

THE CFPB AND BNPL: PERSPECTIVES ON NEW REPORT

Buy Now, Pay Later: Market trends and consumer impacts released by CFPB on 9/15/22

September 2022

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THE CFPB'S BUY NOW, PAY LATER REPORT SUGGESTS THAT BNPL FIRMS SHOULD BE SUBJECT TO FINANCIAL REGULATION AND INCREASED SCRUTINY

Background

- CFPB issued a market-monitoring inquiry into BNPL products and business practices in December 2021
- Five BNPL providers were compelled to participate and share data: Affirm, Afterpay, Klarna, PayPal, and Zip (previously Quadpay)
- The Agency sought to understand buyer and merchant experiences, benefits, and risks

Findings

- BNPL volumes have grown rapidly (10x since 2019), though unit economics are under pressure
- Three areas of risk of consumer harm were highlighted:
 1. Inconsistent consumer protections (non-standard disclosures, minimal dispute resolution rights, default opt-in autopay, multiple late fees)
 2. Debt accumulation and overextension (limited data on loan stacking, potential lack of information on total debt / ability to repay)
 3. Data harvesting and monetization (risk to privacy, security, autonomy and potential for consolidated market power for a few large tech platforms)

Why now?

- The report is a possible extension of CFPB Director Rohit Chopra's former FTC focus on data monetization and large tech consolidation (Director Chopra served as the FTC Commissioner from 2018-2021 during which he supported agency efforts to scrutinize Big Tech firm practices and strengthen FI oversight)
- The CFPB has also been scrutinizing comprehensive credit reporting to bureaus and so-called "junk fees" (overdrafts, late fees, etc.) across financial products; the BNPL report lays out several consumer risks associated with both topics
- The Biden administration has tasked financial services agencies with promoting financial inclusion and prohibiting unfair treatment / regulatory arbitrage

What's next?






















Specific to BNPL, the CFPB is:

- Working to identify and codify "baseline protection" rules that all BNPL firms must adhere to
- Reviewing data surveillance practices (what should be curtailed, how should CFPB coordinate with FTC, etc.)
- Strengthening credit reporting standards
- Crafting guidance on supervisory exams for BNPL firms (will work with state regulators to update/conduct exams)
- Updating household debt burden estimate methodology to confirm ability to repay (existing approaches exclude BNPL)

Open questions

- Will the CFPB's formal regulatory reach into BNPL be extended (through Reg Z or otherwise)?
- How does Director Chopra want to interface with the FTC? Will the CFPB pursue further regulation for embedded commerce and super apps?
- How sustainable is BNPL growth and profitability if impacted by new rules and standards?

BNPL IS OFFERED IN MANY CONSTRUCTS; THE CFPB REPORT FOCUSED ON “PAY-IN-4”

| | Card Linked Features | CFPB Focus Pay-in-4 | Off-Card Financing | Invoice | Line of Credit |
|----------------|---|--|--|--|--|
| Description | Use buyers' credit limits to create automatic installment payments with pre-auth holds equal to the remaining balance | Service that fronts funds with no interest to merchant; buyer repays in equal installments ; installments are auto-funded by credit, debit, or ACH | Fixed monthly installments , usually over 6+ months | Consumer pays for purchased item after a set amount of time | Revolving credit line for one-off transactions with min. monthly payments , which often have no-interest financing |
| Credit Check | None | No check or soft check | Soft or hard check | No check or soft check | One-time, hard check |
| Fee Model | Issuers charge fees in-app; some models have no fees | "MDR" fees to merchant and late fees to consumer; interchange revenue is shared on virtual cards | Merchant fees and interest-based fees with APR promos and penalties for missed payments | Incurs reminder or late fees, which may lead to collections | Interest-based fees incur when balance is carried |
| Select Players |     |       |      |   |     |

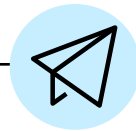
Today, BNPL is largely not considered a loan and has so far been exempt from Reg Z (no interest, fixed four installments). As such, BNPL providers do not have the same disclosure requirements, can limit credit bureau interactions, and do not need to assess a user's ability to repay. Notably, there has been significant debate as to whether BNPL should be classified as a loan (California moved to regulate BNPL firms in 2020); the CFPB's report suggests that BNPL products are loans and should be regulated.

