eBook

Buy Now Pay Later: *Risks and Regulatory Drivers*

GLASSBOX

Introduction

Buy now pay later (BNPL) products offer consumers a means of purchasing goods and services in installments, allowing for the cost to be spread over a defined period. The BNPL market has seen a huge uptake in demand in recent years with the Covid-19 pandemic and cost of living crisis driving this. Take up of BNPL in 2021 in the UK accelerated with 18% of Britons claiming they had used a form of BNPL product (source). BNPL also spiked in the US following the Covid-19 pandemic, while Black Friday and Cyber Monday saw BNPL used more than expected (source).

BNPL products are not only offered by companies such as Klarna and AfterPay.Technology giants have also entered the market, with Apple launching Apple Pay Later and retail firms offering their own "in-house" version of these products. Because these products do not charge interest as such, they have largely fallen outside the scope of the regulators. The issue featured as a major concern in the Woolard review and, since then, the risk from these products has increased dramatically as the cost of living crisis has seen consumers diverting more of their income to paying for essentials and looking to other forms of credit.

As the demand for these products increases, considerable concerns have been highlighted on both the supplier and consumer side. For firms, these challenges include higher default rates on loans via onboarding 'risky' customers. For consumers, these risks relate largely to affordability concerns, manifesting in high, sometimes 'unmanageable' levels of debt.

As a result of these emerging issues, regulators are beginning to develop their responses. BNPL products are interest-free and so typically fall outside the normal processes for providing credit and corresponding affordability checks. Therefore, regulators are concerned about the risk of customers racking up large amounts of debt. It is easy to imagine how BNPL might develop into the next PPI scandal, with products being mis-sold to consumers who cannot afford their fees.

This eBook will focus on the challenges BNPL poses to consumers and firms and the regulatory response. We will then examine how these regulatory developments will impact firms and consumers. Particular focus will be given to the UK and US, although BNPL products are a global phenomenon. We will look at how firms could put in place solutions that could provide greater insight into the behavior of customers who are using these products. We will then look at ways firms can evidence they have given customers the essential information to understand the nature of the product as well as being able to prove that customers were given the information in the event of complaints or some form of past business review being necessary.

Risks and Challenges of BNPL

Affordability concerns
BNPL can give the impression that goods and services are cheaper, as payments are not made immediately. This has led to some customers taking on more debt than they can afford and defaulting on their loans. Klarna has recently experienced this, seeing defaults on their loans double in 2021. With consumers currently able to use multiple BNPL providers' services, individual provider credit limits are rendered meaningless.

Consumer awareness
Currently, there is insufficient information for customers to fully understand the implications of BNPL. Consumers often use BNPL services simply because it is available to them; 24% of BNPL users spent more than they planned because BNPL was available at checkout. Indeed, 84% of BNPL consumers in the US have experienced late fees as a result of late payments. To make more informed decisions, consumers need to be made aware of the consequences of BNPL usage, including late fees and repayment periods.

Credit ratings negatively impacted
BNPL providers do not report back to credit rating agencies on whether consumers pay their debts on time and in full. Consequently, it is difficult to get a fully accurate picture of the credit position of consumers using BNPL products. have experienced late fees as a result of late payments. To make more informed decisions, consumers need to be made aware of the consequences of BNPL usage, including late fees and repayment periods.

Regulatory uncertainty

Regulators must be clear on how they categorize and interpret BNPL. For example, the FCA recognizes that BNPL can be beneficial as a way of balancing finances but also presents risks of debt accumulation. The UK is clear that BNPL products can be categorized like traditional loan companies. Conversely, the US Consumer Financial Protection Bureau (CFPB) is unsure how to categorize BNPL firms; they are uncertain as to whether to treat them like traditional loan companies and therefore be subject to more vigorous affordability and suitability checks.

How are regulators responding to these risks and challenges?

Across the world, regulators are beginning to recognize the risks and challenges associated with BNPL. However, regulators have different views on the market, as evidenced by the different stages of regulatory framework development. The FCA is one of the most proactive regulators in this space with plans to bring BNPL products under their remit. The US is behind the UK but has begun proceedings to improve market understanding. The EU has opted against regulating BNPL products, demonstrating a clear distinction in interpretation.

