HARVARD Kennedy School
MOSSAVAR-RAHMANI CENTER
for Business and Government

Grow Now, Regulate Later? Regulation urgently needed to support transparency and sustainable growth for Buy-Now, Pay-Later

Marshall Lux
Harvard Kennedy School

Bryan Epps
Harvard Kennedy School

April 2022

M-RCBG Associate Working Paper Series | No. 182

Mossavar-Rahmani Center for Business & Government
Weil Hall | Harvard Kennedy School | www.hks.harvard.edu/mrcbg

Grow Now, Regulate Later?
Regulation urgently needed to support transparency and sustainable growth for Buy-Now, Pay-Later

April 2022

Marshall Lux
Research Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School
marshall_lux@hks.harvard.edu

Bryan Epps
Research Assistant, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School
Master of Public Policy Candidate, David M. Rubenstein Fellow and George Leadership Fellow, Harvard Kennedy School
Master of Business Administration Candidate, Harvard Business School
bepps@hks.harvard.edu

Abstract
"Buy Now, Pay Later" (BNPL) companies have seen significant growth in the past few years in the U.S. market. BNPL products are expected to account for a considerable portion (12%) of ecommerce sales by 2025. Despite BNPL's significance in the American economy, most BNPL products are far less regulated than their near substitutes. BNPL product design often places it in a legally confusing position (or solidly outside of regulatory oversight). Regulators have struggled to react at a pace consistent with the pace of BNPL growth. To support sustainable growth of BNPL in the US, greater transparency is needed for consumers, investors, lenders, and regulators. This working paper explores the implications of BNPL uncertainties with a focus on consumer risk, options for self-regulation, and recommendations for regulatory and policy intervention. It investigates the origins of the challenges and opportunities presented by BNPL and explains how interventions can help maximize the social and commercial value of BNPL.

Acknowledgements:
We are deeply grateful for the support of the Mossavar-Rahmani Center for Business and Government at The Harvard Kennedy School, and in particular from John Haigh and Dan Murphy. We are also grateful to acknowledge the helpful insights of Inderpreet Batra, Max Blumenfeld, Steve Freiberg, Dan Friedman, Aaron Goldman, Ash Gupta, Tom Hutton, Mike Marcus, Tom Mildenhall, Jeffrey Newman, Tushar Srivastava, Rich Tambor, and Neil Underwood. All errors are our own.

Contents

Introduction: A Rapidly Emerging Market and Its Rapidly Emerging Challenges

Without precedent, regulation, or oversight, consumers, investors, and leading credit risk managers cannot evaluate the risks of significant subprime borrowing in an unregulated industry with revenues approaching $1 trillion.

Buy-Now, Pay Later (BNPL) is an innovative and fast-growing segment of the fintech market. Globally BNPL is projected to account for $680 billion in transactions by 2025 (representing 12% of all eCommerce sales on goods, where BNPL is currently concentrated).[1] Despite its significance, the U.S. BNPL market segment exists in a legal gray space. Variation and complexity of products make it difficult for regulators to categorize products and intervene appropriately. For example, requirements of the U.S. Federal Truth in Lending Act (TILA) designed to protect consumers are triggered if payment occurs over *more than* four installments,[2] but Pay-in-4 is among the most popular BNPL products available in the market. BNPL Pay-in-4 consumers are, thus, not protected by TILA. While BNPL companies can and have already done much to protect consumers – providing voluntary credit bureau reporting and thorough fees disclosures at the point of sale (POS) – the scale and potential consumer impact of BNPL products warrant immediate and more thorough oversight.

Amid a dramatic shift toward ecommerce during the COVID-19 pandemic more generally, innovation in partnerships, product design, user interface, and aggressive merchant promotion have driven BNPL's recent growth. Regulatory arbitrage also has played a role – some BNPL companies appreciate the flexibility of unregulated sides of the market as they rapidly iterate to explore paths to positive unit economics. In December 2021, concern about regulatory arbitrage (as well as debt accumulation and data harvesting practices) prompted the Consumer Financial Protection Bureau (CFPB) to issue information collection orders to leading BNPL companies to assess the "risks and benefits [to consumers] of these fast-growing loans."[3] The CFPB's inquiry will undoubtedly lead to consumer protections in the coming years. However, the CFPB has not yet given a timeline on its next steps, and many consumers struggle to manage their BNPL debts today. BNPL consumer trends substantiate the CFPB's concerns. A 2021 TransUnion survey revealed that two-thirds of BNPL applicants are subprime.[4] Additionally, there are few checks on how many BNPL products any individual consumer can use at once, and, due to BNPL's recent growth, the shape and resilience of the market is untested through a credit cycle. Indicators of distress are not yet clear: is it a sign of deferred necessity or impulse that many BNPL companies predominantly finance apparel purchases?[5] Or is it just the sign of an immature market? Or is it aggressive marketing? Or is it ignorance on the impact on credit reporting? The list goes on.

---

[1] "Buy Now Pay Later Digital Spend, Led by Klarna, Paypal, and Afterpay, to Double by 2025: Reaching $680 Billion," Kaleido Intelligence, September 2020.
[2] FDIC Law, Regulations, Related Acts, 6500 – Consumer Financial Protection Bureau, Part 1002 – Equal Credit Opportunity Act (Regulation B), December 2011.
[3] "Consumer Financial Protection Bureau Opens Inquiry into "Buy Now, Pay Later" Credit," *Consumer Financial Protection Bureau*, 16 December 2021.
[4] "POS Financing Virtual Forum," TransUnion, 28 July 2021.
[5] Proprietary data and analysis from YipitData, https://www.yipitdata.com/.

The CFPB is not alone in its concerns about BNPL: financial institutions and investors have expressed apprehension about the value proposition and overall impact of BNPL products. Based on our many interviews, venture capitalists have also increasingly shied away from consumer facing BNPL in favor of innovation in BNPL infrastructure and B2B BNPL products.

Consumer perspectives on BNPL remain largely positive. While the story of BNPL and the American people is nuanced, the rapid growth of the segment is powerful evidence that consumers need and/or enjoy BNPL products. Consumer preference for BNPL is unsurprising in an environment where demand for and constraints to new consumer credit are high, especially for lower income Americans. Contributing to consumer credit supply constraints are (1) a "rise in credit card regulatory restrictions by financial regulators; (2) regulation of risk-based pricing; (3) a rising share of unbanked Americans; and (4) unpredictable CFPB actions," as discussed at length in the 2016 working paper, "Out of Reach: Regressive Trends in Credit Card Access" (Lux and Greene, 2016).[6] In short, the consumer credit market has been ripe for disruption.