THE CFPB'S REPORT WAS PUBLISHED AFTER INITIATING AN INQUIRY IN DECEMBER 2021



July 2021: CFPB releases a blog post with an intent to better educate consumers on BNPL product structure, benefits, and risks

- July 6th: CFPB released an article titled *Should you buy now and pay later?*
- The article acknowledged BNPL as a growing payment option since the beginning of the pandemic and highlights:
 - Ease / convenience of BNPL financing
 - Risk of overextending finances
 - Potential late fees and limited consumer protections for disputes
 - Credit reporting associated with BNPL products



December 2021: CFPB issues a series of orders to five firms (Affirm, Afterpay, Klarna, PayPal, Zip) to ascertain industry practices and risks

- December 16th: CFPB issued an official market monitoring order under Section 1022(c)(1)&(4) of the Dodd-Frank Act in compliance with Congress's mandate for the Bureau to monitor risks
- This order, due on March 1st, 2022, requested information from BNPL providers on business models, loan performance, consumer protections, user interactions and demographics, data harvesting, and data monetization



September 2022: CFPB publishes report summarizing analysis and next steps – “Buy Now, Pay Later: Market trends and consumer impacts”

- September 15th: CFPB released report synthesizing the results of the market monitoring order and 40 comment submissions from various organizations such as consumer advocacy groups, trade associations, and government agencies¹
- The report highlights BNPL interactions with users, market performance and growth, impact on consumer financial health, and risks to consumers, and proposes changes and increased regulatory oversight

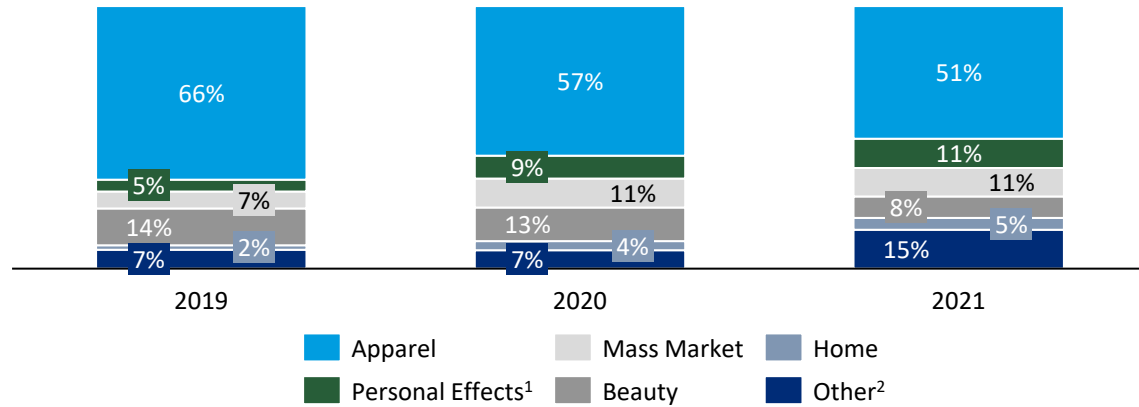
Source: CFPB. 1. The 40 comment submissions are from consumer advocacy groups (13), trade associations (12; 8 bank/credit union, 2 retail, 2 fintech), private entities (8), governmental agencies (3), academics (2), individuals (1), and unknown sources (1)

THE REPORT PUBLISHED NEW DATA ON HOW THE INDUSTRY HAS EVOLVED

Four consequential findings

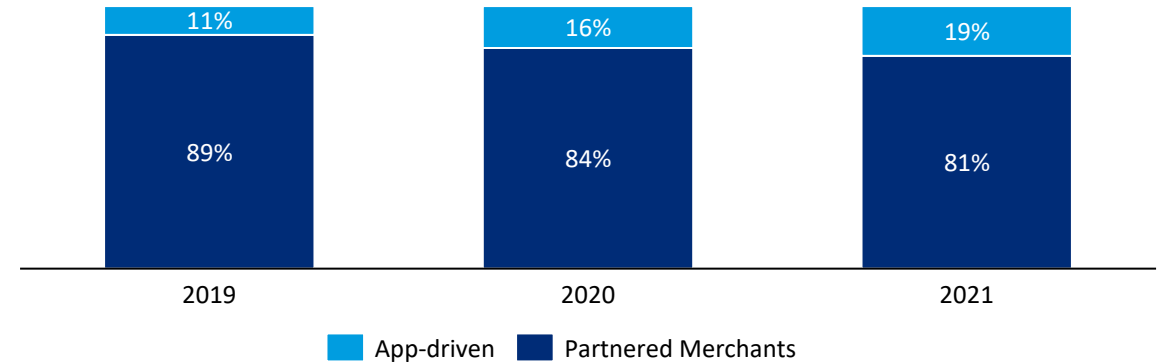
BNPL is diversifying from apparel (personal and home are two key areas)

