Buy Now, Pay Later

What's Old is New Again
in Payment Choices

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Buy Now, Pay Later (BNPL) as a concept has been around since the 19th century. It has, as is the case with most things, been rebranded into a catchphrase and appears to be the new kid on the financial institution offerings block.

BNPL is one of many promising ideas energizing the payments landscape, though it seems more attention has been focused on the rise of cryptocurrencies. That has been well documented, including in this **recent SRM report**. Additionally, the long-simmering potential of US "faster payments" – which are already commonplace in many countries – is coming to fruition via solutions like Zelle, The Clearing House's RTP rails, and the Federal Reserve's planned 2023 launch of its FedNow service.

None of these has caused a fundamental shift in established payments dynamics, yet. However, BNPL solutions are expected to grow on a different trajectory. There are multiple factors behind BNPL's rapid adoption, including a rise in online shopping in the wake of the pandemic. Still, the main reason may be its sheer simplicity – even its name conveys the value proposition. The service's astonishing growth is projected to continue – Allied Market Research forecasts that the global BNPL market will grow at a 45.7% compound annual growth rate (CAGR) through 2030.

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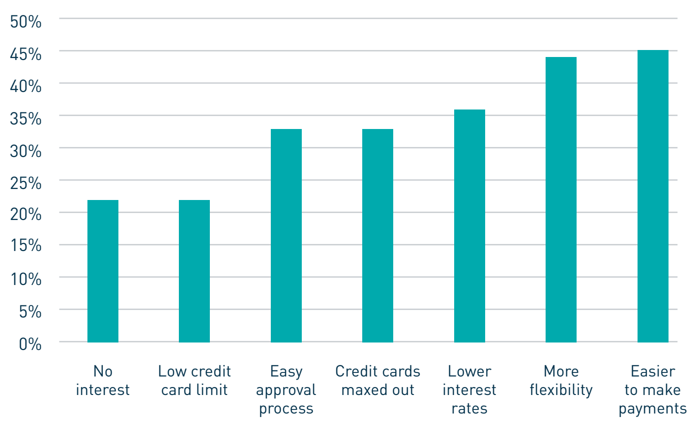
To date, nearly all BNPL financing volume has been captured by fintech companies (Affirm, Klarna, Afterpay) rather than established credit providers. This carries implications for card issuers affecting consumer and merchant relationships – the former through the potential for diminished revolving card balances and the latter due to less interchange and more disintermediation. Although the card networks have introduced their own BNPL models, at this point, fintech providers have claimed the first-mover advantage.

SRM sees the BNPL model reaching a critical juncture. The product makes purchasing decisions more seamless and convenient by offering a scalable payment option at many merchants, unlike traditional POS financing solutions that were merchant-specific. On the other hand, BNPL providers have yet to demonstrate an ability to generate profits, even before emerging signs of escalating default rates. Regulatory scrutiny is increasing, with agencies such as the Consumer Financial Protection Bureau (CFPB) expressing concern with rising debt levels and inconsistent disclosures.

TOP REASONS CONSUMERS PREFER BNPL



Source: *C + R Research*

While larger issuers have offered installment options tied to their cards for some time, many community banks and credit unions are taking a wait-and-see approach to BNPL, observing how regulation and initial credit risk cycles play out. A study by IntraFI Network found that 80% of small FIs have no interest in offering a BNPL product. A recent survey by PYMNTS.com, on the other hand, found that 70% of consumers would be interested in using the service if offered by their bank.

The Independent Community Bankers of America, while it didn't endorse banks entering the market, noted in a recent comment letter to the CFPB that Buy Now, Pay Later can be one of many products to meet the needs of the unbanked and underbanked.

SRM believes banks and credit unions must give serious strategic consideration to BNPL – not as a standalone installment credit offering but as a component of a holistic product set. Given rapid declines in nonsufficient funds (NSF) and overdraft fees, BNPL could offer a welcome new source of non-interest income. Our report provides an overview of the existing and projected BNPL landscape, current market lessons, and the opportunities and threats stemming from action and inaction.