Merchant perspectives, too, are wildly positive because merchants benefit significantly from the current business models of BNPL companies. BNPL is in many ways designed more as a merchant product than as a consumer product. With convenient access at point-of-sale (POS) — particularly in online sales — BNPL products help merchants drive sales. RBC Capital Markets reported in 2021 that online BNPL "increases conversion rates 20-30% and lifts average ticket sales 30-50%."[7] BNPL impact on revenue is for many merchants definitively worth the fees.

With these benefits to merchants and many consumers come major challenges. For consumers with high financial literacy, strong credit scores, and easy access to credit, BNPL can offer substantial improvements in the timing of payments and in convenience at POS. For consumers who already struggle to manage personal finances, though, BNPL can facilitate spending beyond capacity to pay. In a 2021 Credit Karma survey, roughly one-third of BNPL consumers had fallen behind on at least one BNPL payment, and of those falling behind, 72% of respondents report that their credit scores declined as a result.[8]

For the most part, though, underlying uncertainties (not evidence of concerning behaviors by BNPL companies) give cause for deeper investigation. And the BNPL segment remains steeped in uncertainty: it is difficult to track BNPL's impact on consumers or the economy; BNPL's market structure and competitive landscape remain fluid; and BNPL lies open to a wide range of potential regulatory regimes.

[6] Lux, Marshall, and Robert Greene, "Out of Reach: Regressive Trends in Credit Card Access, M-RCBG Associate Working Paper Series, No. 54," *Harvard Kennedy School, Mossavar-Rahmani Center for Business and Government*, April 2016.

[7] Perlin, Dan, "2021 Outlook: Payments, Processing and IT Services," *RBC Capital Markets*, 9 April 2021.

[8] "Buy now pay later surges throughout pandemic, consumers' credit takes a hit," *Credit Karma*, 9 September 2021.

What is BNPL?

Background

BNPL describes a variety of POS financial services. In the most popular format, Pay-in-4, consumers are given the option at the POS to make four payments for their purchases over a period of six weeks (25% upfront and 25% every two weeks until fully paid off), but there is some variety in current BNPL offerings. While new BNPL products have recently changed the consumer finance landscape, POS financing services have existed for years. For example, in the 1960s American Express launched "Sign and Fly" in a partnership with American Airlines to provide POS financing for flights. American Express noted this product contributed to a 24% increase in new sales – similar to claims made by BNPL companies today.[9] In the latest iterations of BNPL products, breadth of merchants and products onboarded, growth in ecommerce, and tremendous improvements to the user experience at the POS have proven a potent combination.

Growth of ecommerce has enabled the emergence of numerous new fintech companies. These companies have, in turn, driven innovation and helped merchants build new markets. BNPL is the only unsecured-lending asset to have experienced double-digit growth (albeit from low volume) over the past two years.[10] BNPL products differ by credit requirements, credit limit, merchant partnerships, and associated fees, but the common theme across BNPL providers is an intended improvement to the user experience of POS financing through simplicity and clarity at the POS. In short, BNPL products are meant to feel like using a credit card without having to apply for and manage a credit card. The very nature of the BNPL user experience (i.e., ease of use) presents consumer protection challenges discussed in this working paper.

While BNPL products focused on consumer goods (PayPal Pay-in-4, Affirm, Afterpay, Klarna, etc.) have seen the most growth in recent years, BNPL companies have also launched innovative products focused on healthcare (e.g., Prima HealthCredit helps consumers finance elective medical procedures), residential rooftop solar energy (e.g., Mosaic provides innovative financing options for homeowners), and many other services (e.g., Deferit offers BNPL for routine household expense like rent and utility bills). Consumer-facing BNPL companies are not the only actors driving innovation in the POS financing space, though. BNPL infrastructure providers and B2B focused companies are two categories experiencing significant innovation. For example, Skeps has developed a blockchain enabled platform to offer a white label BNPL product, giving financial institutions a viable alternative to internal BNPL product development. ChargeAfter has launched a platform that enables merchants to offer BNPL products from multiple lenders. Fintech companies Versapay, Hokodo, and others are pioneering B2B BNPL,

---

[9] Gross, Daniel, et al, "American Express and the Charge Card," *Forbes Greatest Stories of All Time.*
[10] "Buy now, pay later: Five business models to compete," McKinsey & Company, 29 July 2021. *(Growth in POS financial services has been driven primarily by five types of providers: (1) Integrated shopping apps, (2) Card-linked installment offerings, (3) Off-card financing solutions that are similar to integrated shopping apps but used for larger purchases with longer pay back periods that may include APRs), (4) Virtual rent-to-own models, and (5) Vertical-focused larger-ticket plays, intended for very large, $2,000-$50,000 purchases such as elective healthcare or home improvements.)*

offering alternative trade credit solutions. The potential for additional BNPL innovation across the economy is substantial.

Economics

The function of BNPL innovation (and thus the unit economics) in the broader consumer finance ecosystem varies by transaction size and customer segment. For example, at the high transaction value end of the market, companies offer consumers with strong existing credit a short-term line of credit with simple terms and clear pricing. These products force the difference in cost onto the merchants, who in turn accept the fees to boost sales. In this sub-market, BNPL solutions may be able to thrive as standalone products as long as they provide a meaningful net benefit to merchants and can charge sufficient fees to fund BNPL operations.

At the high end of the market, merchants find BNPL products useful enough as customer acquisition tools that they are willing to subsidize the entirety of the interest for their customers. Peloton, for example, covers the interest on their up to 39-month payment plan through Affirm.[11] In some ways, this approach is simple price subsidization: customers who choose to pay for the Peloton purchase upfront are in effect subsidizing the interest on customers who choose BNPL plans.

At the low transaction value end of the BNPL market, the unit economics have a harder time demonstrating the potential for profitability as standalone products; BNPL companies struggle to charge fees high enough to cover the cost of services and customer acquisition costs. BNPL solutions can, however, provide meaningful new data on consumer creditworthiness. BNPL may also provide a far more affordable means of customer acquisition for third parties. Such functions could be highly valued by traditional commercial banks, neo-banks, and other financial institutions, who may partner with, acquire, or become the customers of standalone BNPL companies.

The Consumer Financial Protection Bureau (CFPB) has expressed a specific concern about the risks created for consumers inherent to BNPL economics. Namely, as some BNPL products without any pathway to sustainable unit economics struggle to reach profitability, will BNPL companies use the payments history data and/or purchase history data they've collected on consumers to seek profit in objectionable ways (just as other tech companies have used consumer data in ways eventually found objectionable to the public). This concern applies to all BNPL companies but especially to those with higher difficulty with standalone unit economics and/or who have less appeal as a customer acquisition tool for other financial services companies.