Gross merchandise volume by industry, 2019-21



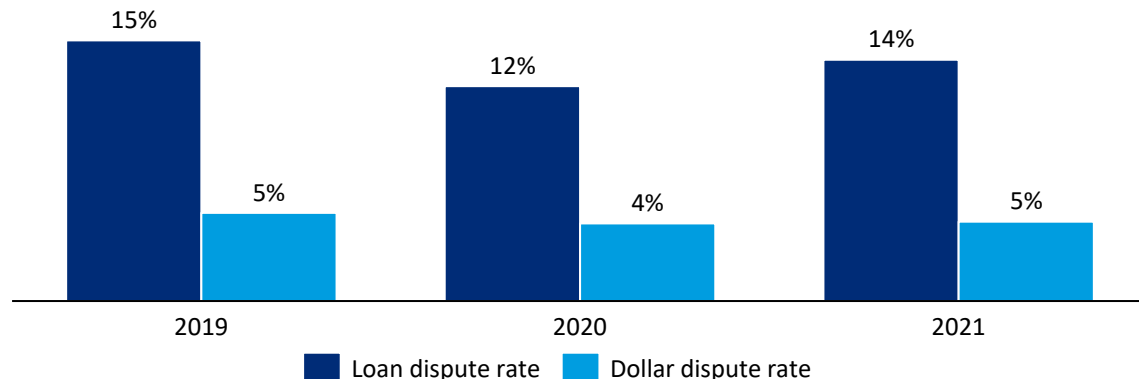
The app-driven³ model is gaining share vis-a-vis partnered merchants

Gross merchandise volume by customer acquisition model, 2019-21



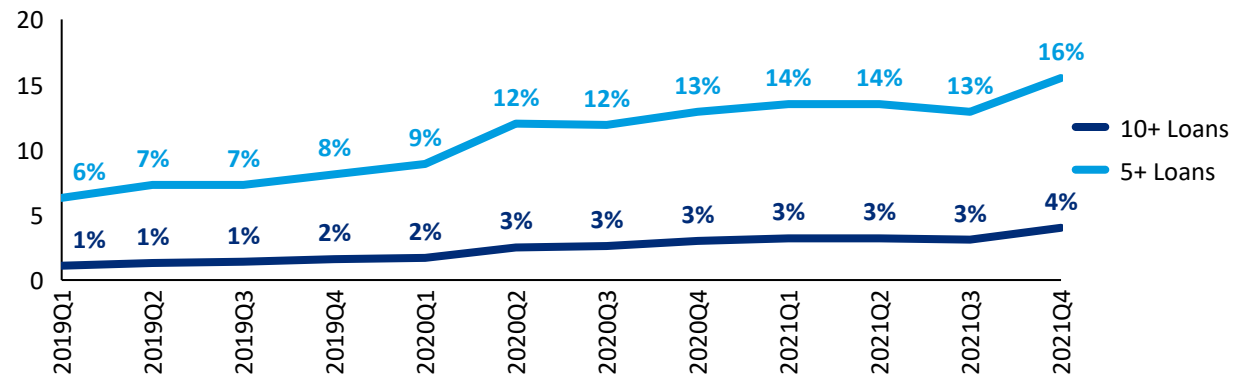
Loan and dollar dispute rates have stayed relatively consistent

