Buy Now, Pay Later

Sustaining Growth and Building Profitability

June 8, 2022

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Executive Summary

- 'Buy Now, Pay Later' (BNPL) is a system of deferred payments that allows consumers to receive a good at the point of purchase and pay for it in installments over time. These programs offer consumers the ability to buy products at the point-of-sale — usually through an online browser or app — and then pay for them in the future.

- BNPL has grown in popularity rapidly over the past few years in the United States and across the globe. Often thought of as synonymous with "Pay-in-4" programs, which structure four payments over the course of six weeks and typically do not require a full credit check, BNPL actually encompasses many types of credit, including installment loans, credit lines, virtual rent-to-own models, and vertical-focused larger ticket plays. Further, BNPL providers frequently offer expanded merchant and customer services, including all-in-one shopping apps.

- BNPLs earn revenue through merchant fees, which can range from two percent to as high as seven percent of purchase transactions. Additionally, while traditional Pay-in-4 programs do not charge interest to customers, they can charge late fees. Other BNPL products, like installment loans, do charge interest. Many BNPL firms are backed by venture capital and have based their growth strategies on rapid accumulation of market share rather than profitability.

- While the BNPL industry has expanded significantly in recent years, the landscape is shifting. In the past, BNPLs were able to grow quickly by increasing partnerships with large merchants and rapidly expanding their customer base. Now, most large merchants have already partnered with at least one BNPL firm, and a significant share of the population, especially younger consumers, already use BNPL regularly. Further, more traditional banks, finance companies, and payment networks are developing their own versions of BNPL, adding to an already competitive landscape.

- As the BNPL market matures, providers will need to address and overcome a variety of challenges concerning both their customer base and merchant partners. For example, fraudulent purchases leave BNPLs on the hook for the full purchase value, and unmitigated fraud risk can erode consumers' trust in the service. BNPLs must also contend with repayment risks: Equifax analysis shows that BNPL customers tend to have lower credit scores, incomes, and assets, and they tend to be more debt-laden than the average consumer. Especially risky are customers who use credit cards or other forms of credit to pay their BNPL loans, effectively stacking one form of debt onto another. Additionally, as BNPLs expand into working with smaller merchants, they may expose themselves to business default and merchant fraud risks.

- Despite these challenges, there are significant opportunities for growth in the industry. BNPLs can work to expand to new merchants and consumers while strengthening relationships with current stakeholders. They can also use new ventures (e.g., all-in-one apps) and linked consumer data to increase profitability.

- The considerable customer and merchant data from Equifax can help BNPL companies enter a new phase of the industry, sustaining growth and promoting profitability. With help from Equifax, BNPL companies can prevent consumer and merchant fraud, scale to onboard new merchants faster, expand merchant services, nurture consumer loyalty, and stay in-step with financial regulators.

I. Background of 'Buy Now, Pay Later' Programs

1.1 History of BNPL

Conceptually, 'Buy Now, Pay Later' programs are not new. Installment plans have existed for more than a century, as merchants sold big-ticket items like furniture and farm equipment through monthly or weekly payment schedules dating back to the 1800s.[1] Some brick-and-mortar stores also allowed customers to pay for items like groceries on credit or through installment plans.[2] Historically, consumers opted into these alternatives because they lacked access to cash and traditional forms of credit, largely due to lower incomes and poor or limited credit histories. Installment plans have been part of the consumer payments system for much of recent history and have paved the way for BNPL.

BNPL products have also drawn comparisons to layaway programs, though there are some key differences. Layaway is a merchant-offered installment plan that allows customers to reserve an item then pay for it with interest-free payments. The customer does not receive the item until they have paid for it in full. Layaway involves little risk for both merchants and customers: if a customer does not pay off their balance, they do not receive the reserved item (though they can be charged a fee if they do not complete the purchase). These programs are similar to traditional installment plans offered by brick-and-mortar stores and were often used by consumers who had trouble accessing other forms of credit, thereby providing them an avenue to purchase goods and services they otherwise may not have been able to access.[3]

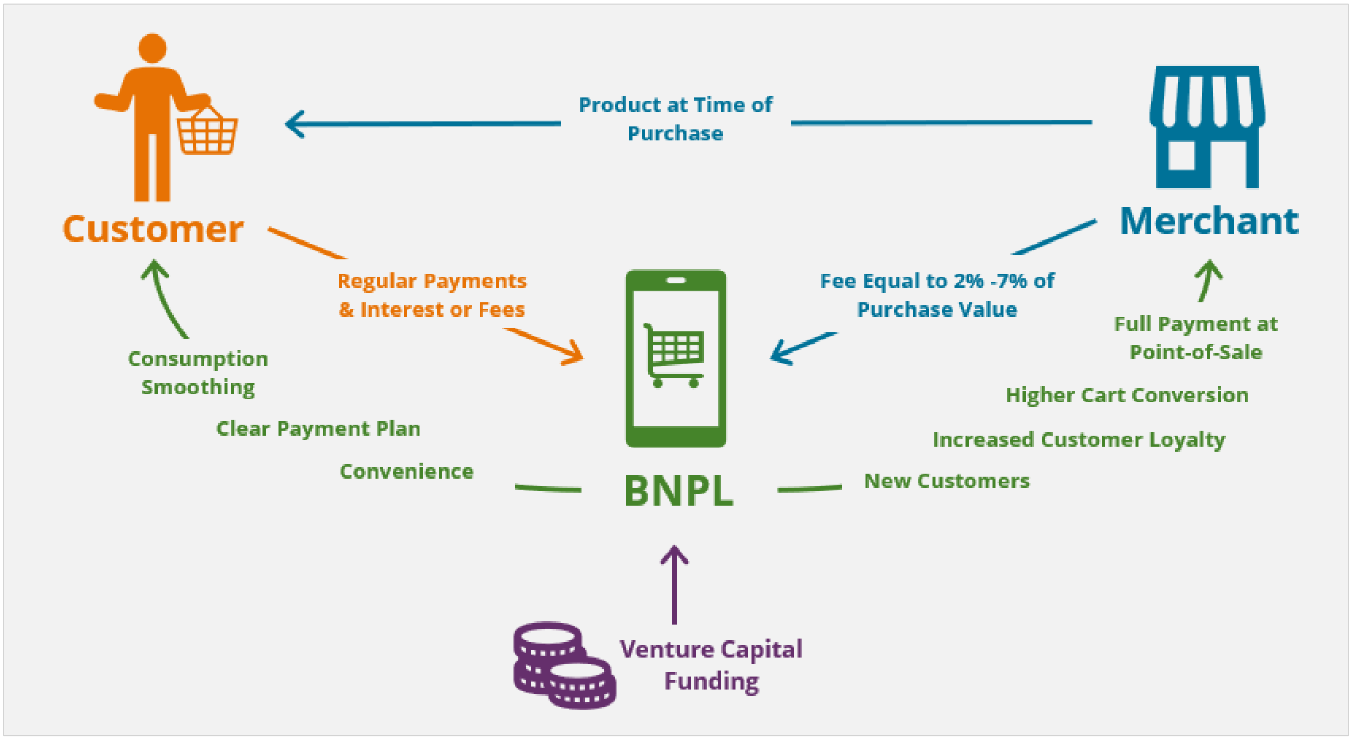
Although they cater to similar populations (i.e., lower income, lower wealth, and higher credit risk), BNPL differs from layaway in that consumers can access their product *before* they have paid in full — a distinction that has helped BNPL skyrocket in popularity. BNPL also differs from layaway programs by primarily targeting online shoppers as opposed to in-store customers, though BNPLs are increasingly expanding to in-store purchases as well. Leveraging the rise of fintech, BNPL loans have rapidly attracted online consumers, demonstrating the continued relevance of installment lending in today's payments landscape. In a recent Equifax survey of U.S. consumers, nearly half responded they were familiar with BNPL, one-fifth had used it in the past, and 70 percent of users planned to use BNPL again.[4]