The Consumer

To explain the rapid growth of BNPL and to understand the risks and opportunities presented by that growth, we must unpack why and by whom BNPL products are being used.

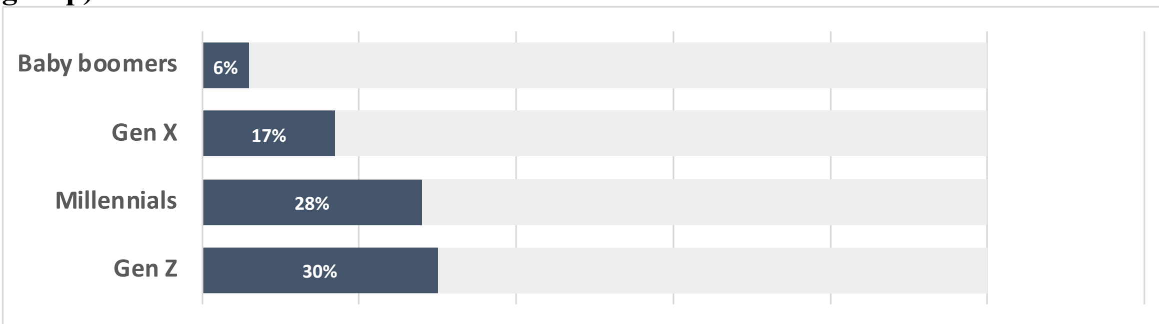
---

[11] "Peloton And Affirm: A Bad Symbiosis For Peloton," *Seeking Alpha*, 15 January 2021.

Who Uses BNPL Products?

BNPL has the highest penetration among Millennial and Gen Z consumers (although BNPL use grew substantially across all consuming generation groups from 2019 to 2021).[12]

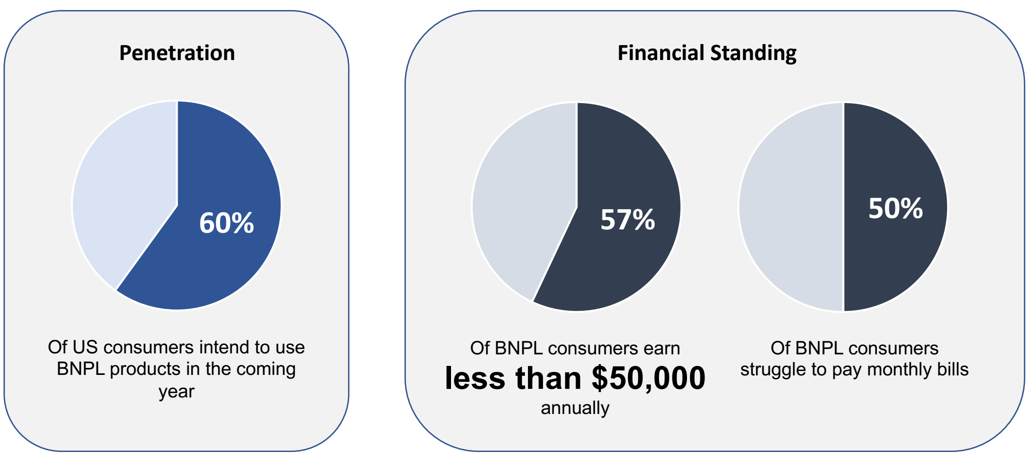
Figure 1: Share of survey respondents who used BNPL in Jan. 2022 (by generation group)[13]



Concentration of BNPL uptake in younger consumers is predictable (they are early adopters of app-based services in general), but it is also concerning given younger consumers are typically less financially mature.

BNPL market penetration[14] and high use among consumers with lower-than-average income and/or existing financial challenges[15] also make clear the potential for harm by BNPL companies as detailed in the figure below.

Figure 2: BNPL market penetration and financial standing of BNPL consumer (2021)



[12] Shevlin, Rob, "Buy Now, Pay Later: The "New" Payments Trend Generating $100 Billion In Sales ," *Forbes*, 7 September 2021.

[13] Williams, Claire, "Buy Now, Pay Later' Users Significantly More Likely to Overdraft Than Nonusers," *The Morning Consult*, 2 March 2022.

[14] "Buy now, pay later: Five business models to compete," McKinsey & Company, 29 July 2021.

[15] "New Filings Show Missed Payments Are on the Rise at BNPL Firms," *PYMNTS,* 23 September 2021.

For assessing risks to consumers, comparison between BNPL consumers and the average consumer can be especially meaningful. Leading consumer credit reporting agency, TransUnion, has been exemplary in studying and publishing data on BNPL consumer trends. TransUnion's 2021 analysis of over 4 million BNPL users found in comparison to the average consumer, BNPL consumers:

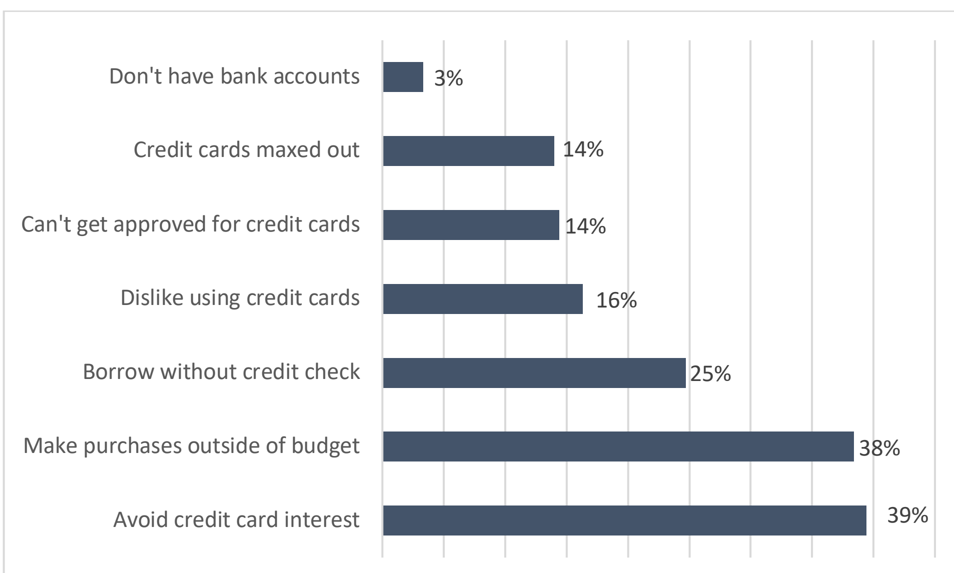
1. are younger (77% between 18 and 50),
2. have worse credit ratings (69% are subprime or near prime),
3. are more likely to be derogatory (90+ days past due on payments generally), and
4. are more likely to be seeking credit (i.e., have higher volume of inquiries for credit).[16]

While BNPL consumers do generally have access to some forms of credit, they have lower than average access to the type of credit they actually need: bankcards and retail cards. For many, this is where BNPL products fill the gap. Analysis of the *average* BNPL consumer can be useful, but it is critical to understand that BNPL products and their target consumers are not a monolith – a variety of BNPL products appeal to a wide variety of consumers.

