

Buy Now Pay Later: a threat or an opportunity?

Visa Consulting & Analytics



The credit landscape is changing

Ecommerce (e-com) growth and technological innovation have converged to deliver transformation across the credit industry; this has opened the door for alternative payment methods including several Buy Now Pay Later (“BNPL”) options.

In this paper we offer our perspective on the rise of BNPL and its consumer and merchant appeal alongside the challenges these products and the industry face. We also outline how Visa can help you to co-create a differentiated credit solution that engages and solves for your customer’s everyday needs and addresses the ever-changing marketplace.

The COVID-19 pandemic forced more of our daily lives online, from working to grocery shopping, children’s education to socialising. Throughout this period, BNPL products continued to grow. At a time when many consumers found themselves in changing financial positions, BNPL was an appealing way to create some liquidity.



| Snapshot of the BNPL market | |
|---|---|
| Size of UK e-com market in 2020 | £120 billion in retail sales ¹ |
| Size of UK BNPL market in 2020 | £6.4 billion (5% of total e-com transaction) ² |
| UK Annual growth rate | 200-300% |
| Top global BNPL markets (% share of total e-com) | Sweden 25% Germany 20% Norway 18% Australia 10% ³ |

Although BNPL is still a relatively small share of all e-com, it is growing rapidly in the UK and between October 2018 - September 2021, showed a 200-300% year on year payment volume growth.⁴ Furthermore, estimates suggest that global spending on BNPL will reach \$995 billion in 2026, from \$266 billion in 2021.⁵ Almost \$51bn (£37 bn) of that will be in the UK. These figures put the UK on a similar growth trajectory to more mature BNPL markets such as Australia and Sweden.



1. E-commerce in the United Kingdom (UK) - statistics & facts, Statista, 11 January 2022
2. Buy Now, Pay Later in the UK, Bain & Company Inc. 2021
3. The Global Payments Report, Powering the Next Payments Frontier, FIS Worldpay, 2022
4. Visa Net data October 2018 - September 2021
5. Buy Now Pay Later, The Future of e-commerce, Juniper Research



What is driving the high rate of consumer adoption?

BNPL products appeal to consumers because they address the need for funding consumer payments in a more seamless and transparent way than traditional payment methods. Some key characteristics include:



1. Low upfront cost

BNPL gives consumers the flexibility that they need to make repayments with a frequency that works best for them. This can be useful as a financial management tool for higher value purchases.

Additionally the pricing structures are transparent and usually interest free. Late fees are charged for late payments. This appeals to consumers who want to manage their finances effectively, without increasing their debt (providing they meet the repayment terms).



2. Optionality

BNPL can appeal to groups who have previously been marginalised by traditional credit products. For example, many younger consumers don't have sufficient credit history to receive approval for traditional credit products. Historically BNPL 'soft' credit checks haven't used traditional credit bureaus to measure affordability, which would otherwise disadvantage this segment.

That said, from 1 June 2022, Klarna started sharing the BNPL purchase data of UK customers with credit bureaus Experian and TransUnion.⁶ We also expect the use of data available through Open Banking to provide a more comprehensive approach to credit decisioning, addressing one of the key criticisms of the industry. And it is worth noting the recent announcement by the UK regulator of upcoming legislation on BNPL products, with special focus on affordability checks.



3. Simplicity and Seamlessness

Online BNPL options are often introduced to the customer on the landing page and throughout their browsing experience. The ability to select a BNPL option is fully integrated into the checkout experience making it easy for consumers to select this option and therefore reducing the risk of abandonment.

Additionally, BNPL offers what can be seen as a better customer experience when compared to traditional credit solutions, including faster real-time 'soft' credit checks and an optimised, digitally native user experience tailored to e-commerce. Most providers also offer an app for BNPL users to easily manage their payments 24/7.

6. The Fintech Times, Spotlight: Klarna to Start Reporting BNPL Data to Credit Agencies, May 11, 2022



Why is BNPL popular with merchants and providers?



Merchants

BNPL has been widely adopted as an embedded finance solution across a huge range of merchants with differing target audiences and average spend. The terms and conditions vary: Harrods allow online customers to pay in three installments with Klarna, whereas ASOS currently offers the choice of three different providers - PayPal Pay in 3, Klarna and Clearpay. Having such a wide range of options improves customer experience and gives shoppers additional choices.