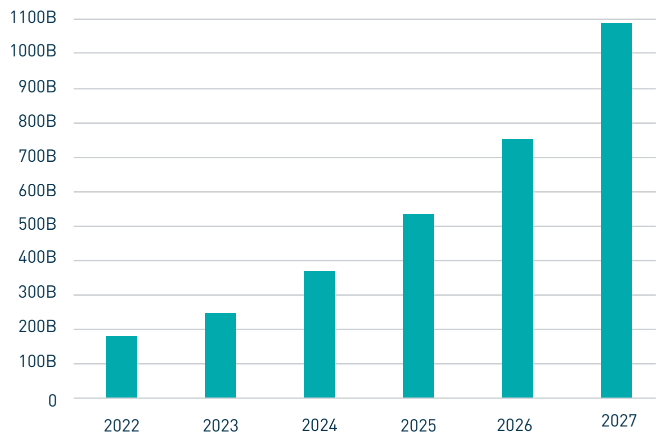
What's Old is New Again

A key driver behind BNPL's rapid adoption may be that the concept, as was mentioned previously, has been around for decades. Layaway plans predate credit cards as a form of point-of-sale financing. Under the preexisting model, a customer would have an item set aside at a local department store and make payments toward its purchase over time. Once the amount was paid in full, the item could be taken home. There are some key differences between layaway plans and their tech-enabled progeny. Most importantly, today's buyer takes immediate possession of the goods. Installments have been automated, with the seller initiating periodic charges against the buyer's bank account or, occasionally, credit card.

BNPL's initial adoption can be traced to e-commerce, where "four easy payments of $24.99" have proven more appealing than a $99.99 lump sum purchase, leading to reduced cart abandonment – a holy grail for online retailers.

BNPL accounts for 8% of European e-commerce payment volume and 2% of the region's physical point-of-sale volume, according to a report

PROJECTED GLOBAL BNPL VOLUME ($B)



Source: *Precedence Research*

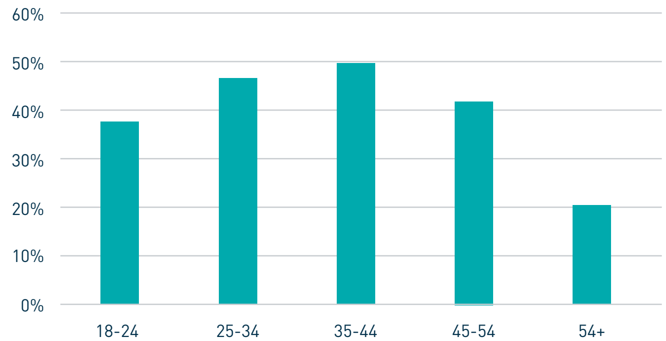
issued by FIS. Australia was among the earliest BNPL adopters; along with the UK, it tends to generate the highest BNPL market shares. Precedence Research estimates that global BNPL volume will amount to more than $500 billion by 2025, while Mercator projects $100 billion of US volume by 2024. As a comparison, US revolving credit card debt has been declining nominally and currently stands at $1 trillion. There is no single BNPL revenue model, and pricing strategies continue to evolve. The most common is the "Pay in 4" model, which benefits from its straightforward, self-explanatory nature. The purchase price is split into four, with the first installment paid at checkout. While some services add a processing fee, this is typically paid by the merchant. Since the rate usually exceeds that of a credit card interchange, it's a signal retailers perceive greater value from BNPL to generate sales (or a leverage move to reduce card network volume).

Other variations include card-linked installment offerings, expanding the "sign and travel" feature American Express has offered for decades. Certain midsize purchases may be screened more closely for risk than standard BNPL, with financing moved off-card. Service providers such as ACI and Mastercard have announced they are working directly with specific merchants to build financing options directly into their website workflow. Citizens Pay is an example of this model. Assorted flavors of BNPL are being tailored for small- and medium-sized enterprise financing, and the longstanding "rent-to-own" paradigm has also been modernized for a virtual setting.