Why Do People Use BNPL?

The most frequent reasons for BNPL use include avoidance of credit card interest (39% of users) and making purchases that "wouldn't fit in [their] budget" (38% of users), but lack of credit and financial distress still account for a substantial portion of users' BNPL engagement rationale (14% for each), as detailed in the figure below.

Figure 3: Consumer rationale for BNPL use[17]



[16] "POS Financing Virtual Forum," TransUnion, 28 July 2021.
[17] "Buy Now Pay Later Report: Market trends in the ecommerce financing, consumer credit, and BNPL industry," *Insider Intelligence*, 3 February 2022.

Reasons for use also differ substantially by the service's business model (and associated target customer). For example, of customers of off-card financing solutions (like Affirm), 80% have credit cards with sufficient credit available to fund their BNPL purchases. These customers may choose BNPL financing for more affordable credit (sometimes even interest free financing) or easier payment terms.[18] For these customers, BNPL competes on price and convenience with credit card companies. In many cases, though, off-card financing solutions still make the difference in purchase decision. For example, by shifting the cost of financing to the merchant, Affirm facilitated Peloton bike purchases in pandemic lockdown for many consumers for whom Peloton bikes would not normally be accessible.

In contrast to off-card financing solutions, most virtual-rent-to-own customers (70%) have credit scores below 600 so likely wouldn't be able to access sufficient credit at affordable rates for larger purchases.[19] Virtual-rent-to-own products offer consumers a variety of payment plans, give them the option to buy out the loan at any time, and typically do not require credit scores. For these customers, BNPL virtual-rent-to-own companies (like AcceptanceNow, Katapult, and Progressive Leasing) compete against non-consumption and facilitate access to consumer credit for items that could theoretically be repossessed by merchants such as furniture or appliances (although such items are rarely repossessed in actuality).

Impact of the COVID-19 Pandemic

Because BNPL products are typically embedded in the online shopping experience, growth in ecommerce is highly likely to drive growth in BNPL. The COVID-19 pandemic boosted ecommerce sales by about 20% in 2020 alone, corresponding to BNPL's growth in the same period.[20] The pandemic also led to unemployment and financial instability for many, increasing the demand for more flexible credit-like products, including BNPL.[21] Projections vary on the degree to which the pandemic's effect on ecommerce will be enduring, but it has certainly given BNPL companies an opportunity to launch and scale far more rapidly than might otherwise have been possible.

For some companies during the pandemic, rapid growth has been driven by a highly concentrated set of products and consumers for discrete periods of time. Novel products unevenly distributed can skew the data but also have a significant impact on certain market segments. For example, in Q3 of 2020, Peloton drove 30% of Affirm's total revenue[22] while enabling households with lower income access to a product normally out of reach. During the pandemic when gyms were largely unusable, the 8% of Peloton bike users who earned less than $50,000 annually could access bikes priced from $1,495 upward by using monthly Affirm payments that were more affordable than most monthly gym fees.[23] Of course, an interest free loan was enticing for consumers at all income brackets. Affirm expressed concern about revenue

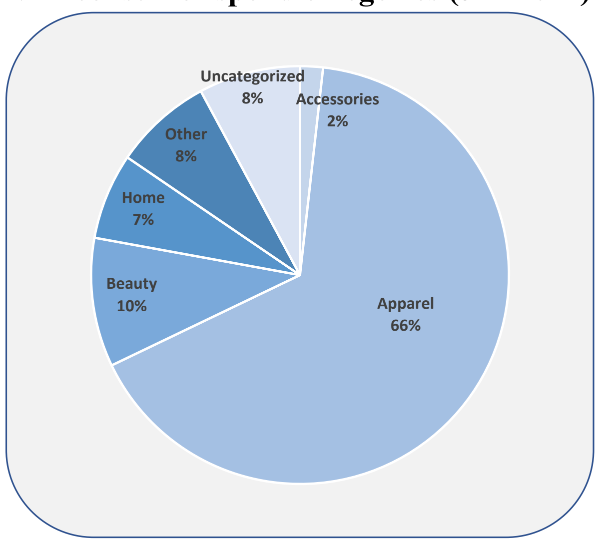
[18] "Buy now, pay later: Five business models to compete," McKinsey & Company, 29 July 2021.
[19] "Buy now, pay later: Five business models to compete," McKinsey & Company, 29 July 2021.
[20] "Impact of COVID Pandemic on eCommerce," *International Trade* Administration, 2021.
[21] "Buy Now Pay Later Report: Market trends in the ecommerce financing, consumer credit, and BNPL industry," *Insider Intelligence*, 3 February 2022.
[22] Affirm Holdings, Inc., Form 10-Q, 30 September 2021.
[23] Dean, Brian, "Peloton Subscriber and Revenue Statistics (2022)," *Backlinko*, 6 January 2022.

concentration in its 2021 Annual Report, noting, "The loss of Peloton as a merchant partner, or the loss of any other significant merchant relationships, would materially and adversely affect our business, results of operations, financial condition, and future prospects."[24] Such revenue concentration has since become less of an issue for Affirm, as Peloton's share of Affirm revenue has declined substantially since 2021 – Peloton accounted for about 10% of Affirm revenue in Q3 2021.[25]

To what extent does this growth constitute healthy net new access to credit?

Spend categories differ substantially by BNPL product and can shed light on BNPL consumer spending patterns. While large value purchases, like Peloton bikes, accounted for large portions of Affirm transactions in 2020, some BNPL companies are focused on far smaller transactions. For example, as shown in the chart below, January 2022 sales for one leading BNPL company (according to analysis by research and analytics firm YippitData) are heavily concentrated in apparel and have an average order value of just $118.[26]

Figure 4: Example of BNPL consumer spend categories (Jan 2022)[27]



While determining sustainable versus unsustainable consumer spending by category is a much larger question, it is important to note that high value single purchases do not dominate most BNPL company transactions. It is also noteworthy that some BNPL products are used primarily as revolving credit for basic goods, which raises concerns from a risk management perspective.