Delving deeper into the popularity of BNPL products with merchants, Visa conducted research with over one thousand merchants.⁷ When questioned about the key drivers for accepting BNPL, the top reasons cited were; customer convenience, customer demand, belief that BNPL could increase average spend and the desire to remain competitive.

Crucially, BNPL has also given smaller merchants an opportunity to compete to win customers that may not have shopped with them in the past. In 2021 Bain reported that more than 90% of Klarna's merchant partners in the UK are small and medium sized enterprises (SMEs) with under £2 million in annual turnover.⁸



Providers

BNPL providers can be split out into three categories:

1. Monoline BNPL providers (Klarna, Clearpay etc)
2. Traditional lenders/Incumbent banks
3. Big Tech - Apple, Block (\$29Bn acquisition of Clearpay in Jan '22)⁹, Stripe (who have partnered with Klarna)¹⁰

The BNPL market landscape is changing quickly and continuously evolving, but providers are convinced there is still space for new entrants. Recently Apple announced that in September 2022, they will enter the US BNPL market with Apple Pay Later, allowing users to pay for goods in four equal payments, without interest.¹¹ This foray into BNPL by the tech giant, demonstrates further the consumer demand for these solutions.

However, BNPL solutions are an attractive proposition for providers who benefit from:

1. Ease and low cost of customer acquisition
2. Ability to offer consumer credit when it's needed which results in greater customer engagement
3. Revenue generated (by merchant or consumer) from lending

It's clear that consumer and merchant adoption of BNPL are high but, despite this rapid growth and clear customer need, BNPL faces some challenges.

7. BNPL UK Multi-Client study, Visa RFI research, 2020

8. Buy Now, Pay Later in the UK, Bain & Company Inc. 2021

9. Afterpay's \$29 bln buyout by Block set to close after Spain nod, Reuters.com, 11 January 2022

10. Klarna partners with Stripe to help online businesses grow their revenue, Stripe.com, 26 October 2021

11. Apple Launches BNPL product, Finextra.com, June 2022



Current challenges BNPL faces

Despite BNPL's rapid growth and ability to address clear customer needs, the industry faces some serious challenges and new solutions must be developed with these in mind:

Challenge #1 Regulation

The need for responsible lending, which is underpinned by **impending regulation**, will drive change in the assessment of affordability and the distribution of lending.

- BNPL is positioned and marketed as a no interest credit option, however if payments are missed, providers will charge interest. If payments are repeatedly missed, then this may impact the consumers' credit score.
- The seamless, user-friendly customer experience can contribute to a lack of awareness on the part of the consumer that they are incurring debt and in fact are borrowing money. Younger consumers who may be digitally savvy are not always financially savvy with little understanding of the long-term implications that missed payments could have on their future.
- Customers can register with multiple BNPL providers with no central record of their various accounts. This means that the financially vulnerable could be accruing debt across several platforms.
- In 2020, BNPL customers experienced default rates of between <1% to 5%, compared with ~1% for credit cards. In that same period, 41% of BNPL users either strongly or somewhat agreed with the statement "I am worried about missing payments on my BNPL purchase," whereas only 30% agreed with an analogous statement about credit cards. When BNPL users were asked why they had first chosen this payment method, 22% stated it was because "they couldn't afford to pay for their purchase upfront."¹²
- The FCA Woolard review published in Feb 2021 highlighted that "To have a long-term, healthy market certain new credit products that are currently unregulated need to be brought within the regulatory framework as a matter of urgency."¹³ Whilst Woolard was clear that innovation in financial services can offer significant benefits to consumers, the potential harms which arise for consumers must be addressed as a matter of urgency given the current cost of living crisis.
- In order to get ahead of impending regulation, BNPL providers are enabling this shift towards responsible lending in different ways. For example, in June 2022, Klarna committed to report to credit reference agencies Experian & TransUnion.¹⁴



Challenge #2 Industry saturation

We expect that **existing business models will continue to evolve** with the rapid pace of entry of new players and market saturation will result in:

- More consolidation from existing players (e.g., PayPal (US) acquisition of Paidy (JPN) for \$2.78 bn in September 2021).¹⁵ Attempts to tackle profitability challenges could result in entrants being purchased by more established players in vertical acquisitions or more horizontal acquisitions. This could become more prevalent as valuations fall. Established companies with larger balance sheets better able to absorb the rising cost of capital, may use this as an opportunity to acquire smaller players and grow their market share.
- The entry of big tech companies (Apple) & incumbents (Issuers), while providers look to grow their customer base and diversify revenue streams (e.g., affiliate revenue) as the rising cost of capital squeezes their margins.