The UK's regulatory approach

The UK's approach to regulating the BNPL market has been largely shaped by the Woolard Review, released in 2021. The review revealed some key findings regarding BNPL risks:

- **Affordability**
  BNPL providers complete only 'soft' checks, often focusing on credit risk to the provider rather than the consumer. This presents a danger of high level debt accumulation to the consumer.

- **Lack of consumer awareness**
  Consumers are given insufficient information from BNPL providers to make informed decisions. Consequently, consumers are not always aware they are taking on debt, or the implications of late payments.

The Woolard Review concluded that BNPL products need to be brought under the regulatory scope of the FCA, with suggestions this will happen by 2024. But with the cost of living crisis, increases in the cost of borrowing and inflation now topping 10%, the issue is likely to get worse in the short term.

Proposed regulatory requirements

Following the Woolard Review, the FCA released its proposed regulatory requirements:

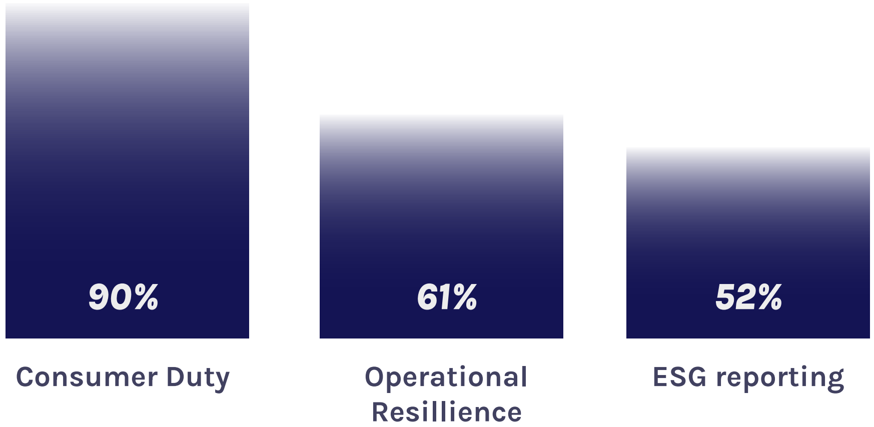
- **Onboarding affordability checks**
  BNPL firms will need to undertake affordability checks on prospective customers. This will support both consumers and firms to ensure they are lending only to customers who can afford the repayments. Affordability checks will help protect customers from accumulating debt that they may struggle to pay.

- **Ongoing affordability checks**
  BNPL firms will need to introduce robust measures to monitor affordability on a continual basis for repeat customers.

- **Advertising changes**
  BNPL firms will need to consider the impact of their consumer advertising and whether they need to comply with financial promotion regulations – including the need to maintain detailed records.

- **BNPL firms must comply with consumer protection legislation**
  Includes the Consumer Rights Act 2015, but also the FCA's new Consumer Duty which requires firms to alter their operational models and thinking to ensure that consumers are receiving 'good outcomes.' The Consumer Duty will place significant requirements on firms around the need to maintain records, monitor customer interactions with the firms' websites, undertake outcome testing to ensure that customers did not suffer harm and provide comprehensive reports to the board and the FCA.

What are the top three regulatory priorities fo your firm?



Source: How the financial services industry is preparing for Consumer Duty, EY, 2022

A recent report by EY found that firms are prioritizing the new Consumer Duty ahead of other regulatory requirements. To demonstrate compliance, firms will need to make sure they are giving customers adequate information to make informed decisions. Firms will also need robust records to evidence that the customer was given all the necessary information to make an informed decision. This requires firms to keep records of the important sessions where the product was offered to customers. Given there may well be a lag before the FCA starts to look at these outcomes, firms will need to keep records for longer to evidence that customers were made fully aware of the risks from the start.

The Woolard Review's findings demonstrate that the FCA wants to ensure that consumer interests are upheld, including ensuring that Consumer Duty is considered by firms.

The US regulatory response

Unlike the UK, the US has not yet developed a specific regulatory strategy to address BNPL. The US remains in a categorization dilemma with BNPL products as they are unclear whether to treat them as traditional loan providers.