Why Financial Institutions Must Pay Attention

It's clear the endgame for BNPL players extends well beyond providing niche financing for online purchases. The valuations of these startups (ranging from $15 billion to $50 billion) assume a broader role in the payments ecosystem. Indeed, this expansion is already underway – Klarna is issuing plastic cards and has introduced a "Pay Now" option – mimicking a standard charge account. Multiple providers are promoting the availability of their BNPL services at the physical point of sale, giving logos like Afterpay and Sezzle similar visibility to those of Visa and Mastercard at checkout.

BNPL USE BY AGE



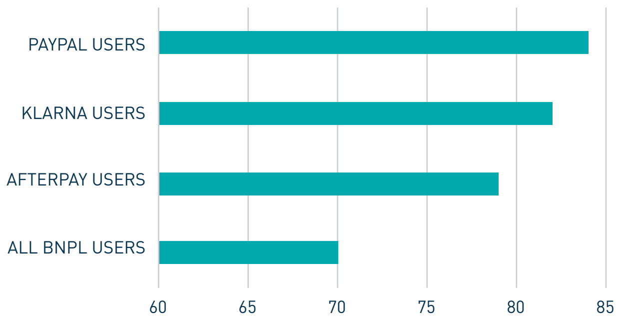
Source: *FIS*

BNPL could easily serve as an entry point for fintechs keen on providing more financial services if banks fail to respond. Additionally, it is often associated with the Generation Z demographic, who demonstrates a relative aversion to credit cards even while embracing e-commerce.

This combination makes BNPL a logical substitute for credit card spending. There is evidence that some users do not even consider such borrowing to be debt due to its prescribed repayment terms.
As Gen Z moves into subsequent life stages, such as home buying, the group will eventually require traditional credit products. If their financial experience and history reside with BNPL, it stands to reason that those providers will receive the first opportunity to earn similar business, including all-important mortgage originations.

It's worth noting that the association of BNPL and Gen Z is something of a stereotype. Although this younger demographic has been an early adopter and remains a dedicated user of the product, multiple studies have shown growing appeal across age brackets. While half of people between 35-44 have used BNPL, about a fifth of those 54 and over have also tried the service, according to FIS.

INTEREST IN USING A BANK FOR BNPL (%)



Source: *PYMNTS.com survey of 2,237 US consumers conducted from Nov. 5-10, 2021*

A Holistic Credit Strategy

Four out of five small institutions have no interest in offering BNPL. We think this is a short-sighted approach – an installment product could be a vital component of a broader array of payments services. And many BNPL customers would prefer to go through their FI.

Applying this holistic perspective may yield a more thoughtful analysis and possibly the addition of a credit offering that addresses consumers' demonstrated demand for greater choices – including some of the attributes that have come to be known as BNPL.

Some key strategic questions each financial institution needs to answer include:

> **"Do I want to expand my credit strategy?"** On the consumer side, many FIs focus on mortgages/home equity lending, auto loans, and credit cards. BNPL traction is a market signal of appetite for another type of installment loan with defined short-term repayment cycles. FIs that wish to remain a one-stop-shop for consumer credit needs should consider addressing this product gap. As a final thought on this, many view BNPL purchases as additive and should not take away from existing card purchase volume.

> **"What is my credit risk tolerance?"** Other than a few higher-ticket exceptions like exercise equipment, most consumer lending will be unsecured – it makes no sense to repossess items like beauty supplies and footwear. As such, delinquency and default rates are likely to resemble credit card balances more closely than auto loans. FIs entering this space need to build assumptions that recognize this dynamic in order to price the product appropriately.

> **"What is the threat if I ignore product demand?"** Leaving a gap in an FI's product portfolio allows other providers to establish a "trusted financial partner" relationship with consumers. When that individual needs another financial product, the newly embedded partner may get the first chance at the business – perhaps before the legacy FI is aware of the need.

