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WHITE PAPER

Buy now, pay later – blind spots and solutions

The post-pandemic rise in convenience credit leaves banks playing catch-up

Executive summary

- The high growth, hugely competitive BNPL marketplace means banks and leaner fintechs are looking for an edge and competitive advantage over each other.
- While younger account segments offer huge potential, traditional lenders are likely to be keen to develop and expand customer relationships over time with tailored offers.
- As the BNPL sector sees greater regulation, customers could be offered more attractive credit products, including cards with higher limits, rewards, Section 75 protection, and so on.
- But it's an area that's already feeling the acute impact of inflation pressures, squeezed household incomes, and rising living costs.
- As a result, legacy businesses are keen to compete and continue growing their customer base, while safeguarding sustainable growth.
- A host of key technologies, including collections insights, will be critical to success in delivering convenience credit at speed and scale.
- Shutting out the fraudsters from a new potential honeypot also poses a headache. But AI and advanced analytics will help keep up with the criminals in real time.

Putting perspective on BNPL's scale of growth

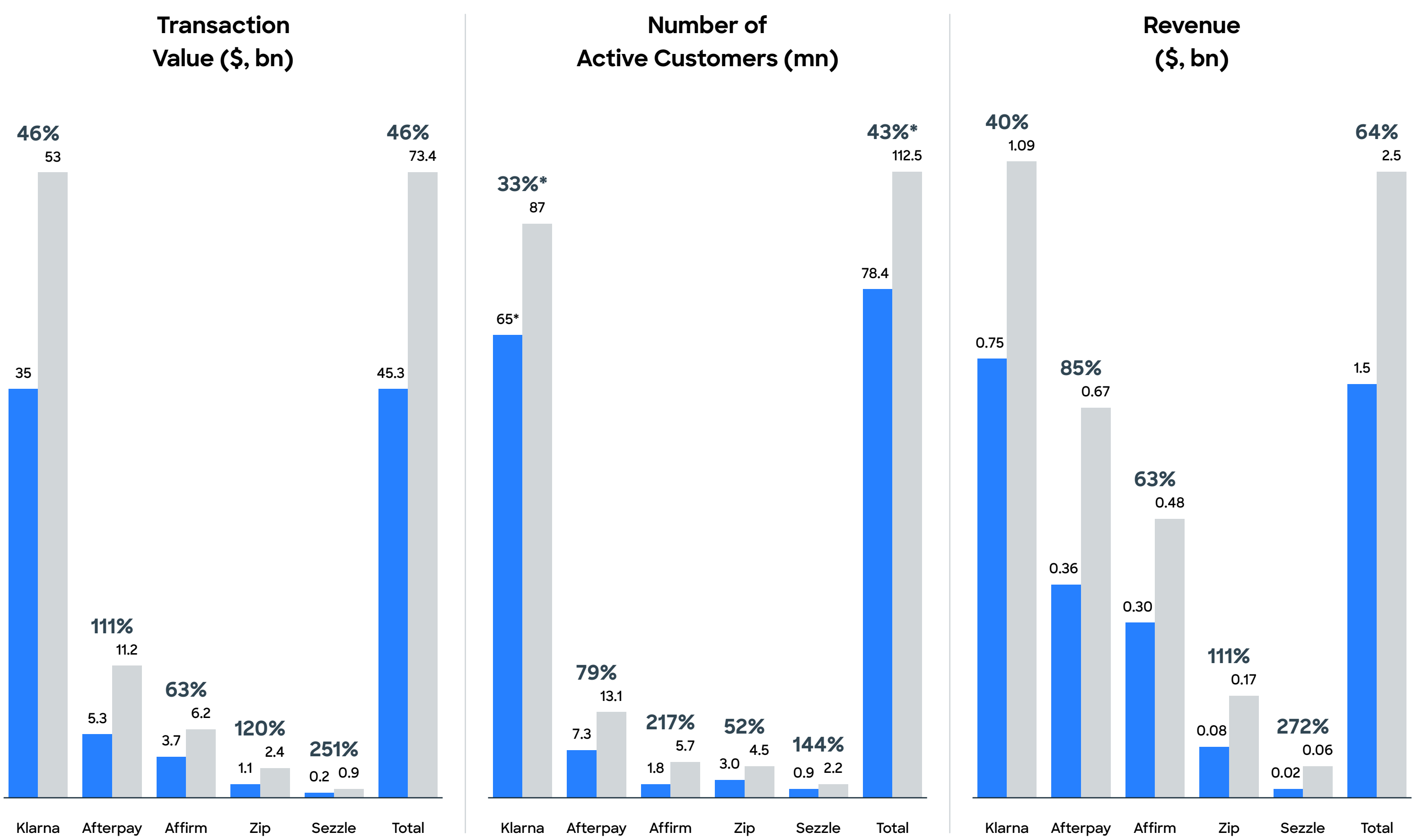
The impact of the pandemic and subsequent global lockdowns has driven consumers to digital channels far faster than many had anticipated. Almost overnight, there's been mass adoption of online and in-app banking, marking a generational cultural shift in typical habits.