The CFPB recognizes there are considerable risks associated with BNPL. They are suspicious of the current activities of some firms, with data and regulatory abuse key concerns. The CFPB asked leading BNPL firms such as Klarna, Afterpay and ZIP to collect information on the risks and benefits of BNPL. These findings are being used by the CFPB to shape their response.

Risks of BNPL

- **Accumulating debt**
  The CFPB is concerned there are no limits in place to prohibit customers from acquiring unmanageable levels of debt.

- **Regulatory arbitrage**
  The CFPB suspects some BNPL firms are not complying with the necessary regulatory frameworks to ensure consumer protection such as the Fair Credit Reporting Act and Dodd-Frank Act.

- **Data harvesting**
  This relates to BNPL firms using data collected from customers, such as buying patterns, and partnering with commercial brands to target these buyers.

Although the CFPB has not begun developing any significant regulatory response, it has released some suggestions for what it wants to see firms do in response to these concerns.

Proposed regulatory requirements

- **Accumulating debt**
  The CFPB has indicated that they want to see all BNPL firms adopt 'standardized furnishing codes'. BNPL firms would be required to provide consumer information that is both positive and negative to nationwide consumer reporting companies (NCRCs). Furnishing such information would enable more consistent and accurate BNPL payment information, providing a more transparent representation of the market.

- **Adaption to consumer reporting data processing**
  The CFPB wants to see consumer credit scoring agencies incorporate BNPL data into core credit files. Credit scoring models will need to be tailored to BNPL's 'unique characteristics.' Experian is set to introduce The Buy Now Pay Later Bureau which will protect consumer credit scores from negative impact and drive more responsible lending. These measures would provide greater transparency of the BNPL market and allow 'appropriate' usage of BNPL products without dampening credit scores.

These considerations will give greater protection to consumers by ensuring that BNPL firms report their data in a standardized format and cause BNPL firms to consider their response to more significant regulatory frameworks.

How will these regulatory developments impact firms and consumers?

Consumers

These developments will support consumer interests with measures, such as affordability checks helping to mitigate consumer debt accumulation. Although the US is less developed on this front, the CFPB has raised concerns about debt accumulation, indicating that some regulatory framework in the future might come out.

Consumers in the UK will be protected by the new Consumer Duty and 2015 Consumer Rights Act. The FCA's new Consumer Duty introduces significant changes to the way firms engage with consumers. Although the deadline for implementing the new Consumer Duty has been extended by up to 12 months, firms need to consider how they will comply from now. Firms will have 'to focus on supporting and empowering their customers to make good financial decisions,' while also providing consumers with information they can understand. In the context of BNPL, this will raise consumer awareness and enable better-informed decisions.