The findings of the consumer rationale survey above (Figure 3) help us separate new market efficiencies from potential consumer exploitation. Consumers who use BNPL because they prefer the user experience to that of credit cards benefit from the alternative BNPL presents. Similarly, consumers who appreciate the structure of BNPL repayment and might otherwise

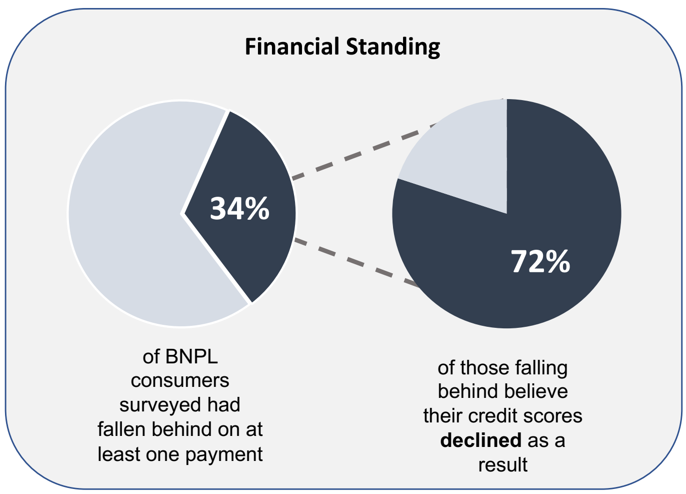
---

[24] "Annual Report 2021," *Affirm*, 2021.
[25] Morris, Malique, "Affirm is Finally Shaking Its Reliance on Peloton – And It Has Amazon to Thank," *The Information*, 3 February 2022.
[26] Proprietary data and analysis from YipitData, https://www.yipitdata.com/.
[27] Proprietary data and analysis from YipitData, https://www.yipitdata.com/.

allow credit card debt to accumulate can also immediately benefit from BNPL. Timing alignment of credit payments with payroll (i.e., every two weeks) is also a simple but powerful characteristic of many BNPL products. Of course, innovation in timing of credit payments comes with challenges. If consumers make multiple BNPL purchases across multiple BNPL products, it can be incredibly difficult for them to track aggregated upcoming payments.

BNPL has undoubtedly given some individuals without access to affordable credit the opportunity to responsibly purchase goods that improve their lives, while building their credit scores. Credit bureaus are increasingly including BNPL data in credit reports and have plans eventually to provide BNPL data for credit score calculations (discussed in more detail below). Additionally, most mainstream BNPL products have reasonable and clear terms. BNPL products on average offer cheaper financing than alternatives for short-term financing and roughly the same cost of financing for longer term. However, the products are so user-friendly that they induce increased spending and drive some of the same negative consumer consequences of high interest products. Surveys suggest BNPL offerings have been major drivers of financial distress. A September 2021 survey by Credit Karma revealed worrying trends:[28]

Figure 5: BNPL financial distress statistics (2021)



BNPL products are designed to provide consumers affordable and accessible financing with the best possible user experience, but these design characteristics may be the very cause of financial distress, stretching consumers' credit beyond their means.

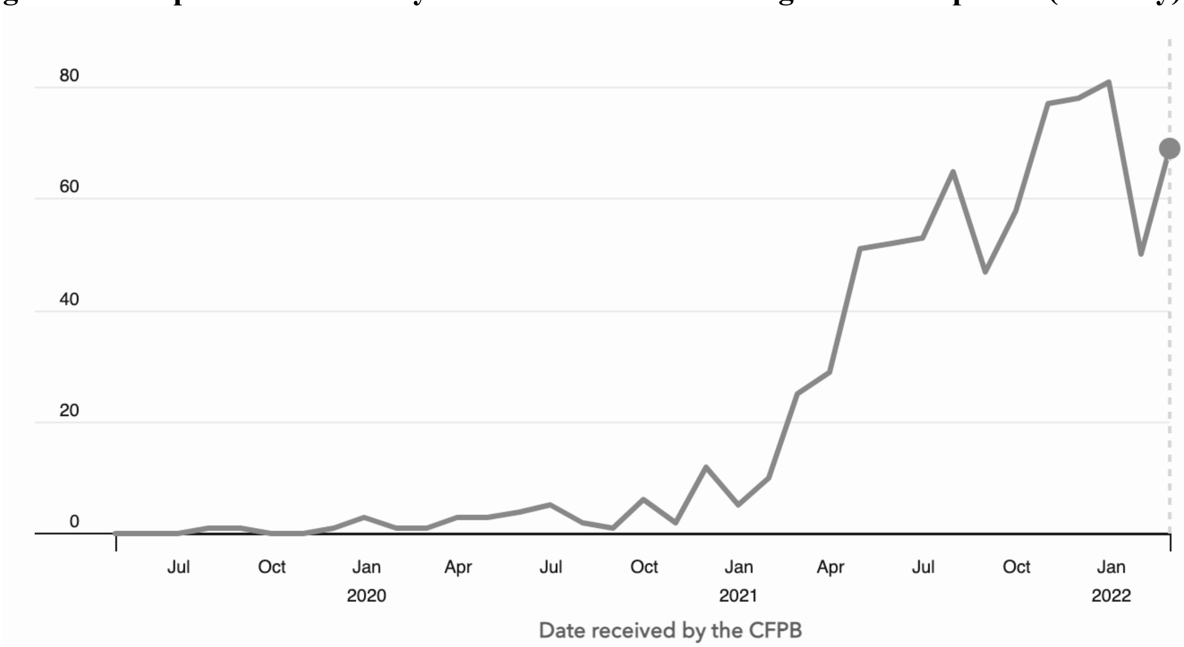
The degree to which the impact of BNPL products differs from the impact of credit card use remains up for debate. Generally, though, aggregate BNPL balances are eight times smaller than credit card balances (roughly $125 and $1,100 respectively likely due to shorter tenure of and more limited uses of BNPL products) so are far more manageable for most consumers.[29]

---

[28] "Buy now pay later surges throughout pandemic, consumers' credit takes a hit," *Credit Karma*, 9 September 2021.
[29] "Buy Now, Pay Later, Consumer Preference and Collections Outlook," *TrueAccord*, 2021.

Delinquent credit repayment rates are also substantially higher for BNPL than for credit cards: three times higher at 30 days past due and two times higher at 90 days past due.[30]
Finally, the number of complaints filed to the Better Business Bureau and CFPB for BNPL remains lower than for many other consumer credit products – although reported issues with BNPL have increased over the past two years, likely driven by the increased volume in BNPL transactions overall.[31] The highest frequency complaint issue categories include “incorrect information on your report” and “attempts to collect debt not owed.”[32] A large volume of the complaints under these issue areas can be traced back to some kind of fraud or identity theft. According to CFPB data, company responses to these complaints were for the most part timely: companies provided a timely response for over 96% of the complaints from April 2021 to April 2022.