Legacy banks now face being left behind as many customers readily switch to leaner new-to-market fin-techs and are clearly willing to adapt to new ways of transacting. Among the global stellar performers is the rise in prevalence of buy now, pay later (BNPL) schemes.

The BNPL industry is now estimated to be worth an **eye-watering US$100 billion** — and it's only set to increase. Millions of shoppers already use a BNPL service to finance their purchases. Options are more varied than ever — Klarna, Affirm, and Afterpay are just a handful of the many providers in the space. Elsewhere, bigger players are jumping on the bandwagon. PayPal is launching its own BNPL channel, while Amazon and Apple are partnering with Affirm, and Square tabled a US$29 billion bid to buy Afterpay.

Leading BNPL companies witnessed a notable growth in volumes and customers in 2020

Transaction value, number of active customers and revenue of leading BNPL companies



*Estimated

Source: TAB Research

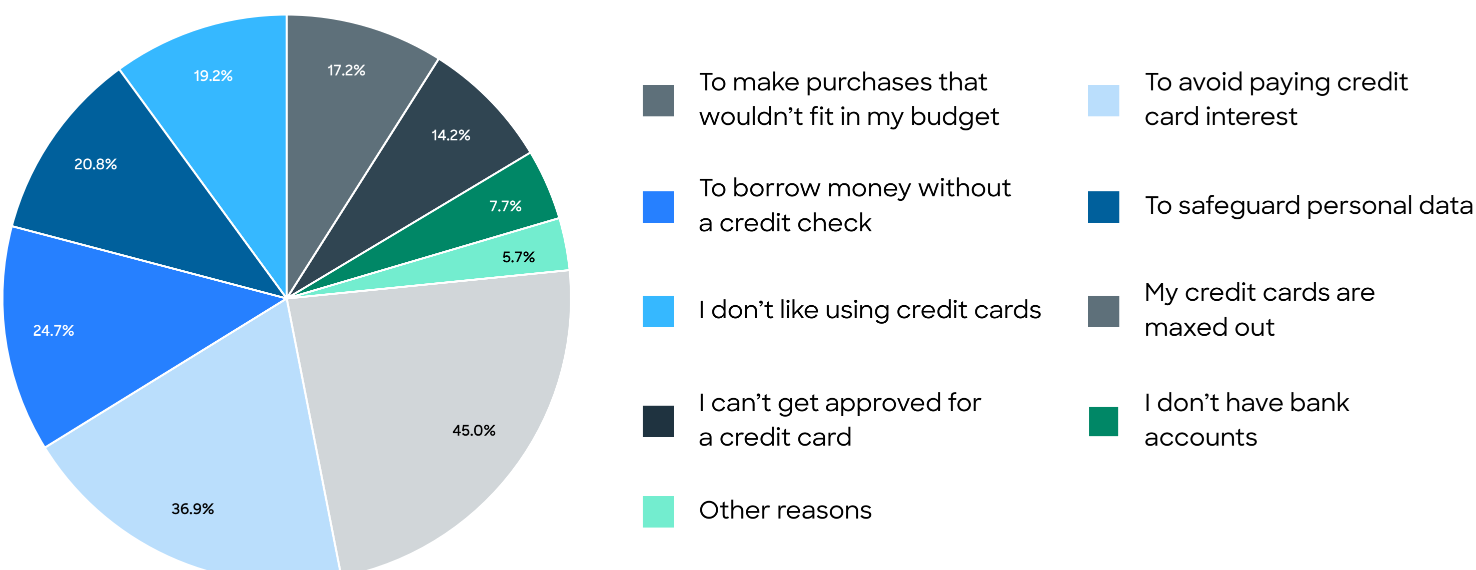
Getting a taste for regional risk appetites