Loan and dollar dispute rates, 2019-21



Proportion of loans from repeat users has increased significantly

Share of unique users with 5+ and 10+ loans, 2019-21

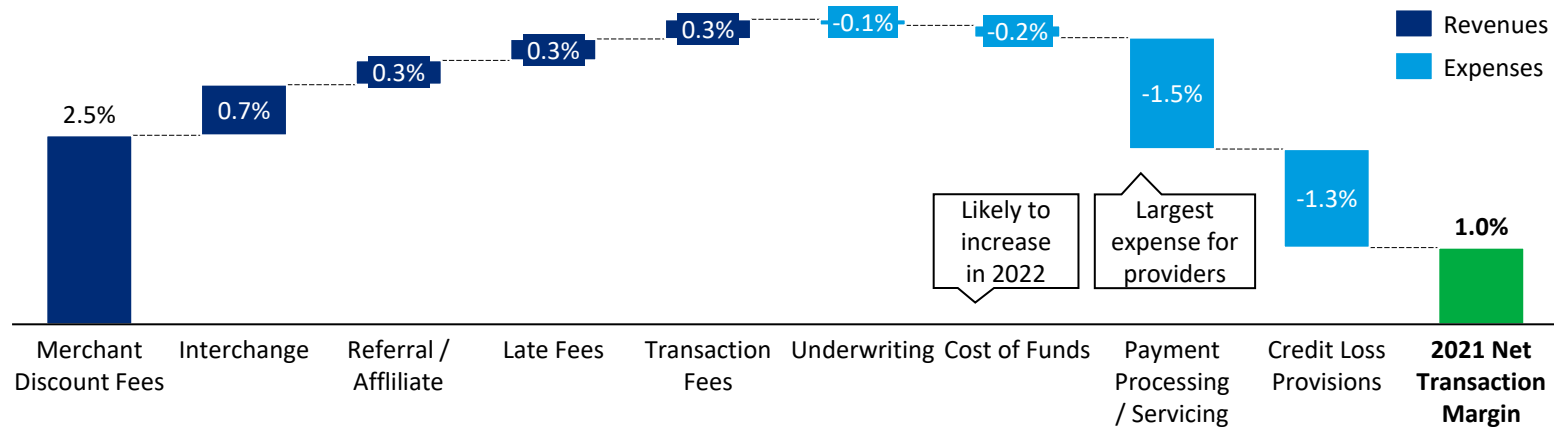


Source: Consumer Financial Protection Bureau, Oliver Wyman

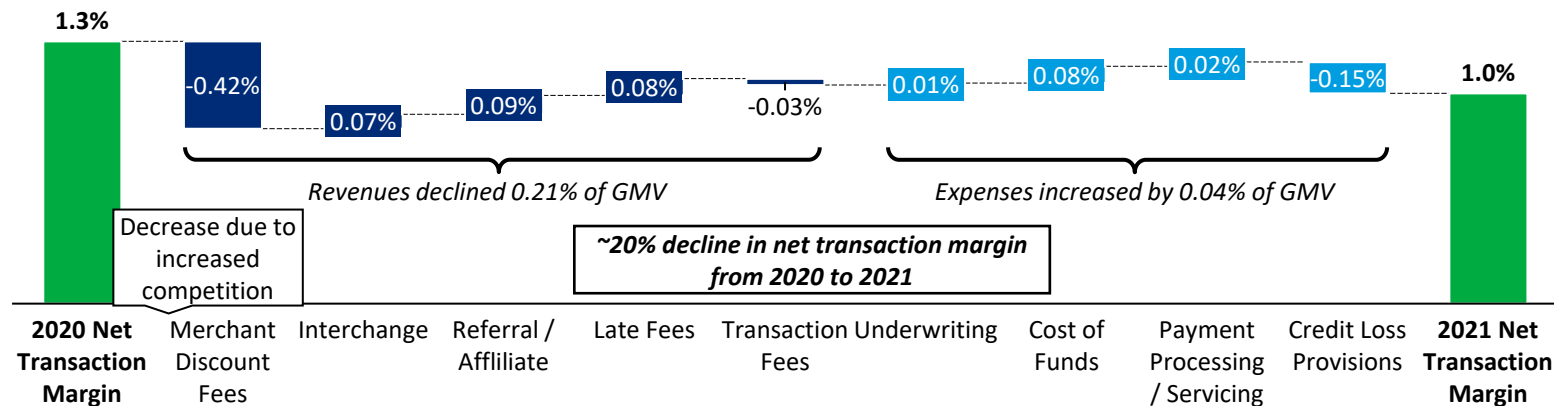
Note: Data based on US data from five BNPL providers – Affirm, Afterpay, Klarna, PayPal, Zip 1. Includes electronics, sporting equipment, jewelry, games 2. All other industries, including travel, services, automotive, health, everyday 3. partnered: BNPL providers contract with merchants to embed their service into the merchant’s checkout process, to be used by consumers; app-driven: consumers sign up directly with the BNPL provider and use the BNPL service at merchants through a virtual mall