12. BNPL UK Multi-Client study, Visa RFI research, 2020

13. The Woolard Review - A review of change and innovation in the unsecured credit market, Financial Conduct Authority, February 2021

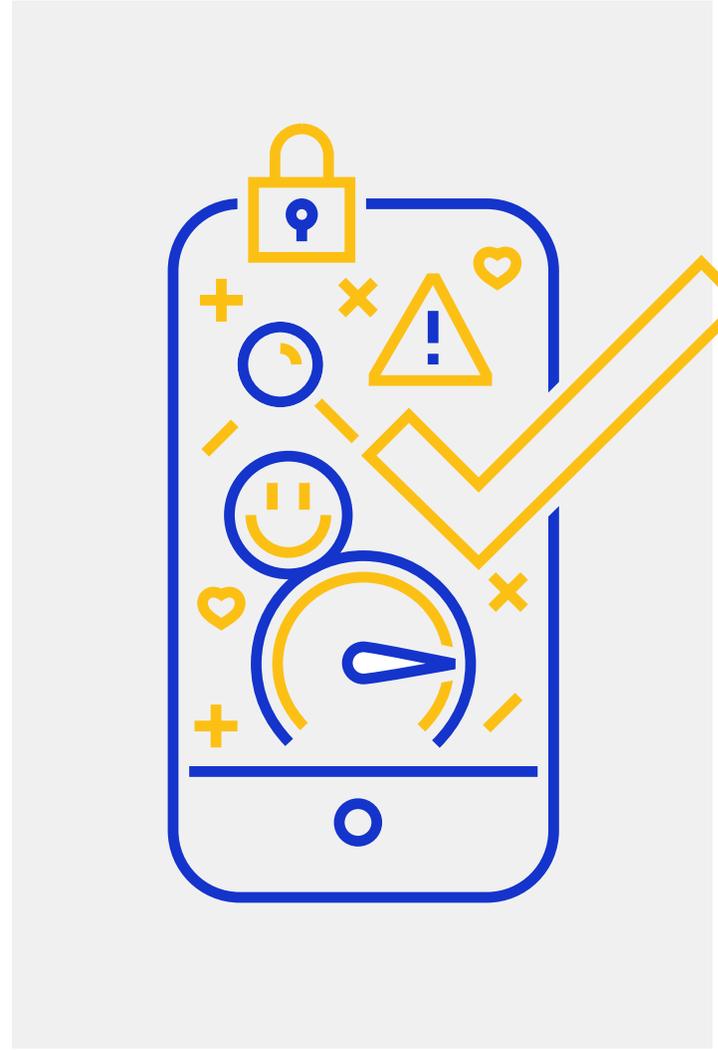
14. Four buy now, pay later firms change 'potentially unfair terms', The Guardian, February 2022

15. PayPal heats up buy now, pay later race with \$2.7 billion Japan deal, CNBC.com, 8 September 2021

Challenge #3 Macro-economic impact

BNPL providers are facing price pressures such as the rising cost of credit due to interest rate increases, which are squeezing provider margins and present a challenge for smaller providers, who are struggling to fund credit. And it's not just smaller players which are affected, Klarna announced in May 2022, it would be laying off around 10% off its workforce – some 700 employees.¹⁶ Providers are tackling these price pressures in different ways:

- Developing new business models targeting different revenue streams including affiliate revenue. BNPL providers give brands the opportunities to reach new consumers and to encourage repeat purchases through additional advertising opportunities. Bain states that 54% of merchants have their brand exposed to new customers through co-marketing activities.¹⁷
- As B2B e-com expands and grows, it makes sense for BNPL providers to diversify their offerings to target this new market. Klarna has partnered with Germany based Billie, who are the leading provider of BNPL payments for businesses.¹⁸
- Existing players are enhancing their offerings to deepen customer ties. Klarna have launched a loyalty program in nine key markets, which rewards users with points when they make on-time payments using BNPL.¹⁹ These points can be redeemed using the app for discounts at selected retailers.
- There is the potential for increased merchant power to drive down the Merchant Discount Rate (MDR) as the market gets more saturated with BNPL providers. In turn, this price pressure may result in providers looking for different revenue streams like affiliate revenue.