As stated previously, a key to BNPL's success has been its effectiveness at cart conversion. A bank-offered solution will need to preserve this benefit, assuming a revenue model that relies on merchants to absorb most fees. Therefore, the rollout process extends beyond appealing to consumers (who have already signaled a preference to engage through their chosen financial institution).

Providers must engage with merchants to integrate their products within the overall shopping experience and present an offer at the optimal point in the purchasing decision. This may involve partnering with enablers (inside and outside the payments sphere) already embedded in the process.

Credit reporting is another important consideration. Reporting agencies are now catching up with the trend, and BNPL obligations and data are surfacing on credit reports. FIs need this data to inform non-BNPL underwriting decisions, and this process is now more streamlined. They are well-positioned to make data-driven, real-time decisions to extend BNPL credit. Assuming execution does not slow or complicate the checkout process, this advantage could prove critical as the BNPL model plays out over the long run.

An Unsettled Regulatory Landscape

Regulatory uncertainty hanging over BNPL has played a role in many FIs' general reluctance to participate, and for good reason. As federally insured and tightly regulated entities, banks and credit unions have encountered significant reputational risk and material fines for falling short of rules that often lack clarity. There is also the potential for legislative intervention that would require subsequent interpretation and implementation from agencies such as the Fed, CFPB, and the Federal Deposit Insurance Corp. Competing startups tend to use an "ask forgiveness rather than permission" approach, testing how far they can push the boundaries confining financial institutions.

The CFPB in December opened an inquiry into BNPL, requesting information from Affirm, Afterpay, Klarna, PayPal, and Zip. The process will likely reveal consumers' struggles to pay their BNPL balances. Expect to see oddities like offers to spread a $7.99 fast food meal over four installments as examples of industry excess.

Rather than fear regulation, banks and credit unions should instead be thoughtful about it. Any actions taken will prove to be a competitive advantage for FIs, which have the infrastructure in place to implement any mandated guardrails rapidly and are unlikely to engage in the envelope-pushing aspects of BNPL that require a course correction.

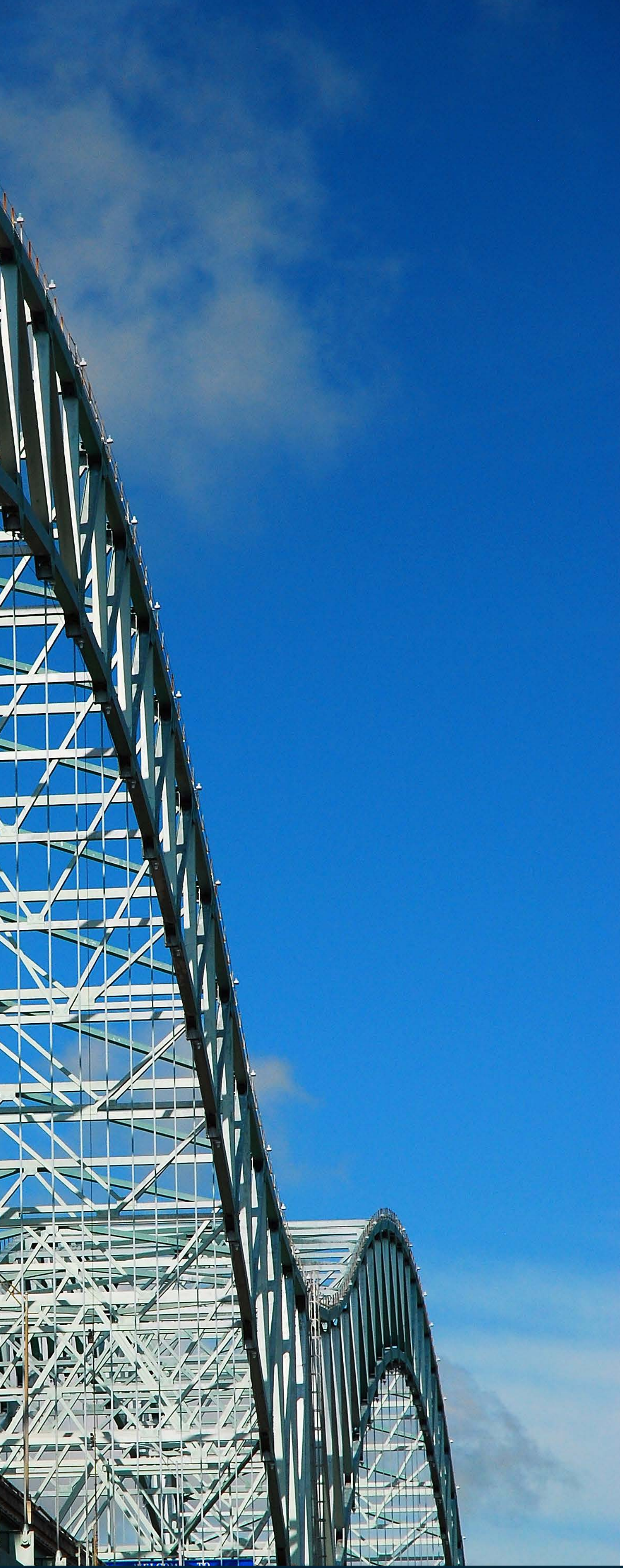
Many laws that the CFPB could enforce with BNPL – including the Truth in Lending Act and the Fair Credit Billing Act – are already followed by traditional FIs when they offer other credit products.