IN 2021, MARGINS DECLINED FROM BOTH REVENUE CONTRACTION AND EXPENSE INCREASE

BNPL provider revenues and expenses, 2021
(% of GMV)



BNPL provider net transaction margin Δ 2020-21 breakdown
(% of GMV)



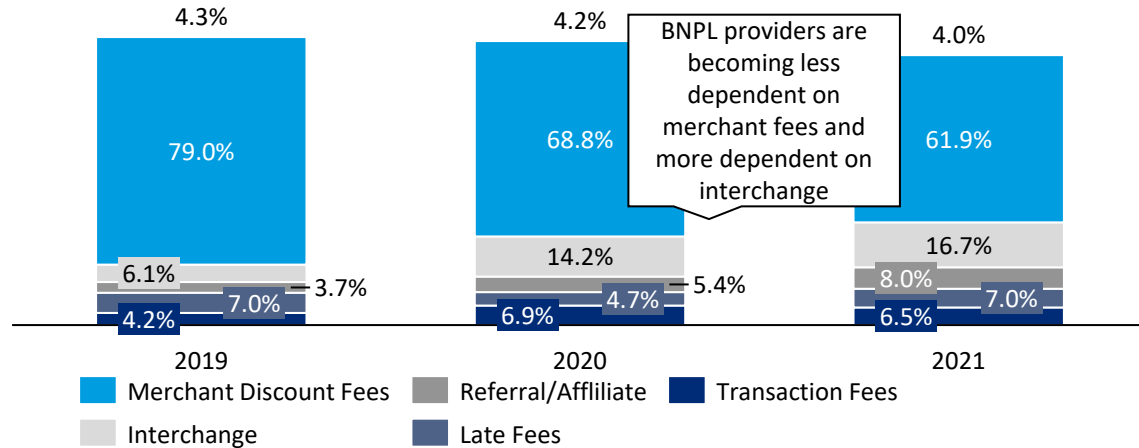
Observations

- Payment processing fees comprise the largest expense for BNPL providers
 - In 2021, 89% and 10% of repayments, respectively, were made via debit and credit card; BNPL providers have an opportunity to reduce costs by promoting more cost-effective methods such as ACH
- Cost of funds is likely to increase this year as interest rates tick up
- The decline in net transaction margin from 2020-21 is primarily due to lower revenues (revenue accounts for 84% of the decrease and expenses 16%)
 - Lower merchant discount fees resulting from higher competition was the largest driver of lower revenues
 - Higher credit loss provisions was the largest driver of increased expenses

DECLINING MARGINS DRIVEN BY LOWER MERCHANT FEES AND INCREASED CREDIT LOSSES

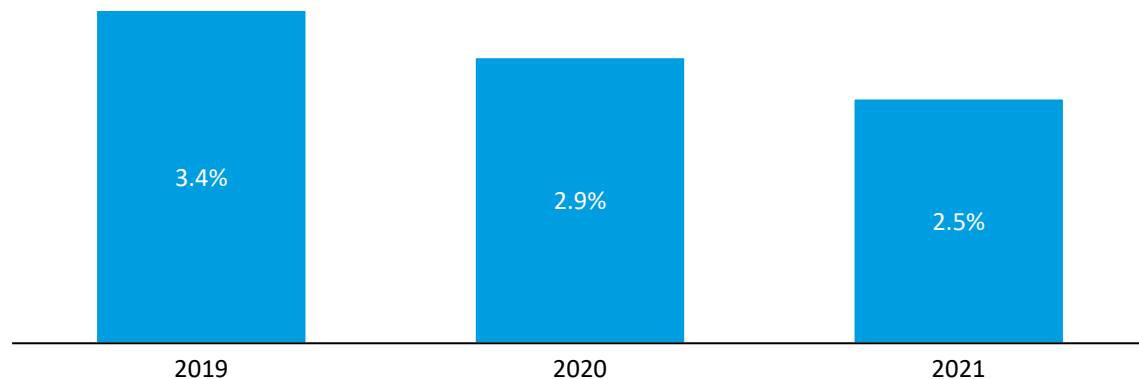
BNPL revenues have declined, driven by lower merchant fees