Right now, Australia has the highest uptake of BNPL of any country, with nearly one in four (24%) Aussie consumers using it, compared to a global average of just over one in ten (11%). Elsewhere, customers' preferences vary but they are clearly willing to embrace it.

United Kingdom	Germany	United States
BNPL market share in the UK 5%	Market share of BNPL in Germany 18%	BNPL market share in the U.S. 2%
Most downloaded BNPL app in the UK Klarna	Most popular online payment brand in Germany PayPal	Klarna, Affirm, Afterpay, and QuadPay monthly installs in the U.S. 1.4m
Users who used BNPL the most in the UK Millennials	Ranking of SOFORT Überweisung (e.g., Klarna) in online payment use in Germany, in terms of frequency of use 5th	Users who use BNPL the most in the U.S. 18–24-year-olds

BNPL is meeting many needs with implications for competition among providers

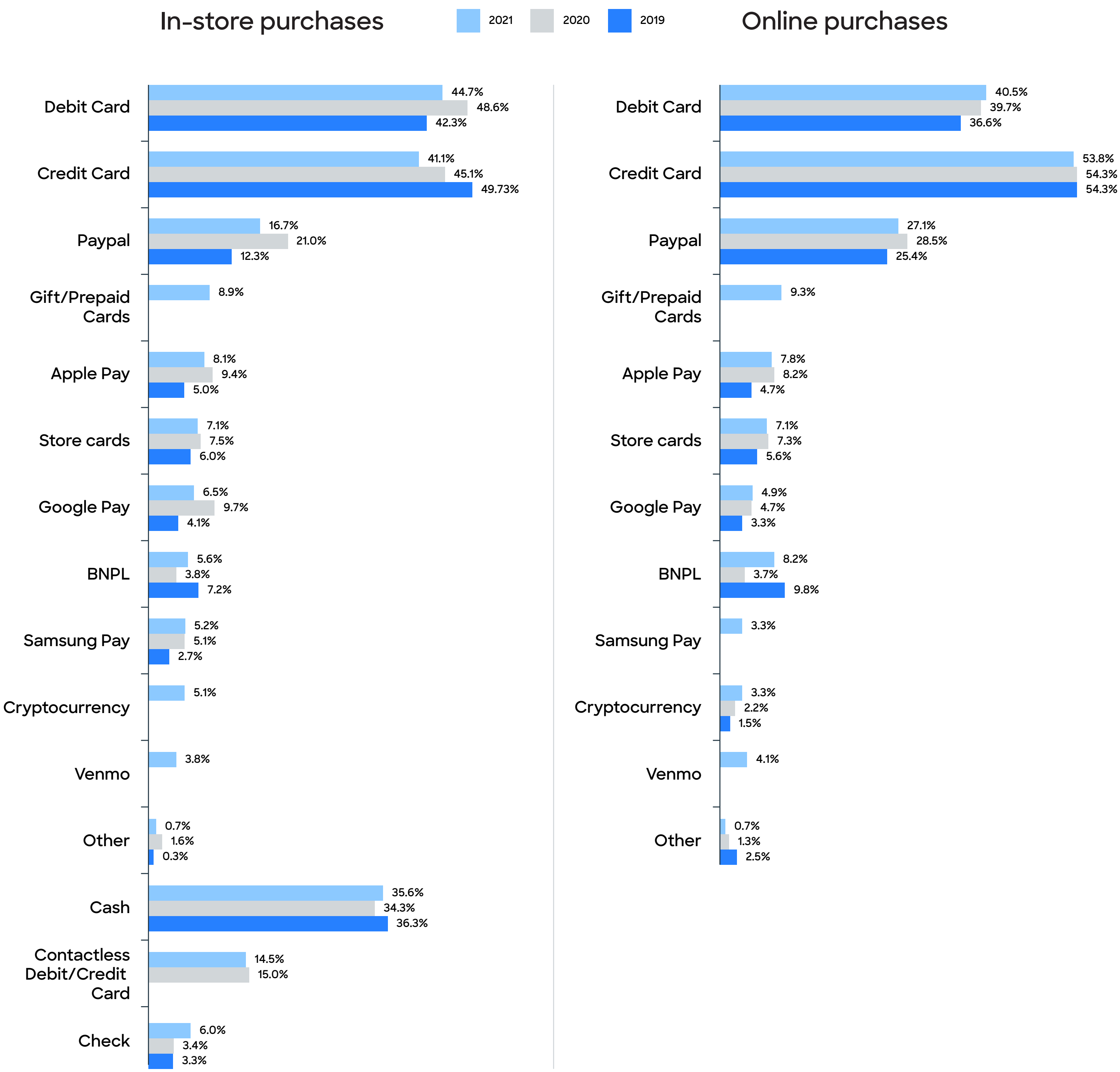
The Ascent Survey of BNPL purchasers: Reason for using BNPL service