Positioning for the Long Term

Buy Now, Pay Later remains a work in progress. Models will continue to evolve, and providers will focus more effort on the experience at the point of interaction (online, app, register), as this will be key to success. Consolidation will continue as it does in the world of fintech. And, still, some will argue BNPL has entered the "trough of disillusionment" stage of its hype cycle, with excessive optimism giving way to the criticisms of the naysayers.

BNPL's journey has revealed demand for a product with foundations in consumers' growing reliance on debit cards and online shopping. Its rise in popularity also speaks to consumers' appetites for greater payment choices and a desire to limit perpetual revolving debt. These are signals that banks and credit unions should heed and build into a holistic portfolio of credit products.

SRM advises that FIs speak with their card networks, payment processors, and mobile providers to explore their options to meet market needs, then determine where a BNPL-like offering falls within their overall strategic initiatives. Consider potential use cases and revenue streams, particularly in light of ongoing fee income reductions in other areas.



About SRM

SRM (Strategic Resource Management) has helped 1,000+ financial institutions add more than $5 billion of value to their bottom line in areas such as payments, digital transformation, core processing, artificial intelligence, cryptocurrency, and overall operating efficiency. SRM – now in its 30th year in business – has lowered costs, created revenue opportunities, increased productivity, and provided a competitive edge for clients in an environment of constant and accelerating change.

Visit **www.srmcorp.com** for more information and follow us on **LinkedIn** and **Twitter** for timely and relevant insights.

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Keith Ash has 25 years of payments expertise across issuer, network, and processor roles. He began his career with Household Bank, supporting the launch and growth of the GM co-brand through Household Credit Services. Keith later joined First Data/Concord EFS, where he was the SVP of Operations and Implementations in the Northeast. He then worked for MasterCard for 14 years in roles ranging from Account Management to Sales, supporting regulated and unregulated issuers. Keith joined SRM to expand the company's payments acumen and to focus on serving regulated issuers.

To learn more about how SRM can consult on this BNPL topic and other payments strategies, contact Keith Ash by email at **kash@srmcorp.com** or at **302-547-9544**.

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Paul Davis has more than 20 years of experience following financial institutions. He was previously editor of community banking and M&A at *American Banker*, supervising the publication's coverage of banks with up to $20 billion of assets. Paul has held leadership positions at SNL Financial and American City Business Journals. His expertise includes balance sheet strategies, credit risk, M&A, payments trends, fintech emergence, and corporate leadership.

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