The BNPL model has been so popular that many credit card companies and networks are introducing their own versions of installment loans. Compared with credit cards, BNPL loans are usually zero-interest installment loans with a quick, simple approval process. Credit cards typically have interest rates of 15–20 percent or higher and rely on hard credit inquiries, using FICO scores and borrowing history to assess a consumer's creditworthiness. In general, consumers with short credit histories or a subpar record of repayment have a harder time gaining access to credit cards. In contrast, most BNPL firms do not conduct a hard credit inquiry when assessing a consumer's ability to repay a "Pay-in-4" loan. In this way, BNPLs are broadening access to short-term, interest-free loans that help to address consumer demand for short-term borrowing.

1.2 BNPL Business Model

Most BNPL firms follow the same skeletal structure and provide the same benefits to merchants and consumers (see Figure 1). However, even among firms who identify as a BNPL, there are a variety of different payment plans, with different priorities for consumer well-being. Pay-in-4 plans and installment loans are some of the most common BNPL programs, though there are several other noteworthy models.

Figure 1: BNPL Business Model



- **Pay-in-4:** This program is the most common form of BNPL. Pay-in-4 is used for smaller ticket items and is typically a six-week loan split into four equal payments, the first at point-of-sale, then one every two weeks. This model is usually zero-interest, charging late fees if consumers miss a payment. Some firms, like PayPal, charge neither late fees nor interest, a trend that may grow as the industry becomes more competitive.[5] Firms that use the Pay-in-4 model earn revenue primarily through merchant fees, which are usually a percentage of the purchase price. These fees are often double the interchange credit card fees and can be as high as seven percent of the cost of the product.[6]

  Merchants are willing to pay for BNPL services in exchange for the increase in sales and access to an expanded customer base. According to marketing material from Affirm, BNPL leads to increased cart sizes and higher sales rates on merchant check-out pages.[7] Many Pay-in-4 BNPL platforms are also building integrated shopping apps. BNPLs draw consumers to the apps for access to Pay-in-4, where they advertise and promote their merchant partners.[8] These apps are growing rapidly in popularity: per Bank of America, downloads for the top four BNPL apps (Affirm, Afterpay, Klarna and Zip) rose more than 20 percent in 2021 to over three million downloads.[9]

- **Medium-Ticket Installment Loan:** Some BNPL firms also offer medium-term installment loans for larger-ticket items. These programs are usually for mid-sized purchases and consist of monthly payments for a period of six to twelve months. Because of the bigger ticket price on products, these programs usually charge consumers interest and, occasionally, fees from merchants. About 80 percent of consumers who opt into BNPL installment loans already have a credit card.[10]

  Sometimes these loans are called "off-card financing solutions," though there are a growing number of card-linked installment offerings.[11] Card-linked installment loans are most popular in Asia and Latin America, but, as previously mentioned, several cards have introduced post-purchase installment plans as credit card companies try to compete in the U.S. BNPL space. According to a recent report from

McKinsey, card-linked installments could soon become necessary to compete in the credit card market by integrating installment plans across purchases and monetizing pre-purchase offerings.[12]

- **Deferred Credit Line:** This model is very similar to a deferred interest store-branded credit card, only provided by a BNPL company. For these payment plans, interest is waived on purchases above a certain amount for a specified period of time. At the end of the deferral period, if the consumer has paid off the item in full, they owe no interest. If they have any remaining balance, however, they are charged interest on the full purchase amount (not just the unpaid balance).[13] PayPal uses this model for their credit service.

- **Virtual Rent-to-Own:** In this model, consumers "rent" an item, paying in installments until they have paid the full cost of the item. Virtual rent-to-own models often target subprime consumers with high APRs. Goods are typically limited to items that could be repossessed, and roughly 80 percent are mattresses, furniture, electronics, or appliances.[14]

- **Large-Ticket Installment Loan:** Companies that provide this BNPL model are usually category specialists (e.g., healthcare or home improvement). A consumer takes out a large loan for an expensive service or good and repays in installments over time. Banks are expected to target this space in the next few years to acquire high-credit customers. They could also leverage this model to cross-sell mortgage refinancing or other banking services.[15]

While these models constitute the major types of BNPL at the moment, this list is not exhaustive, and new models that are attractive to both consumers and merchants are likely to emerge as the industry evolves.

One practice that will remain crucial for BNPL business models is integration into the consumer shopping experience. Most BNPL firms are incorporated into consumer check-outs — about 40 percent of consumers make their decision to use BNPL at the point-of-sale — and several others are integrated into the entire consumer shopping experience through all-in-one apps.[16] As more shoppers make purchases via BNPL apps, BNPL firms have a unique opportunity to influence consumers' choices of products and merchants earlier in the process.[17] Further, while BNPLs have enjoyed rapid growth over the past few years in part because of the pandemic's effect on e-commerce, there is evidence that BNPL is being used in brick-and-mortar settings more frequently. For example, French BNPL startup Alma reports that nearly one-third of their payment volume now comes from in-store purchases.[18] Wider use of BNPL apps and availability of BNPL in-store will move BNPL firms further into consumers' day-to-day transactions, giving them a stronger foothold in the electronic payments market.

1.3 BNPL Providers

While there are dozens of startup BNPL firms in the market, Affirm, Afterpay, and Klarna are considered the top performing BNPL companies,[19] reporting the highest purchase volume in 2020 (see Figure 2). PayPal is also a top performer in the BNPL space, though it started as a digital payment platform and has expanded into the BNPL space in recent years.

Figure 2: Largest BNPL Providers Globally by 2020 Purchase Volume

In Billions, USD

Source: Bussler, F. (2022). "BNPL Research Guide," FingerprintJS citing various company reports and websites.
Note: PayPal is not included in this chart because the company did not expand BNPL outside of the U.S. until mid-2020.

- **PayPal:** In the early 2000s, PayPal served as an e-commerce alternative to checks or money orders between consumers and online sellers like eBay. In recent years, PayPal's Pay-in-4 program has exploded in popularity. In the first quarter of 2022 alone, PayPal's BNPL purchase volume was $3.6 billion, and they have signed on more than 18 million customer accounts since the service launched.[20] PayPal also has a digital wallet service, and 70 percent of their BNPL customers use the digital wallet to make BNPL transactions.

- **Klarna:** Founded in 2005 and based in Sweden, Klarna is a well-established global BNPL firm. Klarna does not charge fees or interest if a customer makes their payments on time, and the company does not conduct a hard credit inquiry if the customer chooses a Pay-in-4 option.[21] Klarna advertises as "no interest, no fee" to consumers, though they do charge late fees if consumers make late payments. The company also uses an integrated shopping app, working with over 400,000 merchants. As shown in Figure 2, Klarna is by far the world leader in purchase volume.