Source: AC Cutts & Associates, The Ascent (fool.com)

How consumers paid for their Black Friday 2021 Purchases

Share of consumers reporting purchases made with these payment options on Black Friday 2021, %



Source: PYMNTS.com. Black Friday Results Show BNPL Gaining Grounds\PYMNTS.com 2021 Survey date was Nov. 27, 2021.

There's pressure on "traditional" lending channels

It's most notable around credit card spend, which is in direct competition with the explosion in diverse point-of-sale finance. As a result, card issuers and unsecured lenders alike face falling revenues, increased dormancy, attrition, and loss of customers. Several well-established banks have also launched BNPL-style offerings. These include Deutsche Bank, JPMorgan Chase, Citigroup, and the Commonwealth Bank of Australia.

But to compete they must now be seen to offer equally flexible payment propositions as BNPL providers. In fact, real-time decision making — based on customers' profiles, spending habits, and specific purchases — underpins the ability to consistently make better offers, the most appropriate offers, or straight-up declines for high-risk customers.

Ease of access to BNPL is driving increased use in some segments of the population, most notably Millennials and Gen-Z

Lack of regulation/robust affordability checks is prompting fears of increased levels of consumer indebtedness. If not carefully managed, it could lead to increased losses with some consumers being disadvantaged. It's also clear many BNPL consumers simply don't regard arrangements as "debt" given the typical short-term, 8 to 12 week nature of agreements.

Instead, it's treated as a convenient route to managing cashflow challenges. In all likelihood, many BNPL users may have multiple plans in place across several merchants or providers, without a single point where they can see a complete picture of their financial position, the amounts due, and when. This highlights the need for lenders to have a comprehensive view as some customers don't and may not make good affordability decisions.

Line of sight

There are inevitably wider implications for creditworthiness assessments due to the lack of comprehensive visibility lenders may have of customers' BNPL commitments. It's an area that's being resolved slowly. New data is continually being made available to lenders via their credit bureaus, with associated implications for risk models, strategies, and affordability assessments.