Figure 6: Complaints received by the CFPB for four leading BNPL companies (monthly)[33]



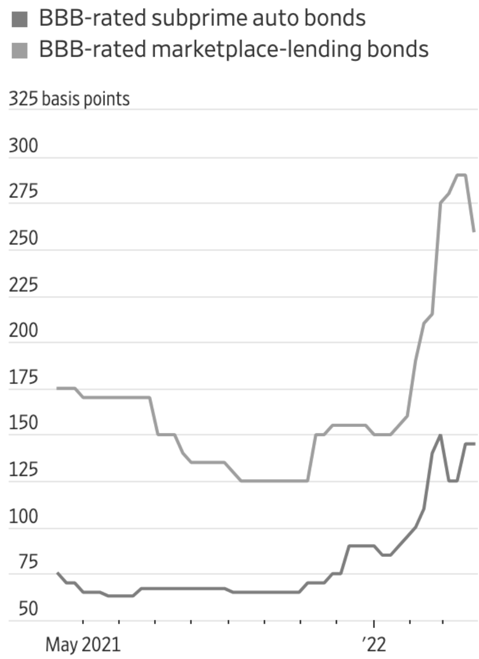
The societal price of broader access to credit in the short-term may be additional financial distress in the long-term, but these effects today may not be all that different quantitatively from the distress presented by credit cards. The concern, though, is more about what those effects will be in the future.

To what degree could broader market dynamics compound the financial distress of some BNPL consumers? A recent article from *The Wall Street Journal* calls attention to the impact of

[30] “Buy Now, Pay Later, Consumer Preference and Collections Outlook,” *TrueAccord*, 2021.
[31] Fitzgerald, Kate, “CFPB urged to act quickly on buy now/pay later loans,” *American Banker*, 15 March 2022.
[32] “Consumer Complaint Database,” *Consumer Financial Protection Bureau*, April 2022.
[33] “Consumer Complaint Database,” Consumer Financial Protection Bureau, April 2022.

inflation and slowing growth on bonds backed by consumer debt.[34] Subprime auto bonds and subprime credit card bonds now have the highest premiums since mid-2020.

Figure 7: Yield premium over interest-rate benchmarks[35]



Source: J.P. Morgan

This is concerning, the article warns, because "bond sales have become especially important for funding loans to lower- and middle-income consumers," for example, "bond issuance backed by the type of loans made by Affirm and Upstart almost doubled to about $18 billion in 2021."[36]

Finally, the article mentions increased short interest for consumer finance companies – "Short interest as a percentage of shares outstanding has tripled for Upstart to about 15% and almost doubled for Affirm to 6%, according to data from S&P Capital IQ."[37]

While yield premiums on bonds and short interest represent short-term patterns, they nonetheless suggest the market's apprehension about the future of some subprime credit products, including BNPL.

---

[34] Grossman, Matt, and Matt Wirz, "Investors Turn Cautious on Consumer Debt," *The Wall Street Journal*, 11 April 2022.
[35] Grossman, Matt, and Matt Wirz, "Investors Turn Cautious on Consumer Debt," *The Wall Street Journal*, 11 April 2022.
[36] Grossman, Matt, and Matt Wirz, "Investors Turn Cautious on Consumer Debt," *The Wall Street Journal*, 11 April 2022.
[37] Grossman, Matt, and Matt Wirz, "Investors Turn Cautious on Consumer Debt," *The Wall Street Journal*, 11 April 2022.

BNPL Market Overview

As of March 2022, the U.S. BNPL market is dominated by a few disruptor fintech companies and Big Tech companies that have developed or acquired BNPL solutions. In response to the rise of BNPL, some banks and credit card companies have introduced installment plans for specific products like 'Pay It Plan It' from American Express and 'My Chase Plan' from Chase. However, the true innovation of BNPL is an overhaul of the user experience of POS financing, and these bank and credit card company originated solutions are largely focused on flexibility in post-sales repayment.

Although BNPL activity is currently the purview of a few new, big players, well-established organizations in adjacent businesses are actively developing new BNPL products. Visa and Mastercard both launched BNPL products in the last year. Additionally, Apple is working with Goldman Sachs to provide a BNPL product for Apple purchases. Similarly, Citizens bank launched Citizens Pay to provide BNPL services for merchants including Microsoft and BJ's.

Traditional consumer banks have for the most part opted to engage with BNPL only through partnerships or as clients — or have stayed away entirely. Some banks have even actively pushed back against BNPL players; last year Capital One stopped customers from using their credit cards to clear any BNPL debt.[38] Banks could be keeping BNPL products at arms-length for a variety of reasons: some are undoubtedly waiting for more regulatory certainty, and some are still exploring various products to ensure value maximization for new and existing customers. A CEO of a major U.S. bank we interviewed commented, "My customers are simply not asking us for BNPL products. If they were, we could launch a BNPL product in a month."

Regulatory environment and self-regulation

Banks aren't the only actors troubled by BNPL uncertainties. In December 2021, CFPB issued an *Order to File Information* that expresses concern about BNPL's contribution to unhealthy consumer debt accumulation, BNPL companies' engaging in regulatory arbitrage (by designing products that technically are not credit despite functioning for consumers much like credit), and BNPL companies' data harvesting practices.

In the United States, most BNPL products currently have no formal standards for disclosures to consumers at the POS regarding fees, amounts owed, credit reporting, payments, or due dates.[39] In this period of regulatory uncertainty, BNPL companies can rapidly expand operations while avoiding some of the administrative burdens of adhering to consumer protection regulations. For example, credit card companies must maintain large customer support teams to resolve charge disputes; BNPL companies, as installment loan providers, are currently exempted from this obligation. In the absence of self-regulation in the United States, though, regulators should

---

[38] Hrushka, Anna, "Can banks win in the booming buy-now-pay-later space?," *Banking Dive*, 2 March 2021.