- **Afterpay:** Afterpay is an Australian company that, like Klarna, is also globally established. Using an integrated shopping app, Afterpay now has over 15 million customers and works with 85,000 merchants. A customer must be approved by the company each time for a purchase. Afterpay offers an initial credit limit of $500, which can rise over time based on consumer use and payment behavior. The customer is not charged a fee if they make their payments on time, though late fees can reach nearly 30 percent of the loan amount if they do not. Square has recently announced that it will be purchasing Afterpay for $29 billion and will expand Afterpay into its peer-to-peer payment application (Cash App).[22]

- **Affirm:** Affirm has financed over 17 million BNPL transactions since its founding in 2012, and it has existing partnerships with several major U.S. retailers including Amazon, Walmart, and Peloton. Affirm offers credit with interest rates ranging between zero and 30 percent, depending on the purchase product, and customers choose their loan tenure (e.g., Pay-in-4, or terms of three, six, or twelve months). Because Affirm charges interest on most products, consumers are not charged late fees, though the company requires a credit check. Additionally, Affirm has recently launched financing for in-store purchases.[23]

Credit card issuers and payment networks are increasingly entering the BNPL market to compete with established firms, either by partnering with BNPLs, acquiring a BNPL, or offering their own BNPL product (see Figure 3).[24]

Figure 3: BNPL Products from Top Credit Card Networks

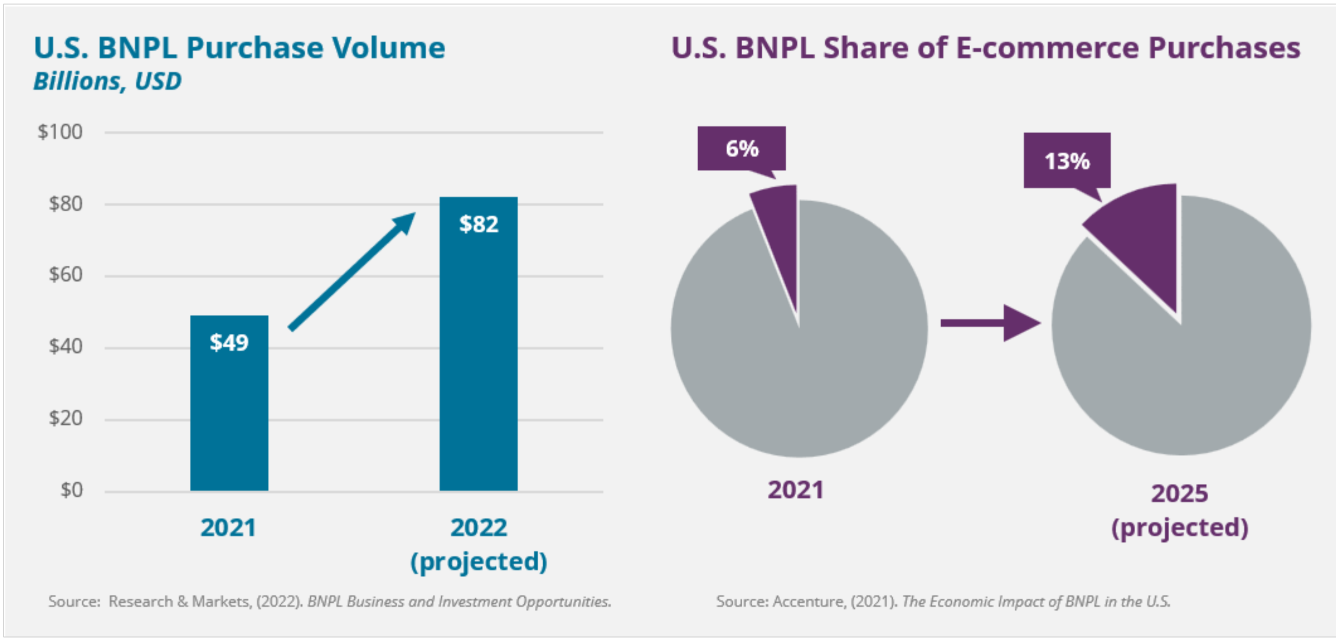
Network	BNPL Product	Description
Discover	Partnering with BNPL firm Splitit	When checking out using their Discover card, cardholders can choose to spread their payments over time. Shoppers with still earn credit card rewards while paying in installments without additional fees or interest.[25]
American Express	"Plan It" card feature	On purchases over $100, customers can choose to use "Plan It" to split the cost into monthly installments that do not carry interest (though a fee is charged). The installments are automatically added to consumers' minimum payment due each month. A customer can have up to 10 plans at a time.[26]
Mastercard	"Mastercard Installments"	Consumers can access Mastercard Installments through their lender's mobile app or through instant approval during checkout. Pre-approved installments can be used on a merchant's website or stored in a digital wallet for in-store use. The product will feature multiple plans, including zero-interest Pay-in-4.[27]
Visa	"Visa Installments"	Visa will offer single-use virtual cards that BNPL providers can use for payments over Visa's network. Cardholders will have the option at some merchants to use BNPL with direct bank financing. Issuers will also be able to offer post-purchase installments to their customers.[28]

1.4 BNPL's Rapid Growth

BNPL already enjoys a significant footprint in several countries outside of the United States, and is growing rapidly. In Australia, BNPL started gaining popularity in 2014 after several major providers, including Afterpay, entered the market. From 2015–2019, the total number of BNPL accounts increased from 487,000 to nearly four million,[29] and from 2016–2019, the total value of BNPL transactions more than quadrupled to $4.2 billion.[30] Today, more than one-tenth of Australian e-commerce is paid for using BNPL.[31] Growth has also been strong in the United Kingdom, where BNPL transactions totaled $8 billion in 2020 and comprised roughly five percent of e-commerce.[32] As more card-linked installment plans and other BNPL products are offered by banks, credit card companies, and other traditional lenders, this share is expected to grow.[33]

The U.S. BNPL market is likely two to three years behind the markets in the United Kingdom and Australia in terms of market share, but it is growing quickly. According to a report jointly published by Accenture and Afterpay, the number of BNPL users in the United States had more than tripled every year since 2018 and reached 45 million users in September 2021, while BNPL spending more than doubled from early 2020 through mid-2021.[34] BNPL users spent nearly $21 billion in 2020, making up 2.5 percent of online retail and 12 percent of online fashion retail.[35] During the first half of 2021, Klarna transactions alone — the majority of which were Pay-in-4 plans — totaled $3.2 billion, more than four times higher than during the same period in 2020.[36] Similarly, in North America between June 2020 and June 2021, Afterpay transactions totaled $9.8 billion in Pay-in-4 plans, more than double a year earlier. [37] As shown in Figure 4, BNPL's rapid growth is expected to continue in 2022.[38]

Figure 4: BNPL Growth in the United States



While BNPL tends to be particularly popular among younger consumers, 42 percent of Americans had used a BNPL service at least once as of mid-2021.[39] One reason for the service's rapid growth is that it fills a hole in the lending market among consumers who may have trouble accessing a credit card or other traditional loan, either due to poor credit or a limited credit history. BNPL users tend to pose a higher credit risk as measured by traditional credit scores, with 70 percent falling into subprime or near subprime risk tier while just 12 percent of applicants have prime credit scores or above.[40]