16. Sweden's Klarna to lay off 10% off staff as war, inflation hits business, Reuters.com. 23 May 2022
 17. Buy Now, Pay Later in the UK, Bain & Company Inc. 2021
 18. Billie and Klarna launch a global partnership, Klarna.com, 11 October 2021
 19. Klarna fuels global expansion with the launch of rewards program and Pay Now in nine new markets, Klarna, 22 February 2022



Our perspective and insight into the BNPL market

As the BNPL market adapts, providers are approaching BNPL in differing ways, addressing unmet customer needs whilst delivering a profitable solution through distinct business models.

Based on Visa marketplace research, we have identified numerous factors, which underpin the various business models:

| | |
|--|---|
|  <p>Card-linked/ off-card/ hybrid</p> | <ul style="list-style-type: none"> • Card-linked – Payments are facilitated through card networks. Uniquely, installment providers earn interchange commission. This offers potential for broader merchant/channel-agnostic distribution and acceptance of solutions. • Off-card – Interaction and relationships with merchants enable BNPL providers to leverage new payment rails. Opportunities exist to monetize the data from the two-sided merchant and consumer relationship. • Hybrid – Combined card linked and off-card models have emerged. Historically off-card-only players (e.g. Klarna) now offer card-linked methods to broaden the distribution opportunity of their solutions. |
|  <p>Merchandise ownership</p> | <p>Own and pay (e.g. Klarna) where consumers own merchandise upfront vs. rent/lease-to-own (e.g. Acima), where ownership transfers once the payment plan is complete.</p> |
|  <p>Revenue/credit funding</p> | <p>Providers have access to various potential revenue streams: fees from consumers, fees from merchants, affiliate marketing fees and interchange fees.</p> |
|  <p>Credit terms and decisioning</p> | <ul style="list-style-type: none"> • Credit terms – There are a range of APRs, eligible transaction value term durations and payment frequencies offered in the market. • Credit decisioning and extension. <ol style="list-style-type: none"> 1. For traditional card players, installment solutions work off existing credit limits on the underlying card. Some players leverage various consumer data points to extend personalised installment terms on a per transaction basis. Providers run (mostly soft) credit searches at their first interaction with the consumer, then pass through internal credit scoring models for every subsequent purchase. The internal underwriting models improve as more data is fed through. 2. For off-card, short-term, low average order value products (e.g. Klarna Pay in 4), lenders typically approve and extend credit on a per transaction basis. 3. For off-card, high average order value or longer term products, (e.g. Klarna Financing, Novuna), lenders run hard credit searches, approve and extend credit on a per transaction basis. |
|  <p>Lending and distribution options/ Go To Market</p> | <p>There are a range of different sales and distribution channels that providers can utilise to generate and facilitate sales. Additional considerations are availability across merchants, branding, financing and partnerships.</p> |
|  <p>Value chain participation</p> | <p>There are a host of activities across the value chain that various players could choose to own; and a range of different combinations and permutations of how providers choose to bundle and organise these activities to deliver their solutions.</p> |



To win in this market, providers need to focus on customer-centric business models that best fits their target segment, and aligns to their targeted business outcome and place in the customer lifecycle.

Whilst we believe a BNPL proposition solves a key unmet need for provision of credit, there are some key success factors for a profitable proposition that must be considered:

Merchant profitability

- Low cost of customer acquisition – Providers such as Klarna use Instagram friendly filters, catchy advertising slogans and access to a wide audience, results in increased visibility for merchants. This translates into more customer traffic and more purchases for little cost when compared to traditional marketing spend. For example, PayPal offers BNPL at no cost to the merchant and LayBuy only charges merchants a transaction fee with every purchase made using its service.
- Increased conversion rate – BNPL providers report a higher Average Order Value (AOV) and a lower abandonment rate compared to traditional e-com transactions. According to Accenture, Merchants that use BNPL are 30% more likely to close a sale than those that don't.²⁰
- High customer retention – BNPL offers a seamless customer experience and an affordable shopping basket which leads to more repeat purchases.
- Moving BNPL to an Omni-Channel/ Omni-Merchant offering – BNPL is evolving from a pure e-com distribution of credit to face to face point of sale channels. This is already being offered in geographies like Australia and we believe UK will follow.