[39] Geron, Tomio, "'Buy now, pay later' is booming. But companies are facing pressure to change," *Protocol*, 28 November 2021.

engage where necessary to protect consumers. Such regulatory responses are already underway in some markets: in 2021 the UK's Financial Conduct Authority extended to BNPL products all the rights and protections afforded to regulated forms of credit, and the Australian Finance Industry Association developed a BNPL code of conduct following a Senate inquiry.[40]

In an attempt to preempt and/or prepare for a similar response in the U.S., major BNPL companies have begun self-regulation efforts. However, many companies appear to be pushing for self-regulation that conforms to their own pre-existing product features and business practices. Companies without late fees have advocated for a ban on late fees, and companies who always check for creditworthiness have called for compulsory credit worthiness checks.[41]

Credit reporting is perhaps the most significant area of regulatory concern. TransUnion and Experian will soon include BNPL data on credit reports, but Experian stated in a press release that to protect consumers in the short-term, "…detailed information related to each BNPL transaction will be stored separately from Experian's core credit bureau data."[42] TransUnion is working with both FICO and VantageScore to determine how best to include BNPL data in future credit score models.[43] Equifax has immediate plans to feed BNPL data to credit scores (but will allow BNPL companies to choose how to report the data). This trend toward BNPL data inclusion by credit bureaus will undoubtedly help generate scores for consumers without credit history and help build credit for consumers with existing weak credit. However, the reporting trend also exposes consumers to potential for damage to credit scores (especially if issuances of BNPL credit are considered single installment loan accounts that are quickly opened and closed, and if consumers simply don't understand the impact of certain credit behaviors). Inclusion of BNPL data in credit reports and credit scores warrants increased regulatory scrutiny. A leading risk manager we spoke with expressed doubt about underwriting BNPL even with better inclusion of data by credit bureaus, "I don't know how to evaluate the risk of consumers anymore. The presence of BNPL in a consumer's portfolio isn't clear to me, nor do I understand their total debt burden. I'm unsure how credit bureaus' actions will improve this."

Recommendations for BNPL regulations and public policy

While many efforts to self-regulate are commendable, they are inadequate for holistic consumer protection. BNPL regulations are almost certainly necessary. The size and rapid growth of the BNPL market and the fact that BNPL has not yet gone through a credit cycle makes some oversight all the more important to prevent a mini-crisis, especially in such an uncertain economic environment. A pro-consumer and pro-business regulatory framework can retain the added convenience and structure of BNPL offerings while reducing the frequency of late

[40] Geron, Tomio, "'Buy now, pay later' is booming. But companies are facing pressure to change," *Protocol*, 28 November 2021.
[41] McAllister, Kevin, "What kind of regulatory move could have the biggest effect on the BNPL market?," *Protocol*, 4 October 2021.
[42] "Experian's industry-first buy now, pay later bureau will protect consumer credit scores and provide real-time insights to drive more inclusive and responsible lending," *Experian*, 27 January 2022.
[43] "BNPL loans will soon be on your credit report: Here's what you need to know," *CNBC*, 17 March 2022.

payment fees, decline in credit scores, and defaults. Such a framework will need to focus on increasing transparency for consumers, investors, and merchants while potentially limiting the scope and scale of subprime lending. Given the innovative and unfamiliar nature of BNPL products, a policy response may also require proactive consumer education.

Existing Federal statutes have relevance and potential applications for BNPL products, should regulators decide to apply them (see Appendix for details).[44] Five sets of interventions could help resolve major consumer protection issues and align BNPL practices with existing relevant statues. These illustrative interventions represent the larger themes across which regulatory and/or policy actions are needed rather than concrete modifications to regulation or law.

1. **Mandatory fees and rights disclosure at point-of-sale**: visible disclosure of the retail price, the price if using the BNPL without late fees, and the price if using BNPL with late fees applied; in the absence of new regulatory protections, visible disclosure of the difference in consumer protection laws between BNPL and the user experience of the products BNPL may imitate (like credit cards). Most BNPL products already have some form of proactive fees disclosure; however, standardized presentation of the real implied cost of finance could help reduce overspending, defaults on credit, and the associated financial distress for consumers. Hidden late fees or misleading and/or confusing POS user experience may be deemed unfair and/or deceptive and may already be in violation of the Unfair, Deceptive, or Abusive Acts and Practices (UDAAP) under section 1036 of the Dodd-Frank Act as well as the Unfair or Deceptive Acts and Practices (UDAP) under Section 5 of the Federal Trade Commission (FTC) Act. The CFPB also expresses concern in its probe that the user experience of BNPL products feels similar and sometimes almost identical to the user experience for credit cards but lacks all the public protections applied to credit cards. The similarity in user experience may mislead consumers, giving them a false sense of security and leading to misunderstandings about their rights. Perhaps most importantly, as BNPL companies engage with credit bureaus, they should disclose at POS how use of their products may affect their credit history and credit scores. The impact on consumers of reporting to credit bureaus could be long-term and substantial (whether positive or negative), so consumers unfamiliar with the relationship between their credit behaviors and long-term credit report need to be made aware.

2. **Credit bureau reporting standards**: requirement that BNPL companies report repayment and defaults to bureaus (even if they choose not to check credit scores prior to lending). While all major credit bureaus have developed or at least have begun to develop standards for receiving BNPL credit data, BNPL companies are only reporting such data voluntarily. Articulation of and enforcement of clear reporting standards could help consumers with low or no credit scores use BNPL products to build credit scores and improve access to affordable finance. While credit scores are in many ways designed to help prospective lenders make assessments of risk, they also serve as a feedback mechanism for consumers. Reviews of some BNPL product mobile applications suggest many consumers have limited understanding of why they have been denied access to a BNPL "loan." Thoughtful incorporation of BNPL products into the credit bureau

[44] Julian Alcazar and Terri Bradford, "The Appeal and Proliferation of Buy Now, Pay Later: Consumer and Merchant Perspectives," *The Federal Reserve Bank of Kansas City*, 10 November 2021.

reporting infrastructure can prevent a future lending landscape highly affected by BNPL products with authority to make credit decisions without justification or feedback. Productive credit bureau reporting standards can increase transparency for consumers and contribute to consumer financial literacy.

3. **Data privacy standards**: requirements for use of alternative data in targeting customers, making credit decisions, and revenue generation. BNPL use of payment history data collected from customers over time is of immediate concern to the CFPB. The CFPB probe calls special attention to the increased competition for growth and profitability in the BNPL space and the likely implications for business model evolution toward data monetization.[45] While all lenders have transaction and payment data, the CFPB (in its public BNPL inquiry) expresses concern about how little is known regarding BNPL intended use of this data and its implications for consumers. Development and enforcement of data use reporting standards can shed light on the real risks created for BNPL consumers and suggest potential interventions required to lessen these risks. While the U.S. market may never be fully aligned with General Data Protection Regulation (GDPR) standards of the EU, U.S. regulators may still react to acute data privacy problems like those presented by BNPL companies.