BNPL is also attractive among debt-conscious consumers who want to avoid or minimize the high interest levied on revolving credit card debt. In fact, nearly 40 percent of BNPL shoppers said that avoiding credit card interest payments drove them to try BNPL.[41] Many Pay-in-4 plans do not charge interest or fees as long as consumers make payments on time, and those that do assess interest often charge lower rates than credit card issuers. Other survey data suggests that some consumers value the short-term commitment to a fixed payment schedule.[42]

Merchant partnerships have been crucial to BNPL's growth, as each partnership expands BNPL firms' reach to a new swath of consumers. Most major retailers, including Amazon, Walmart and Target, have already partnered with a BNPL firm,[43] and retailers that specialize in home goods, clothing, and electronics — all fast-growing industries in the e-commerce market — have been a major driver of BNPL growth, particularly during the pandemic.[44, 45]

II. Challenges to Growth & Profitability

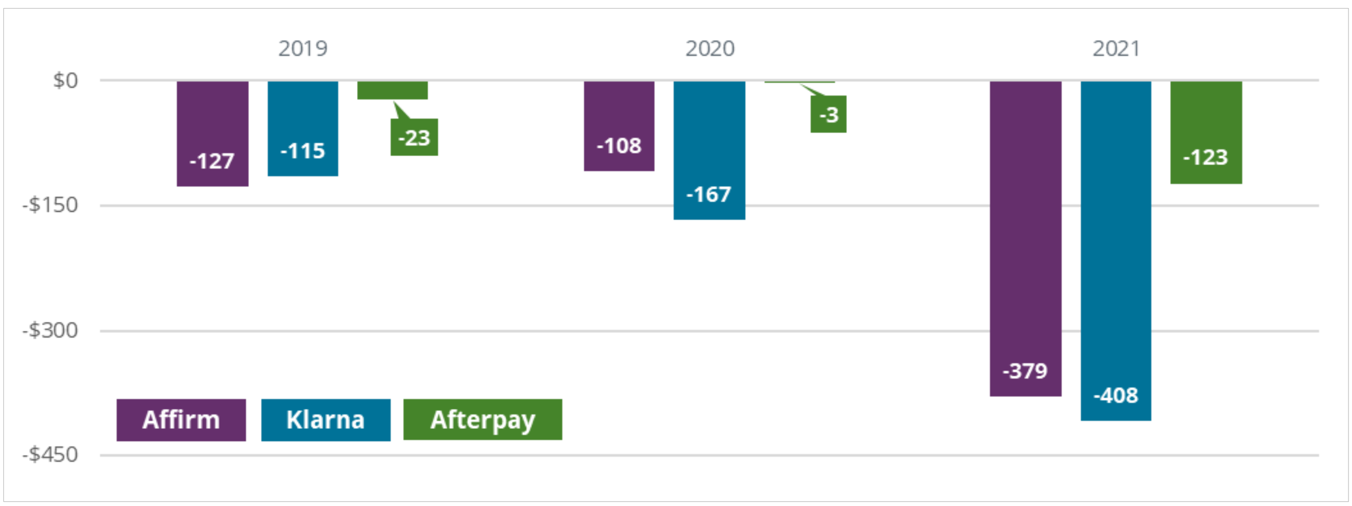
2.1 High Costs & Increased Competition

In just three years, BNPL went from an uncommon payment method to an option on most online check-out pages. This booming growth reflects the breakneck pace at which BNPLs established partnerships with merchants, a phase that some observers have likened to a "land grab."[46] E-commerce sales skyrocketed in the United States during the pandemic, and U.S. merchants embraced BNPL to attract new customers and drive sales. Currently, most major retailers have established partnerships with a BNPL firm to provide short-term financing for their customers. However, as the number of merchants unaffiliated with a BNPL firm dwindles, BNPLs will face more competition from one another for customers and retailers, as well as from traditional lenders and other payments industry players who are entering the BNPL market. BNPLs need to shift to a "post-land grab" growth strategy to stay competitive.

However, the BNPL market is still in its infancy in the United States and shifting to this new strategy may pose difficulties. Many BNPL firms have been backed by venture capital, and profit has been a secondary concern to market share thus far. According to the *Financial Times,* none of the three largest standalone BNPL firms (Affirm, Klarna, and Afterpay) are currently earning a profit; in fact, all three firms lost significantly more money in 2021 than in previous years (see Figure 5).[47] For example, Affirm's sales and marketing costs are high and increasing, and although its revenue has also risen, core earnings have been subdued in part due to lack of pricing power.[48] As funders seek positive returns on their investments, profitability will matter more in the years ahead: indeed, Klarna recently announced that it is shifting its focus from growth to short-term profitability and laid off 10 percent of its staff.[49] In a more competitive environment, some BNPL firms may struggle to keep up with their investor's demands.

Figure 5: Pre-Tax Losses

Millions, USD



Source: Financial Times, (2021). "Is BNPL a Viable Business Model?"

As banks and other legacy companies and institutions create their own versions of BNPL, start-up BNPLs that are already struggling to differentiate themselves from their peers will face even stiffer competition. These larger competitors have several advantages, including extensive merchant networks and larger, more established customer bases.[50] For example, as previously mentioned, PayPal's BNPL service is rapidly becoming one of the most popular in the United States, overtaking BNPL start-ups despite their initial market dominance.[51]

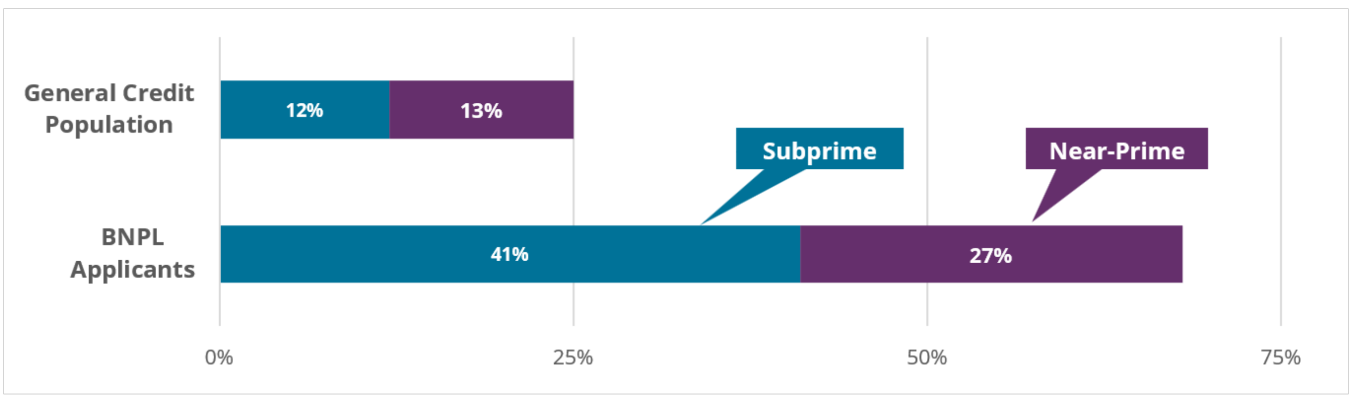
While Equifax expects the BNPL market to continue growing over the next few years, it is critical that BNPL firms find new ways to appeal to both merchants and consumers if they are to transition to profitability and sustainability. As described in Section IV, Equifax has tools that can help streamline the merchant and consumer approval process, broaden the services BNPLs offer to merchants and consumers alike, and enhance customer loyalty.

