merchants will factor into their considerations. Finally, according to the bureau's Q1'22 Consumer Pulse Survey, lending of this sort has seen consumers using multiple channels: 26% have used BNPL services in a physical retailer; 40% on a PC; and 61% on a phone or mobile device.

How can issuers respond to the BNPL threat?

In order to retain market share, issuers would be well advised to get closer to the needs and thinking of both merchants and customers. For the latter, this means morphing into financial superapps as far as possible. With PayPal and Klarna already well advanced, consumers are getting us to a one-stop-shop answer to their spending (and financing) needs. If BNPL 1.0 was the typical pay later website, then BNPL 2.0 is centred around the superapp and thus the race is on to 'own' the customer and serve their every need when it comes to the shopping experience and financing opportunities. Young people are particularly wary of compound interest and may need some contextualisation to understand how disciplined and restrained borrowing on credit cards can serve them well over the long run.



The rewards offerings from credit card issuers are a powerful differentiator: incumbents can emphasise this all the while foregrounding prompt settlement of due accounts as desirable for both parties. Another response would be to develop credit-builder credit cards that incorporate features familiar to BNPL borrowers: instalments could be one of these. However, there is work to be done here as credit-builder products now have a significant competitor format.

BNPL advocates often argue the new format also gives young or inexperienced borrowers the chance to build up a credit history in those markets where BNPL accounts are reported to credit bureaus, thus making the lending vehicle comparable in that respect to secured credit or credit-builder cards.

> ***"The rewards offerings from credit card issuers are a powerful differentiator"***

Traditional lenders have long observed that tech-centric solutions from challengers coming from a non-financial service background lack understanding of managing a customer base over the course of a long term that necessarily involves economic cycles. As they enter a cash-crunch period, fintechs and tech players are also finding having the kind of access to capital pools that established lenders enjoy is of inestimable value in building a consumer finance business; in a downturn, access to such a backstop is worth more than any number of social media recommendations for your product.

Superapps and partnerships

The multifaceted shift currently underway is leading BNPL firms to stack up as many different offerings as possible — to the point that one of them (Klarna) no longer wants to be seen as a BNPL specialist. Seeking to morph into a Swiss Army knife of financial services, it has launched a new division called Klarna Kosma that's dedicated to exploiting the powerful possibilities of Open Banking. This follows its 'pay now' product available in all major Western markets, and the late last year addition of a feature in its app allowing shoppers to use its solution at any online checkout (certain geographical restrictions apply). Such bundling comes in a strategic tandem with the forging of new partnerships (eg, Stripe and eBay) as necessary tactics in a time of tightening margins.

> ***"The pure one-trick ponies won't survive"***
> ***–David Sandstrom, Klarna***

As this report was being written, the Visa-branded Klarna Card was launched in the US, with a million Americans on the waiting list. Issued by WebBank, the card is not only free of interest but free even of its $3.99 monthly fee for the first year. As with Apple's BNPL, Klarna Card holders can pay in four equal instalments. This offering, in addition to other moves like the recent acquisition of product comparison website PriceRunner, is taking the Swedish fintech far beyond its origins and into competition with the likes of PayPal for the much-desired superapp status enjoyed by Chinese ecosystem pioneers WeChat Pay and Alipay.

The Chinese superapp: more than an enhanced banking app

China's AliPay and WeChat Pay are the paradigm-case superapps that Western payments and BNPL apps are now seeking to emulate.

Besides sophisticated messaging interfaces and QR code-based facilities for in-store payments and card-detail storage, these offer in-app services for P2P transfer, prepaid top ups, ticket purchases on public transport, food ordering, ridehailing and insurance as well as checkout facilities for most online retailers in China and interfaces for paying credit-card bills and managing bank accounts.

Alipay is the more popular of the two, with approximately 700 million active monthly users in September 2021, and a market share of 69% in terms of mobile transaction value. Rival WeChat Pay, owned by Tencent, was launched in 2011 as a simple messaging solution — effectively the Chinese WhatsApp — but has evolved considerably over the years.

Although WeChat Pay is a relative newcomer, it managed to gain traction almost immediately, surpassing Alipay in the number of registered users, although not in total transaction volume. In the second quarter of 2021, WeChat Pay had over 1.25 billion monthly active users.

How can Argus help credit card issuers to compete in this space?

Argus can provide an overview of BNPL activity in the UK and US Credit Card markets, with a focus on the profile of customers who engage with the service as well as the impact that employing BNPL usage has on their credit card usage and payment behaviour.

Argus Advisory's Research division tracks developments in consumer payments in 70+ markets around the globe, helping businesses understand opportunities and challenges in new markets. Expert insights and detailed data (both historic and forecast) covering consumer payments preferences, market sizing and market shares, provides essential reading for credit card issuers and payments companies worldwide.

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