4. **Services and/or charge dispute settlement procedures:** means of settling disputes for unauthorized charges, incorrect charge amounts, charges for goods and services not accepted by the consumer or not delivered as agreed, etc. Currently the Fair Credit Billing Act (FCBA) facilitates the dispute process for consumers with "open end" credit accounts.[46] This law was developed to solve many of the issues consumers face when incorrectly charged for goods and services, but it does not apply to installment contracts, including BNPL. An addendum to the FCBA to include BNPL, classifying BNPL as loans unless explicitly functioning as direct debit, could help consumers of BNPL receive the same protections as consumers of credit cards and revolving charge accounts. CFPB complaint reports and reviews of BNPL products in App stores reveals a not inconsequential volume of consumer challenges with dispute resolution. As noted above, BNPL companies respond to formal CFPB complaints in a timely matter 96% of the time. As BNPL companies scale, though, a level playing field for dispute resolution procedures could benefit companies and consumers. Also, as BNPL use increasingly feeds into consumer credit ratings, the need for application of FCBA to BNPL becomes more important.

5. **Stress testing protocols:** While a credit crunch in BNPL today may be unlikely to cause an economic crisis given the tenure and per person volume of BNPL lending, the growing breadth of uses for BNPL and increased use by particular consumer segments could expose BNPL companies and their customers to significant risk in the near future. Stress testing protocols can help BNPL companies better understand where there may be major vulnerabilities. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Reserve and the FDIC supervise annual stress tests for

[45] "Consumer Financial Protection Bureau Opens Inquiry into "Buy Now, Pay Later" Credit," *Consumer Financial Protection Bureau*, 16 December 2021.
[46] "Disputing Credit Card Charges," *Federal Trade Commission, Consumer Information*, August 2012.

qualifying financial institutions.[47] Many major financial institutions that are not required to conduct stress tests under Dodd-Frank nonetheless conduct stress tests voluntarily. BNPL companies can partner with the FDIC and CFPB to develop stress test scenarios and voluntarily engage in stress testing on an annual basis to reduce risk to consumers and to the economy more broadly. Mandatory stress testing may be wise until the market has matured and BNPL has been through a credit cycle. As noted above, the BNPL segment is composed of a variety of financial products, with variation in duration of exposure and total volume of credit issued per consumer. Pay-in-4 products will likely need different stress testing protocols from longer duration installment loans. A comprehensive framework for BNPL stress testing can articulate the testing protocols needed to reduce consumer risk exposure for each of the various BNPL product types.

Conclusion

A few regulatory interventions can help BNPL products continue to create value for merchants, consumers, and the financial system while protecting those most vulnerable consumers.

- **Mandatory fees and rights disclosure at point-of-sale** can help consumers understand the real cost of BNPL financing and make clear that BNPL products lack the consumer protections of similar products, like credit cards.
- **Credit bureau reporting standards** can help BNPL permanently improve consumer access to finance while increasing accountability for both consumers and lenders**.**
- **Data privacy standards** can protect consumers from exploitative use of data as some BNPL companies struggle to generate profit through monetization of new consumer data.
- **Services and/or charge dispute settlement procedures** can help eliminate a large volume of current BNPL consumer complaints and provide a more even playing field for credit cards and BNPL products.
- **Stress testing and stress scenarios** can help improve understanding of the potential impact of an economic shock. This is especially important given the uncertain economic outlook and the expiration of COVID-era public funding for income support.

While many BNPL companies have already or plan to implement changes to their products aligned with the recommendations above (in what could be considered an effort to self-regulate), legitimate oversight from the public sector is necessary to protect consumers in the long-term in a sector with so many remaining uncertainties. The CFPB is already engaged in efforts to better understand the impact of BNPL on consumers and, eventually, intervene as needed. Additional support for the CFPB (from policymakers and the BNPL companies themselves) can expedite this process and reduce potential harm to BNPL consumers in the near-term. Given the rapid adoption of BNPL products in the U.S. and the considerable potential for harm to consumers, near-term consumer protection is essential.

---

[47] "Principles for Development and Distribution of Stress Test Scenarios," *FDIC Law, Regulations, Related Acts*.

Appendix

Figure A: U.S. statutes with anticipated BNPL regulatory implications[48]

Statute	Summary	Relevance
Equal Credit Opportunity Act (ECOA), Regulation B	Creditors may not discriminate against an applicant in any aspect of a credit transaction based on (1) race, color, religion, national origin, sex, marital status, or age; (2) the fact that all or part of an applicant's income derives from a public assistance program; or (3) the fact that an applicant has in good faith exercised any right under the Consumer Credit Protection Act (CFPB 2013)	Use of alternative data to make credit decisions may be in violation of this statute.
Fair Credit Reporting Act (FCRA)	FCRA promotes the accuracy, fairness, and privacy of information in the files of consumer reporting agencies such as credit bureaus, medical information companies, and agencies that screen check-writing histories or rental history records (FTC 2018)	Increased clarity on credit bureau reporting standards may be required to meet fairness requirement.
Gramm-Leach-Bliley Act (GLBA)	GLBA "provides a framework for regulating data privacy and security practices in the financial services industry." The framework emphasizes "(1) privacy standards that impose disclosure limitations on financial institutions concerning consumers' information and (2) security standards that require institutions to implement certain practices to safeguard the information from unauthorized access, use, and disclosure" (CRS 2019)	Data security standards specific to BNPL products may be required.
Truth in Lending Act (TILA), Regulation Z	Concerning open-ended credit, Regulation Z contains rules on account-opening disclosures and periodic statements and sets forth special rules that apply to credit card transactions, treatment of payments and credit balances, procedures for resolving credit billing errors, annual percentage rate calculations, and advertising. Regulation Z also includes rules that apply to credit and charge card application and solicitation disclosures. Institutions must comply with all requirements of Regulation Z, including when disclosing any fees or charges for debt cancellation and debt suspension plans (CFPB 2021).	Regulators need to determine how Regulation Z applies to BNPL.
Unfair, Deceptive, or Abusive Acts and Practices (UDAAP) under section 1036 of the Dodd-Frank Act	It is unlawful for any provider of consumer financial products or services or a service provider to engage in any unfair, deceptive, or abusive act or practice (CFPB 2021).	Hidden late fees or coercive POS user experience may be deemed unfair, deceptive, and/or abusive.

[48] (Statue and Summary columns copied verbatim from source)
Julian Alcazar and Terri Bradford, "The Appeal and Proliferation of Buy Now, Pay Later: Consumer and Merchant Perspectives," *The Federal Reserve Bank of Kansas City*, 10 November 2021.

Unfair or Deceptive Acts and Practices (UDAP) under Section 5 of the Federal Trade Commission (FTC) Act	UDAP prohibits "unfair or deceptive acts or practices in or affecting commerce." This prohibition applies to all persons engage in commerce, including banks (FTC 2016).	Hidden late fees or coercive POS user experience may be deemed unfair and/or deceptive.