2.2 Consumer Repayment Risk

High rates of consumer loan defaults present another challenge to BNPLs' profitability. Some market professionals have hypothesized that the BNPL market is targeting so-called "invisible primes" — that is, consumers with low or non-existent FICO scores who may not qualify for traditional credit but who still pose a low risk of nonpayment. However, Equifax research suggests that most BNPL users do not fit this definition: nearly 70 percent of BNPL users have less-than-prime credit scores, compared with just a quarter of the general credit population (see Figure 6).[52] Indeed, Equifax data suggest that BNPL borrowers are similar to the overall credit population in terms of the size of their credit file; they are simply using BNPL as an alternative or addition to other forms of credit, such as credit cards. The same study found that BNPL users tend to have significantly higher credit utilization rates than the general credit population.[53]

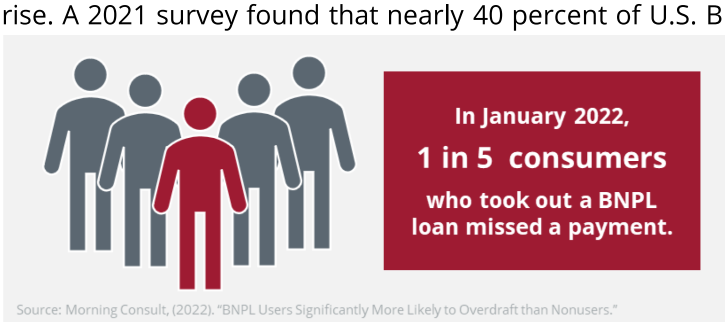
The subprime credit scores and high utilization rates of BNPL borrowers indicate that they could be at higher risk of late or non-payment. In Australia, the Australia Securities and Investment Commission (ASIC) reported that 21 percent of BNPL users missed a payment in the prior year, and missed payment fees rose 40 percent in the 2018 – 2019 fiscal year.[54] The ASIC also found that some consumers who use BNPL are experiencing financial hardship, such as cutting back on or going without essentials, or taking out additional loans to make their BNPL payments on time.[55]

Figure 6: Risk Scores Among BNPL and General Credit Populations

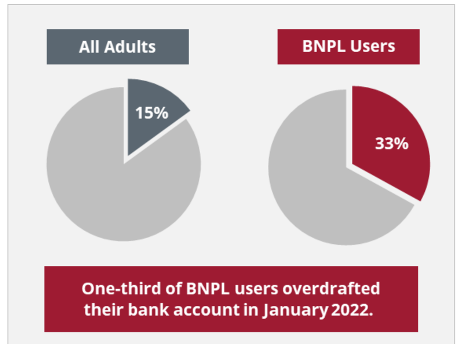


Source: Equifax, (2021).

While the BNPL market is less mature in the United States than Australia, delinquencies appear to be on the rise. A 2021 survey found that nearly 40 percent of U.S. BNPL users report they have fallen behind on their payments at least once.[56] Other surveys have found that less than half of BNPL applicants were "very confident" that they could pay off their loans in full without missing a payment,[57] and a recent Morning Consult survey found that one in five U.S. adults who took out a BNPL loan in January 2022 missed a payment.[58]



Beyond late payments, some BNPL users are exhibiting other signs of financial stress. For example, in January 2022, one in three BNPL users had overdrafted their bank or credit union accounts.[59] It is not clear whether BNPL payments are the cause of these overdrafts, but several BNPL firms offer automated debit payments from checking accounts which could lead to overdraft or non-sufficient funds fees. In this way, BNPL offerings may help consumers purchase goods and services without incurring credit card debt or having to pay interest but may still lead to negative financial outcomes if payments are not met.

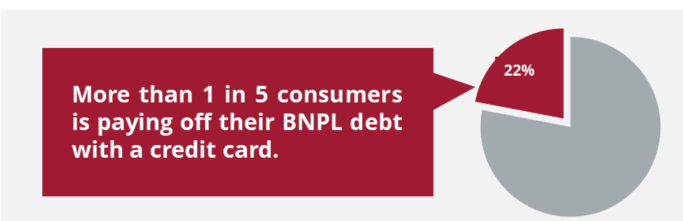


Source: Morning Consult, (2022). "BNPL Users Significantly More Likely to Overdraft than Nonusers."

Looking ahead, consumer financial stress may rise in the months and years ahead due to high inflation and the end of pandemic-era support measures. Early signs are already emerging: according to the Census Bureau, the share of Americans who are struggling to afford household expenses has risen steadily since late summer 2021 and now stands at 34.4 percent as of May 2022.[60]

While delinquency and default rates remain near historic lows, these traditional measures of financial stress will almost certainly rise in the months ahead. Indeed, the credit card market has already begun to show early signs of stress: revolving consumer credit has climbed nearly $100 billion in the past year and the share of cardholders who are revolving a balance is increasing.[61, 62] As interest rates rise to combat inflation, these borrowers will face a growing debt burden at the same time that real wages are falling (unlike some other forms of debt, most credit cards have variable interest rates that are pegged to the prime rate). Over time, this could lead to a significant and potentially rapid increase in credit card delinquency rates and charge-offs. These trends are not isolated to the credit card market and will likely affect other forms of consumer credit as well, including BNPL.

Finally, the credit card industry is subject to regulation that prevents consumers from paying off one debt with another. The BNPL industry, however, is still relatively unregulated, and BNPL companies often accept payments through a consumer's credit card. Klarna, Affirm, and Afterpay all accept credit cards as payment, and according to one poll, 22 percent of BNPL users report using credit cards to pay off their BNPL loan.[63] This behavior, also known as credit stacking, increases the risk of consumers accruing unsustainable levels of debt and could lead to an increase in charge-offs, which would further degrade BNPL profitability.



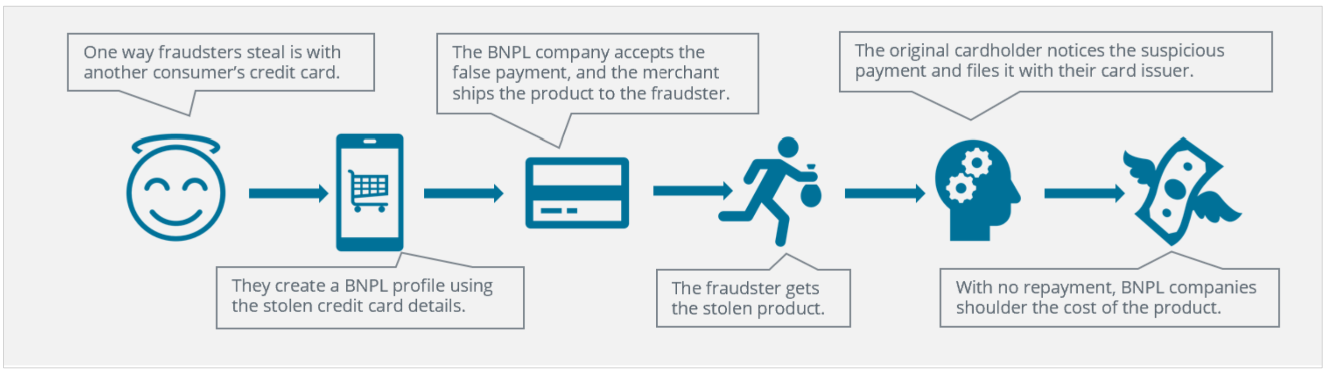
Source: Credit Karma, (2022). "Consumers rely on BNPL amidst record inflation, use credit to pay it off."