Revenue as a % of GMV including breakdown, 2019-21



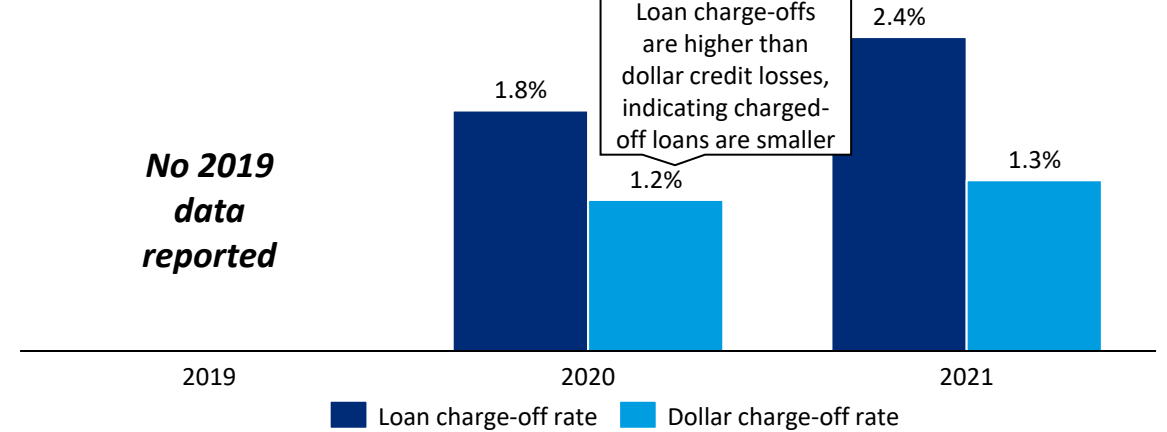
BNPL merchant fees have declined significantly

Merchant discount fees as % of GMV, 2019-21



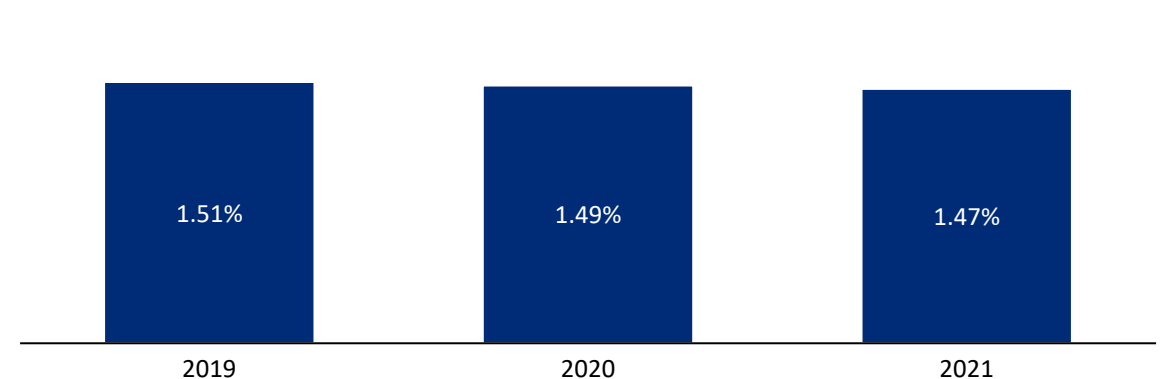
BNPL credit losses are increasing

Loan and dollar charge-off rates, 2019-21



Payment processing costs have stayed consistent

Payment processing/servicing costs % of GMV, 2019-21



Source: Consumer Financial Protection Bureau

Note: Data based on US data from five BNPL providers – Affirm, Afterpay, Klarna, PayPal, Zip

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WHAT'S NEXT?