There may also be opportunities in the near future to improve collections treatment, while helping prevent some BNPL customers getting over-committed or sliding towards pre-delinquency. For instance, setting maximum limits, pro-actively setting shadow limits, or carefully configuring action sets to highlight customer months-to-repay options more accurately.

Why real-time affordability analytics are everything

You can use the AI-driven FICO® Platform to assess credit risk of new-to-bank customers expected to use their new BNPL service.

Among many other aspects, risk assessment is a critical component to decision BNPL customers. FICO Platform boosts banks' BNPL programs with an advanced credit risk scoring framework leveraging transaction data (employing external sources such as Open Banking Data Aggregator APIs or internal data sources), advanced customer profiling technology, analytics, and machine learning models.

As the target is primarily the younger Millennial and Gen Z segments, who may have thin credit files, transaction data holds key insights into BNPL applications with FICO Platform enabling some clients to process them at speed, scale, and decision customers in real time.

The key capability is FICO's Digital Customer Profiling engine, which is able to process large volumes of customer transaction data and create digital profiles of customers. Transaction data on income, expenses, commitments, discretionary spend, and savings are available in real time, driving the speed to decision.

Understanding customers' profiles through the use of transaction data gives increased accuracy and an up-to-date view of their financial picture. It helps improve repayment propensity risk assessments and also ensures that customers can afford the BNPL line of credit, enabling responsible lending decisions.

There are also opportunities for so-called "traditional lenders" to target existing credit card customers and use existing customer management tools to offer some of BNPL's flexible payment options. Well established banks have a competitive advantage in already having affordability data and risk scores. They are likely to already have transactional data coming in and also have the ability to make decisions in real time. They also have direct line of sight on bureaus and customer-level data.

As more BNPL data becomes available, established lenders have the functionality in place to easily add it in. They can also refresh data-driven, optimized strategies to ensure that with new data and feeds, the most predictive data is being used to help achieve their strategic aims — be it risk control, improved profitability, growing the customer base, or improved experience.

Transactional data and razor sharp analytics point the way for real-time affordability indicators

To get a true picture of financial commitments, lenders are now combining open banking transactional data and alternative datasets alongside sharper analytics and real-time data streaming, given adjustments of shadow and actual credit limits can be triggered by a spend, within a matter of nanoseconds. Examples of sharper analytics include calculations of a score that indicates the risk of upcoming potential delinquency based on patterns in transactional data. Analytics would subsequently adjust the score based on a host of key metrics, including employer, job type, and increases in certain spending types versus reductions in others to assess any early indicators of financial stress. To read more, click **here.**

Innovation and emerging consumer finance models

All-in-one card fintech Curve has launched a new BNPL product called **Curve Flex.** It's pitched as retrospective finance, which it says allows customers to convert past payments from up to a year ago into three, six, nine, or 12-step instalment plans.

Unlike other BNPL options, the instalment plans aren't interest-free. Instead, consumers get an APR based on their profile. Curve says the addition to the BNPL market will offer customers the opportunity to pay later for almost any purchase from any retailer, or from any card, from up to a year ago, thanks to its retrospective analysis. Curve clinched UK regulatory approval at the beginning of September 2021. The company has also patented its so-called "Go Back in Time" technology.

Curve's Flex launch shortly followed fellow fintech Monzo, which has a similarly named BNPL feature called Monzo Flex. On the face of it, Monzo Flex has all the hallmarks of a traditional credit card. It offers users the flexibility to defer the full upfront payment of purchases, either in-store or online, within an agreed credit limit up to a maximum of £3,000. While Monzo Flex differs from the checkout button options provided by the new wave of BNPL players such as Klarna and Afterpay, the product includes the ability to roll back the clock on previous purchases, the means for consumers to split transactions, self-select credit ceilings, and edit payment plans. Most notably, hard credit checks by Monzo do appear on customers' credit files, unlike more "traditional" BNPL firms.