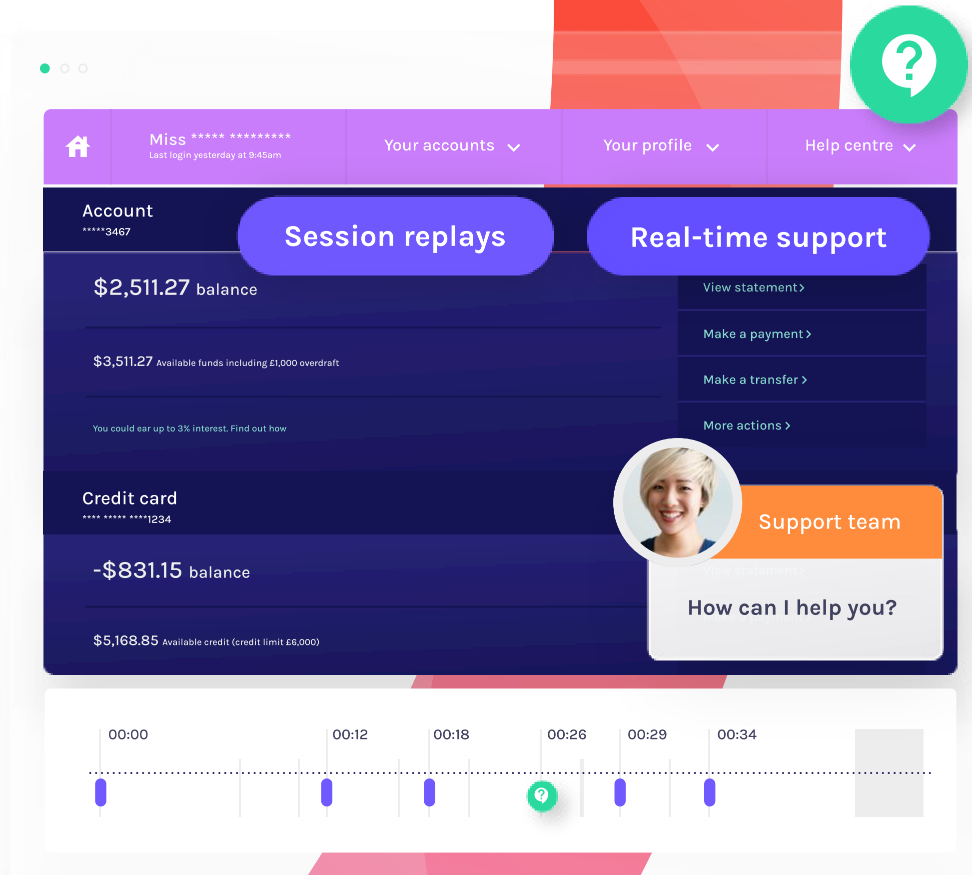
Firms

Affordability checks will require firms to introduce robust checking/onboarding of prospective customers. In both the UK and US, BNPL firms will need to be more accountable and transparent with data sharing. Firms must be more open with customers, ensuring that full information around products and services is provided. This will support firms to reduce high-risk customers accessing their products. To ensure that firms can effectively onboard customers in coherence with affordability checks, it is vital to maintain a record of digital journeys. In line with this and the FCA's new Consumer Duty, firms must adopt new measures relating to digital conduct:

- **Create and maintain an accurate record of customer activity in digital channels**
- **Identify and track any risky behaviors of customers**
- **Use new sources of information to better understand the customer experience, including voice of the customer (VoC), complaints, root cause analysis and behavioral insights**
- **Undertake outcome testing to ensure that customers are not suffering harm**

Given that the vast majority of BNPL transactions occur as part of a digital journey, firms need to look at how they manage and oversee their digital channels. Firms need to create and maintain an accurate audit trail and record of every digital journey that can be replayed as needed. They need accurate record keeping and monitoring to ensure they can investigate and resolve customer complaints, undertake real-time reviews and support potentially vulnerable customers. Glassbox can support firms in these areas through:

- **Maintaining forensic records of digital journeys that can prove exactly what happened**
- **Monitoring every session for signs of customer struggles – or simply not reading essential information**
- **Identifying customer issues**
- **Gathering and analyzing relevant information to assess the nature and extent of any issues**
- **Demonstrating clearly how the issue happened (supporting communication with the regulator)**



Closing remarks

The increasing use of BNPL products has caused regulators to consider the risks and their regulatory response. In the UK, BNPL firms will have to revamp their operations more so than in other jurisdictions to comply with significant regulatory changes, for example the Consumer Duty plus new regulatory requirements for BNPL products when they have been finalized.

Firms shouldn't wait for the regulators to make changes to the rules. They should act now and identify new technologies and digital tools which enable them to keep records of checkout processes, where customers were offered these products and monitor how customers reacted to the information provided. Firms need to be able to assess whether customers understood what they read and if not, be able to support them. Addressing these challenges acts in both firms and consumer interests and can help to prevent BNPL from creating further complexities and risks to the welfare of wider society.

Read more about how to reduce the risk associated with BNPL products on our blog: Avoid Business Risks of Buy Now, Pay Later Loans.

About Glassbox

Glassbox provides a digital experience intelligence platform designed for high-volume, data-sensitive environments. Supporting many of the world's largest financial institutions, our platform provides the most advanced capabilities to ensure compliance with ever-changing regulatory standards while also optimizing the digital customer experience.
Learn more at glassbox.com.

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