2.3 Risks from Merchant and Consumer Fraud

Alongside consumer defaults, fraudulent consumers and merchants can also cut into BNPL profits. Fraudulent transactions are a growing problem across the electronic payments industry, and BNPLs are at especially high risk.[64] In Australia, where BNPL is already popular, fraud reports doubled in 2020,[65] and the United States is following a similar pattern: per anti-fraud company Sift, fraud attacks aimed at BNPL services increased 54 percent year-over-year in 2021.[66]

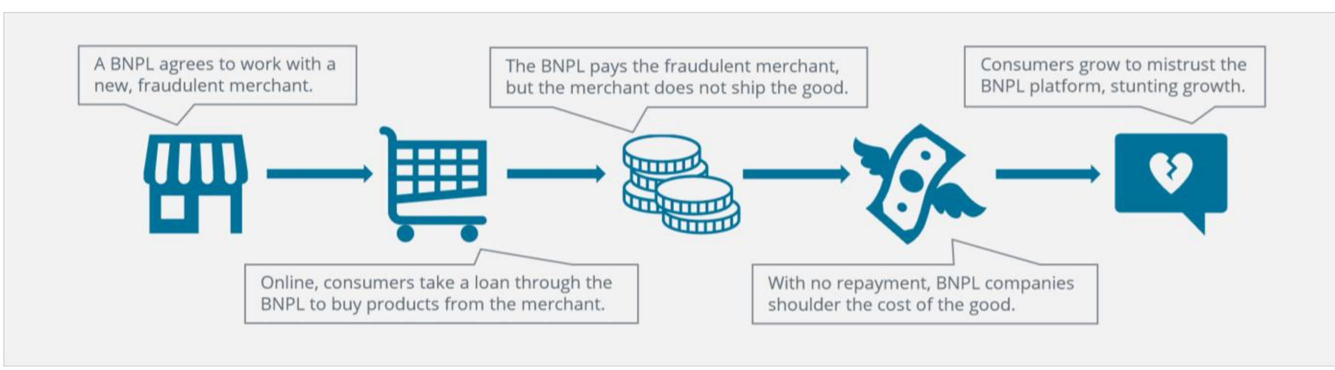
As shown in Figure 7, one channel through which fraud occurs is the consumer. According to Equifax research, more than one-third of consumers with good credit are being manipulated by synthetic identity fraud, and the figures for BNPL specifically are likely similar.[67] In the case of BNPL, fraudsters steal consumer information (e.g., credit card number) and create a BNPL profile using the stolen credentials. Since most BNPLs do not run a full consumer credit check, it is easier for fraudsters to manipulate BNPLs and have their false identity verified. If this occurs, the BNPL company would accept the fraudulent payment and the merchant will ship the product to the fraudster. When the legitimate cardholder or card issuer notices the fraudulent activity, the transaction will be cancelled, and the cardholder will be refunded by the card issuer for the initial payment. The BNPL, however, has paid the merchant the full cost of the product (less the BNPL fee) but will not receive any repayments beyond the initial payment since the purchase was made fraudulently. In this way, the BNPL bears most of the cost of the fraud.

Figure 7: Example of Consumer BNPL Fraud



Merchants-perpetrated BNPL fraud works slightly differently (see Figure 8). If a BNPL company is defrauded by a merchant, they are at risk of losing significantly more money than with a single incident of consumer fraud because of the higher volume of potential transactions. In one example, consumers take loans through the BNPL to buy a product from a merchant via e-commerce. The fraudulent merchant, however, does not ship the product, resulting in the BNPL user not repaying the loan (and likely losing faith in the BNPL firm's ability to facilitate legitimate commerce), leaving the BNPL to shoulder the full cost of the product. However, whereas the BNPL is unlikely to have a large number of transactions with a single fraudulent consumer, it is quite possible that they would have many transactions with a fraudulent merchant partner. For this reason, it is critical that BNPLs develop tactics to mitigate the risk of fraud as they partner with smaller, lesser-known merchants.

Figure 8: Example of Merchant BNPL Fraud



Beyond the monetary cost, high levels of fraud put the reputation of BNPL at risk, both from the merchant and the consumer sides. Should consumers or merchants feel that BNPL is not a secure payment mechanism, both might step away from using BNPLs altogether. It will be difficult for BNPLs to remain viable if the industry is not seen as trustworthy by consumers and merchants due to unmitigated fraud risk.

2.4 Increased Regulatory Scrutiny

New regulations may also become a challenge to BNPL firms. As BNPL continues to grow, government regulators, both in the United States and abroad, are looking at point-of-purchase loans with more scrutiny.

As previously mentioned, BNPL is well-established in the United Kingdom and Australia, and regulators are carefully examining the industry in both countries. In December, the Australian treasurer proposed a major overhaul of the Australian payments system, including new regulation for BNPL products. One measure from the Australian central bank will no longer allow BNPLs to prohibit merchants from passing on the cost of their services to consumers through a surcharge, which could deter consumers from using BNPL.[68] Australian BNPL companies are also likely to face regulation requiring underlying fees, interest, and delinquency charges to be clearer to consumers. BNPL will soon face regulation in the United Kingdom as well, as the Financial Conduct Authority and U.K. government begin regulatory consultations. Soon, firms will be required to check the affordability of a loan and will make it easier for consumers to file complaints to the U.K.'s Financial Ombudsman. These U.K. and Australian policies have set a precedent for BNPL regulation and will be important as U.S. regulators consider tighter restrictions on the industry.

In the United States, several states have begun regulating BNPL. In California, BNPL plans have been classified as loans, bringing them under their regulatory umbrella.[69] Nationally, the Consumer Financial Protection Bureau (CFPB) opened an inquiry into BNPL in December 2021, signaling the potential for regulatory activity. Specifically, the CFPB asked Affirm, Afterpay, Klarna, PayPal, and Zip to report data that will clarify the risks and benefits of BNPL to consumers. While it remains unclear whether the CFPB will take regulatory action, such a response would be more likely if the requested data indicate the following:

> *"Part of what we need to do is **make sure that we are monitoring these markets** because we saw time and time again — and the American public has seen this over and over again — of law enforcement agencies and regulators simply just asleep at the switch, not understanding how markets work, and then being too late when things go badly wrong."*
>
> *— Rohit Chopra, CFPB Director[67]*

- **Accumulation of Debt:** If consumers are spending more than they can afford and accumulating more debt through BNPL (e.g., maxing out credit cards and turning to BNPL to take on more debt), the CFPB may determine that additional consumer protections are necessary.
- **Failure to Protect the Consumer:** If BNPL companies are not adequately evaluating consumers' creditworthiness or adhering to the specific consumer protection laws that apply to BNPL products, the CFPB may pursue regulation to expand protections to BNPL users.
- **Data Harvesting:** If BNPL companies are misusing consumer data either by manipulating consumer purchases or selling it to other companies, a regulatory response is likely.[70]

In response to the CFPB's inquiry, 21 attorneys general submitted comments encouraging CFPB to take a stronger regulatory stance in response to BNPLs, citing concerns of regulatory arbitrage and arguing that BNPL products were evading consumer protection laws. In their own letter, the National Association of Convenience Stores (NACS) emphasized the impacts on retailers, focusing on the "large fees" associated with BNPL products.[71] Further, CFPB often includes a disclaimer in its data requests that any information provided will not be used for enforcement actions, but in this instance CFPB omitted such a disclaimer, suggesting that enforcement actions could be imminent.[72,73]

Increased regulation would add an immediate challenge to the rapid growth in the BNPL industry, but in the long run could be a positive development for sustained BNPL growth and profitability if it increases trust among merchants and consumers.