Financial watchdogs retain a regulatory eye

Among the main criticisms of BNPL is that it encourages shoppers to spend more than they can afford, with pay-later plans particularly favored by younger customers.

Consumer advocacy groups warn it preys on the vulnerable amid claims nearly a quarter of BNPL shoppers spend more than they initially intended because the service was available. Evidence is also emerging that some shoppers are now buying their weekly groceries via BNPL schemes. There are also fears around how easily consumers can get into debt and become over-committed without even realizing, given there are no hard credit checks involved.

Unsurprisingly, BNPL has been compared to controversial payday loans, which allow high-interest rates on short-term borrowing. While BNPL is typically interest-free at the outset, some providers go on to charge high late payment fees.

But BNPL providers insist safeguards are in place to ensure shoppers don't overspend, with some setting spending limits on a case-by-case basis. Critics argue BNPL needs further regulation to sufficiently protect consumers. The UK government says it's seeking to rein in the industry with a range of proposals, including affordability checks. **A consultation on the rules** was launched in November 2021, with recommendations set to follow. In the UK, the Financial Conduct Authority (FCA) has also unveiled a new **Consumer Duty** setting out clearer standards for increased consumer protection across financial services.

Within the EU, regulators' attention is turning to BNPL. The European Commission has filed a draft revision of the new consumer credit directive with the final aim of ensuring greater consumer protection. In the US, the **House Financial Services Committee's** task force is also scrutinizing BNPL's impact on consumer debt and ways the product could be governed. The BNPL industry in Australia has so far managed to grow unhindered, largely because it is deemed too small to properly regulate. But analysts admit the "regulatory clock is ticking" and expect the country to follow the positions shaping up in the UK and Singapore.

BNPL challenges – How FICO is helping banks and financial services firms

The high growth, hugely competitive BNPL marketplace means banks and leaner fintechs are looking for an edge and competitive advantage over each other. Younger account segments, whether they are an existing low-risk credit user or completely new to banking, offer potential. Traditional lenders offering mortgages and personal loans are likely to be keen to develop and expand customer relationships over time with offers tailored to specific life events. Even customers who have only ever used BNPL offerings, have thin credit files, or low bureau scores will see their risk profiles improve if they continue to make their payments on time. As the BNPL sector sees greater regulation, customers could be offered more attractive credit products, including cards with higher limits, rewards, Section 75 protection, and so on. It's an area that's already feeling the acute impact of inflation pressures, squeezed household incomes, and rising living costs. As a result, investment in industry-leading risk, fraud, and customer management technologies are critical to success.

Safeguarding sustainable customer growth

In a crowded, competitive BNPL environment, how do legacy businesses compete and continue to rapidly grow their customer base, while keeping bad debts and risk in check? **FICO can help implement appropriate risk controls through innovations such as transaction data and machine learning models to grow customers and profits while keeping bad debts low.**

Delivering convenience credit at speed and scale

But which BNPL players will survive in an already packed marketplace? Which players will grow the fastest? What technologies will help drive growth? **FICO cloud-based solutions and heritage in customer management and merchant onboarding allow it to deliver the results and agility that lenders need.**

Collections insights

BNPL clearly isn't going away, and with greater regulation, it could help pave the way for reducing future bad debt. Although BNPL balances are likely to be far smaller compared to credit cards, there will always be customers who struggle to make their payments and may end up with sizeable BNPL balances if they are relying on multiple payment plans. Traditional lenders already have effective collections strategies in place to manage missed payments. As a result, they will be well placed to tailor these strategies for BNPL customers based on thin files and alternative data sources. **FICO® Platform allows real-time insights and agility to help lenders make informed decisions on the most appropriate customer treatments.**

Shutting out the fraudsters

As BNPL grows, it becomes a honeypot for criminals. What are the risks? How are SMEs protected? How do banks stop AML and identity fraud? **FICO has comprehensive enterprise fraud solutions that use AI and advanced analytics to keep up with the criminals in real time.**

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5136WP 08/22 PDF