The CFPB outlined five next steps it plans to undertake:

- 1 Codify “baseline protection” rules that all BNPL firms must adhere to**
 - Identify potential interpretive guidance/rules to ensure BNPL firms adhere to baseline protections Congress has already established for credit cards (unclear if this will be part of Reg Z)
 - Conduct outreach to investors and new BNPL market entrants to ensure “a level playing field”
- 2 Craft guidance on supervisory exams for BNPL firms (similar to exams for credit card companies)**
 - Review CFPB authority to conduct compulsory examinations
 - Work with state regulators that license nonbank finance companies to conduct exams
- 3 Strengthen credit reporting standards**

Surface options on how industry and consumer reporting companies can develop “appropriate and accurate” credit reporting practices
- 4 Update household debt burden estimate methodology**

Explore options to update methodology to include BNPL loans (reflects total picture of debt burden and ability to repay)
- 5 Review data surveillance practices**
 - Identify what data should be curtailed and by whom
 - Coordinate with the FTC and other regulators regarding inquiry into Big Tech payment systems; note: if FTC’s rules on commercial surveillance are finalized, they will be enforceable by the CFPB

Open questions

Will the CFPB’s formal regulatory reach into BNPL be extended (through Reg Z or otherwise)?

How quickly is the CFPB likely to establish and enforce rules?

Is the CFPB or other regulation likely to target other types or constructs of BNPL?

How sustainable is BNPL profitability? How does that change with the threat of regulation, if at all?

How does Director Chopra want to interface with the FTC? Will the CFPB pursue further regulation for embedded commerce and super apps?

ANY CODIFIED BNPL REGULATION WOULD LIKELY HAVE FAR-REACHING IMPACTS

Preliminary impact

Legend
 + Potential benefit
 - Risk
 ~ Neutral

| Potential impact if CFPB... | ① ② ...codifies rules for BNPL firms and guidance for supervisory exams | ③ ④ ...strengthens credit reporting standards and updates debt burden methodology | ⑤ ...reviews data surveillance practices |
|---------------------------------|--|--|--|
| BNPL firms | <ul style="list-style-type: none"> - Profitability may be burdened further by cost of compliance and/or pressure to reduce or eliminate fees + Providers without late fees today (Affirm) may be advantaged relative to competitors | <ul style="list-style-type: none"> ~ Increased visibility on creditworthiness may decrease target users, but improve loss rates | <ul style="list-style-type: none"> - Diluted value proposition if use of data is curtailed (less effective targeting via BNPL shopping malls) |
| Consumers | <ul style="list-style-type: none"> + Transparent disclosures + Lower fees + Easier refund processes | <ul style="list-style-type: none"> + Creditworthiness is more comprehensive and reduces risk of overexposure - Reduced optionality for financing (if accessibility of BNPL is reduced) | <ul style="list-style-type: none"> + Fewer breaches of personal data + Lower likelihood of discriminatory or predatory targeting |
| Merchants | <ul style="list-style-type: none"> - Streamlined return process may create overhead or increase losses (e.g., due to returned, unsellable merchandise) + Potential benefit if BNPL providers share responsibility for resolving disputes | <ul style="list-style-type: none"> - Fewer incremental sales with a weakened BNPL proposition (e.g., fewer loan approvals may create customer friction at POS) | <ul style="list-style-type: none"> - Weakening of targeting/ad effectiveness through reduced distribution/marketing channels (less promotion in BNPL malls) + Levels playing field for merchants who view BNPL marketplaces as risks/competitors |
| Issuers | <ul style="list-style-type: none"> + Lending viewed as “level playing field” again (fintechs subject to same regulatory burden) + Opportunity to launch new products that cater to this demographic (e.g., subscription credit) + More accurate credit checks prior to issuing loans (e.g., credit cards, mortgage, auto, etc.) | | <ul style="list-style-type: none"> - CFPB and FTC’s focus on embedded finance (unclear if/how regulators may take action) |
| Credit bureaus | | <ul style="list-style-type: none"> + Regulatory pressure for industry to establish and use bureau reporting services | |
| CFPB | <ul style="list-style-type: none"> + Increases optionality to work with federal and state regulators to monitor consumer financial products - Potential to face litigation from BNPL providers if proposed regulation is overreaching | | |
| FTC, other regulators | <ul style="list-style-type: none"> + Increased confidence to pursue regulatory action on advertising and set data monetization/harvesting standards | | |
| Big Tech (Apple, Google) | <ul style="list-style-type: none"> - Could be subject to increased FTC scrutiny on super apps and embedded finance plays | | |



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