III. Opportunities for Growth and Profitability

3.1 Expand Merchant Services

Despite challenges to the BNPL industry's growth and profitability, there are significant opportunities for growth that could launch the industry into further success in the United States. One way for BNPL firms to continue growing is through expansion of merchant services. As discussed in Section I, merchant acquisition drove much of the BNPL industry's rapid development in recent years. Merchants will continue to play a large role in the success of the industry. If BNPLs can make merchant onboarding easier and more secure while continuing to help merchants increase sales, BNPLs can build stronger relationships that will drive growth.

At this point, most large merchants have already partnered with a BNPL, and merchants have generally only partnered with one BNPL. However, some companies, such as Bed Bath & Beyond, Ulta, and Target, have partnered with multiple BNPLs,[74] a practice that may become increasingly prevalent. To maintain growth rates, some BNPL firms may look to partner with large merchants who are already working with one or more BNPL partners, but this strategy could lead to intense competition for consumers at checkout and, potentially, impact profitability.

Alternatively, other BNPLs may seek to be the sole Pay-in-4 provider for retailers by offering them incentives (e.g., lower fees, "preferred status" in its mobile app, or access to consumer data) in exchange for an exclusive partnership. BNPLs will need to justify their high merchant fees by demonstrating their reach with consumers and will likely compete for merchants on both the fees they charge merchants and the customer base they bring to the table. BNPLs can also grow by improving the relationships they have already established with merchants or by partnering with outside companies, including Equifax, to use consumer data from account profiles and transaction histories to help merchants target consumer offers.

Small merchants who have not yet partnered with a BNPL present another avenue of expansion. However, smaller merchants can be more difficult to verify and present a higher fraud risk that, as described in Section 2.3 and illustrated in Figure 8, can present a major financial risk for BNPL firms. Moving forward, BNPLs must find ways to make the merchant review process both fast and thorough to prevent merchant fraud and improve merchant profitability. BNPLs may need to outsource merchant vetting to other companies or purchase new software that can improve the merchant onboarding process via faster and more effective merchant vetting.

In the future, BNPL could become a direct and integral part of consumers' daily lives through the development of apps and digital wallets. Until then, merchant partnerships will remain crucial to BNPLs' success, providing BNPL exposure to new consumers at the point-of-sale.

3.2 Cultivate Customer Relationships

To continue to grow, BNPLs must cultivate strong customer relationships. By expanding to new customers and strengthening relationships with their current base, BNPLs have the potential to integrate into consumers' daily purchases, promote financial health, and become leaders in the electronic payments industry.

BNPLs have room for growth in attracting new consumers, particularly among Gen Z. Much of the conventional wisdom around BNPL suggests that its customers are primarily younger Gen Z and Millennial consumers. However, Millennials and Gen X are by far the heaviest users of BNPL, comprising roughly three-fourths of BNPL consumers, while only thirteen percent of BNPL customers are Gen Z.[75] The future of BNPL growth is dependent upon bringing more of Gen Z into the BNPL market, especially young consumers who are not yet financially independent. Most of Gen Z still have thin credit files, and quick approval for a BNPL loan could be appealing compared to the credit card approval process. BNPLs can differentiate themselves in part based on the consumer segments they target.

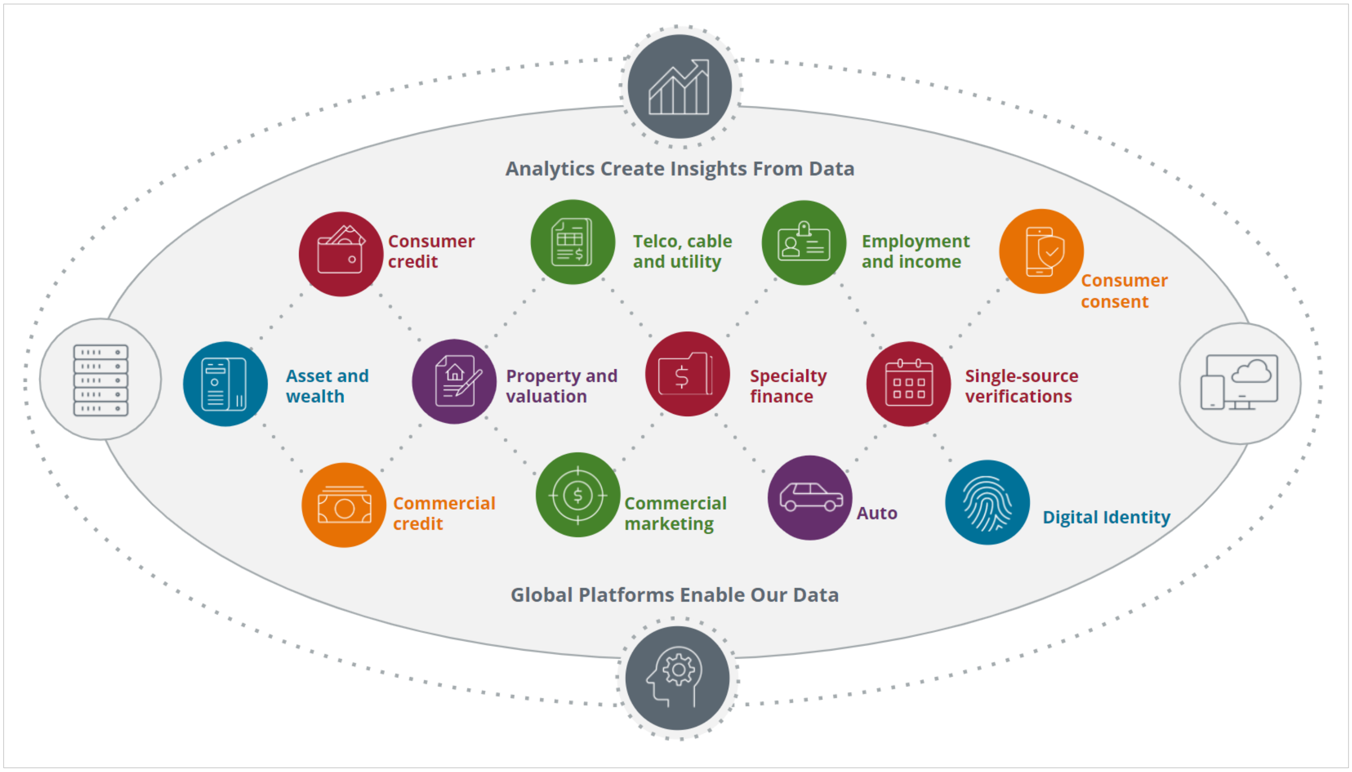
At the same time as they target new customers, BNPLs must also strengthen the relationships they already have with their core customer base. One way to strengthen these relationships is by integrating into consumers' daily payments through apps or by partnering with popular merchants. Some BNPLs are already doing this effectively. Currently, many consumers purchase nonessential items like electronics and fashion rather than household essentials with BNPL. However, some data suggest that more consumers are moving toward using BNPL for everyday purchases: a March 2022 survey found that 53 percent of consumers who have used BNPL products did so to pay for items out of necessity.[76] Another study found that nearly one in five BNPL customers use the service at discount stores, and 13 percent use it at supermarkets.[77] Should this pattern continue, especially as more Gen Z consumers enter the market, it is possible that some consumers will turn to BNPL as their preferred payment option.