Issuer profitability

- Strengthened and deepened customer relationships – This is particularly important in the millennial and Gen Z categories for whom BNPL is popular and who often don't yet have strong financial ties to a bank. In some instances, BNPL will be the first time consumers are accessing credit (this demographic are unlikely to have mortgages, loans etc).
- Low cost of customer acquisition – Issuers can cross-sell BNPL products to existing customers at a low cost.
- Drive customer engagement – providing credit to customers not covered within the traditional affordability assessment models.
- Responsible lending:
 - Lenders will automatically be given access to the necessary data to verify the affordability of users before completing purchases. This transparency will allow BNPL providers to offer a better experience with more clarity, richness of data and ease of affordability checks.
 - Existing credit referencing systems were not designed to meet the needs of such high frequency, low value transactions. However, with Klarna's move to report to two of the credit bureaus it shows that systems are being adapted.
- Transparency with built-in rewards or loyalty to show the full picture and incentivise the right behaviours:
 - Currently, consumers can get credit across several different BNPL providers simultaneously. In the event that a customer has missed a payment with one provider, they could still gain credit with another provider. Unlike in traditional credit models where a full credit check is completed, the "soft" checks of BNPL will not flag any concerns. There is a need for more transparency and aggregation across all credit providers to create accurate affordability checks. Bain research suggests that consumers themselves want this transparency. Of the more than 400 BNPL users under 45 in the survey, two thirds wanted BNPL activity to contribute to credit score.²¹

Given the variety of BNPL business models, there is room to be creative when designing a BNPL solution. Providers can choose to target a specific segment of the value chain and bundle the many activities, (from consumer acquisition to repayment processing to managing consumer accounts), in a bespoke way to deliver their solutions.

20. Can banks grab the Buy Now Pay Later opportunity?, Accenture, April 2022

21. Buy Now, Pay Later in the UK, Bain & Company Inc. 2021

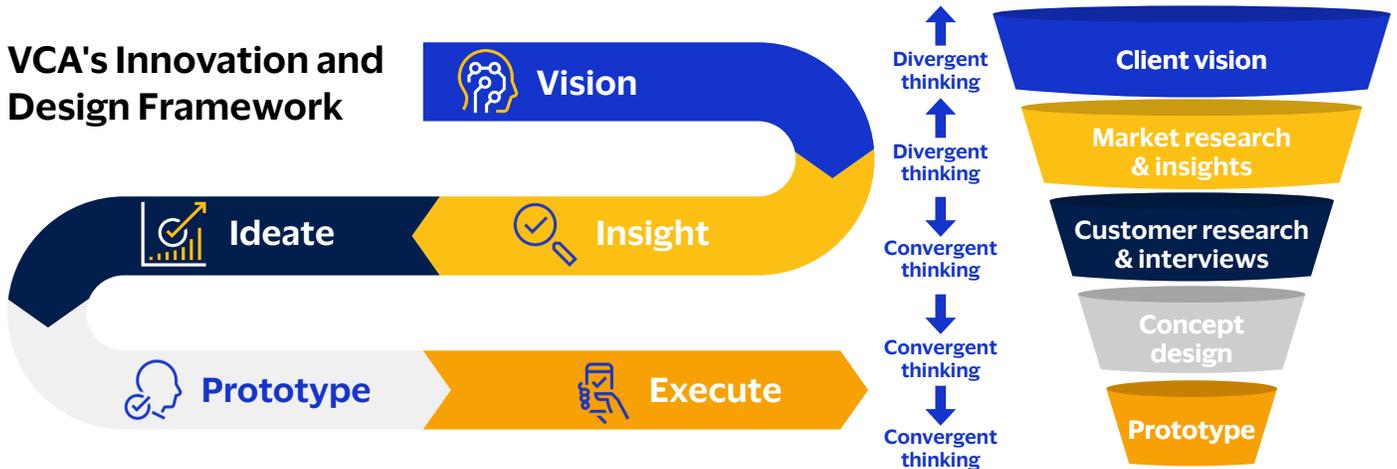
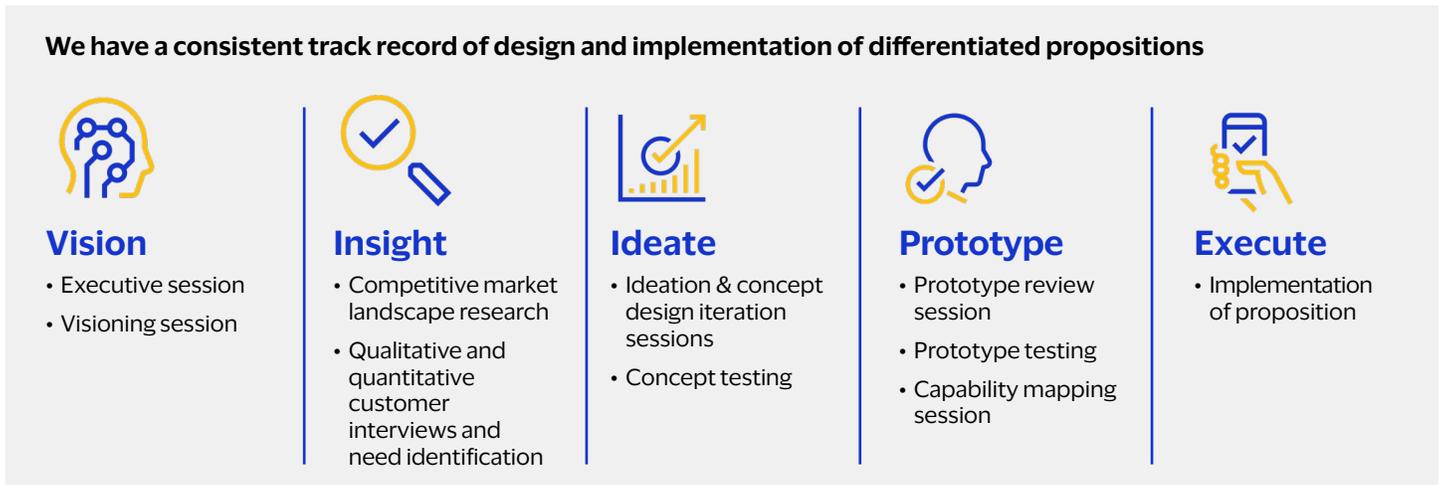


How can Visa Consulting & Analytics help you differentiate your BNPL solution

Visa can support Issuers to take a dual faceted approach to installments. Enabling Issuer led BNPL models and by leveraging the existing Visa network of merchants and acquirers to accelerate time to market. Proposition design is at the heart of what we do, this includes some core elements:

Customer centric design

Using our Innovation and design framework, the team can take into account specific business objectives, market trends, client context and capabilities, and pre-empt potential challenges to co-create a relevant BNPL business model that caters to the target audience.



Data driven insights

Our best in class data can unearth ground breaking opportunities for you, refreshed daily we can provide actionable insights on consumer spend and behaviour on BNPL products. You can analyse daily and monthly data across your portfolio at cardholder, merchant and transaction levels. Our applications can provide market and competitive peer benchmarks to help uncover key opportunities.

Design of value chain ownership

We will work closely with you to understand your requirements, making recommendations as to which activities across the value chain you should own. We can help you to clarify the different options available to bundle and organize activities to best deliver your solution.





Business model definition and profitability assessment

We have the capability and expertise to help you define a business model that is fit for today's changing BNPL marketplace. We can undertake a profitability assessment to determine business value and ensure that our agreed strategy drives growth and profitability.

Accelerator for launch including Visa Instalments Solution (VIS) as a key asset:

VIS enables cardholders to split qualifying purchases into equal monthly payments at select retailers. Visa Instalments uses customers' existing credit limit so there's no need for an extra credit check. The payment schedule is provided at checkout so it's clear what needs to be paid and when.

With our access to extensive customer behavioural data combined with our knowledge and expertise of the marketplace, we are ideally placed to help you deliver against all the requirements for a successful BNPL solution.

Benefits of VIS

- **Network level solution**
A single integration for the Issuer enables enrolled cardholders access to an increasing list of participating merchants.
- **Consistent user experience**
Uniform user experience for Issuer cardholders across all participating merchants including co-brands.
- **Highly customisable**
Account-level targeting and ability to update offers daily plus the ability to differentiate offers at co-brand partners.
- **Flexible plans**
Customise your instalment plans to suit the specific needs of your business.
- **Visa Support and product updates**
Marketing support as well as product updates for new functionalities and use cases.