As mentioned in Section II, one major challenge to BNPL growth is consumer defaults. Becoming an industry advocate for consumer financial health could present an important opportunity for BNPLs to become industry leaders. Using alternative data to approve consumers for a loan has clearly been attractive to consumers, and, in doing so, BNPLs have widened access to credit to consumers who may have been denied otherwise. Many BNPLs are already prioritizing ways to help consumers borrow responsibly. Creating ways to limit over-borrowing, prevent credit stacking, and help consumers build credit history through credit reporting will be crucial to continue building strong relationships with consumers.

IV. Partnering for Insights: Equifax Can Help

Equifax maintains an extensive suite of fully configurable, cloud-native data, including more than 32 billion interactions, 600 million consumers, 81 million businesses, 4.5 billion trade accounts, and 500 million employee files. Linked consumer data includes more than 600 million names and emails, 300 million phone numbers, 1 billion unique devices and payment tokens, and 420 million unique addresses. Business data includes firmographics on 33 million U.S. companies with 111 million tradeline records, and data on commercial loans, leases, and letters of credit for 8 million businesses. This massive and uniquely curated data, combined with Equifax advanced analytics and global platforms, can help BNPL companies reduce consumer and merchant fraud, assess merchant viability and scale to onboard new merchants faster, expand merchant services, nurture consumer loyalty, and stay in-step with financial regulators. (For more information about Equifax solutions for BNPL providers, visit www.equifax.com/bnpl.)

Figure 9: Equifax Complete Cloud Native Suite



- **Prevent Consumer Fraud:** Companies that offer credit must strike a balance between identifying fraud risks accurately and casting an overly wide net that inadvertently flags real customers as fraudulent. In addition to this fundamental challenge that all lenders face, start-up BNPLs must contend with the additional hurdle of having less access to customer-specific data that allow customer identities to be verified. Because of the BNPL business model, identify verification must be conducted nearly instantaneously so that the customer experience at the point-of-sale is not disrupted. Equifax can provide a wide array of payment, location, customer, and digital identifier data to help BNPL firms better identify fraudulent customers. Moreover, Equifax data allow BNPLs to streamline customer verification so that fraud risk can be assessed instantly and accurately.
- **Prevent Merchant Fraud:** As BNPLs expand and partner with smaller merchants, the risk of fraudulent merchant operations increases. BNPLs must strike a balance between accurately assessing fraud risk and maintaining a smooth onboarding process for new merchants. Equifax can provide extensive data on merchants, allowing BNPLs to more accurately assess merchant risk of fraud to improve the vetting and onboarding process. With over 2,400 small business portfolios, and 111 million accounts, and 2.4 billion historical instances recorded, BNPLs can make confident decisions to partner with merchants of all sizes without worrying about whether they are actual retailers or scammers in disguise.

- **Mitigate Merchant Business Default Risk:** In cases where a merchant fails to deliver a good to a consumer or if the merchant appears to be unreliable, Equifax can provide data to assess business viability with extensive data on small business portfolios. These data can help BNPLs determine the reliability of a merchant business and mitigate the risk of partnering with a merchant that is at higher risk of default.
- **Improve Merchant Onboarding:** Beyond assessing fraud risks, Equifax can help identify merchants to target for partnership, and Equifax can make the onboarding process more efficient for BNPLs and more seamless for merchants. Equifax offers solutions to support faster, low-friction merchant onboarding. With access to data from 33 million U.S. businesses, BNPLs can quickly verify merchants.
- **Mitigate Customer Repayment Risk:** With more accurate data on customer repayment risk, BNPLs can maximize their customer base while protecting themselves from the risk of extensive customer nonpayment. With a wealth of alternative data, including information on 240+ million unique consumers from Telco, Pay TV, and utilities industries, BNPLs can better understand how a consumer will treat a payment obligation, and by extension better assess the likelihood that they will repay a loan.
- **Nurture Consumer Loyalty:** Through its extensive customer data, Equifax can help BNPLs identify customers who may be targets for other services. For example, Equifax data would allow BNPLs to sort current Pay-in-4 customers into targets for other financial products or services. Customers with high incomes and high credit scores may be prime targets for high-end stores via BNPL shopping apps, while those with lower incomes and slimmer credit reports may be more suited to installment loans for large purchases. With Equifax data, BNPLs can more readily segment their customers into targets for various products, allowing them to further expand the services offered to consumers.
- **Expand Merchant Services:** Similarly, with Equifax data, BNPLs can help merchants target offers to subscribers based on preferences revealed within their account profiles and transaction histories. Equifax data-driven marketing solutions can augment BNPL subscriber data to provide a more complete view of consumer buying habits and preferences.
- **Improve Consumer Financial Health:** Equifax is incorporating BNPL tradelines into credit reports. By reporting credit and repayment data to Equifax, BNPL companies can help their customers improve credit with on-time payments. This will expand consumer access to additional financial services — a key component of the long-term growth strategy for BNPL providers — and cultivate BNPL's reputation among consumers, regulators, and other stakeholders as a consumer-friendly alternative to other short-term lending options. BNPLs can serve those without access to traditional credit, improve their credit scores, and then expand underserved consumers' access to financial services. By helping consumers build credit, BNPL companies can increase customer loyalty and retain these consumers when they are offered competing services.
- **Mitigate Regulatory Risk:** Regulators have demonstrated increased interest in how BNPL companies impact consumer financial health. The Equifax tradeline reporting solution is designed to provide lenders a more complete view of borrowers' obligations while offering many consumers the opportunity to build a stronger financial profile.

V. Conclusion

'Buy Now, Pay Later' has grown rapidly in recent years, changing the landscape of the short-term lending market. The popular Pay-in-4 plans and online installment loans appeal to consumers' desire for fast, simple, and affordable access to credit. Additionally, by integrating into the consumer shopping experience through merchant partnerships and all-in-one shopping apps, the BNPL industry has blurred the lines between financing and merchandising.

Despite this impressive expansion, the industry faces significant challenges that it must overcome in the next few years. As the market becomes crowded with new start-ups and bank- or network-owned BNPL services, the industry is becoming more competitive. Customer repayment risk is another concern for many BNPL firms, given the credit profile of the typical BNPL consumer. In addition, fraudulent merchants and customers threaten to raise costs even further, delaying or preventing profitability. Finally, the regulatory landscape is uncertain: the no-credit-check, Pay-in-4 model as it currently exists may no longer be an option for BNPL providers if regulators step in, and the costs of regulatory compliance could become another threat to profitability.

Given these challenges, BNPLs must acquire new consumers and merchants and strengthen relationships with current stakeholders in order to survive and grow. As BNPLs seek to sustain growth and build profitability, Equifax can serve as a valuable resource and partner. The considerable customer and merchant data from Equifax can help BNPL companies enter a new phase of the industry. With access to Equifax resources, BNPLs can begin to prevent consumer and merchant fraud, onboard new merchants faster, expand merchant services, nurture consumer loyalty, and stay in-step with financial regulators.

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