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Buy Now, Pay Later: The New Face of Consumer Credit

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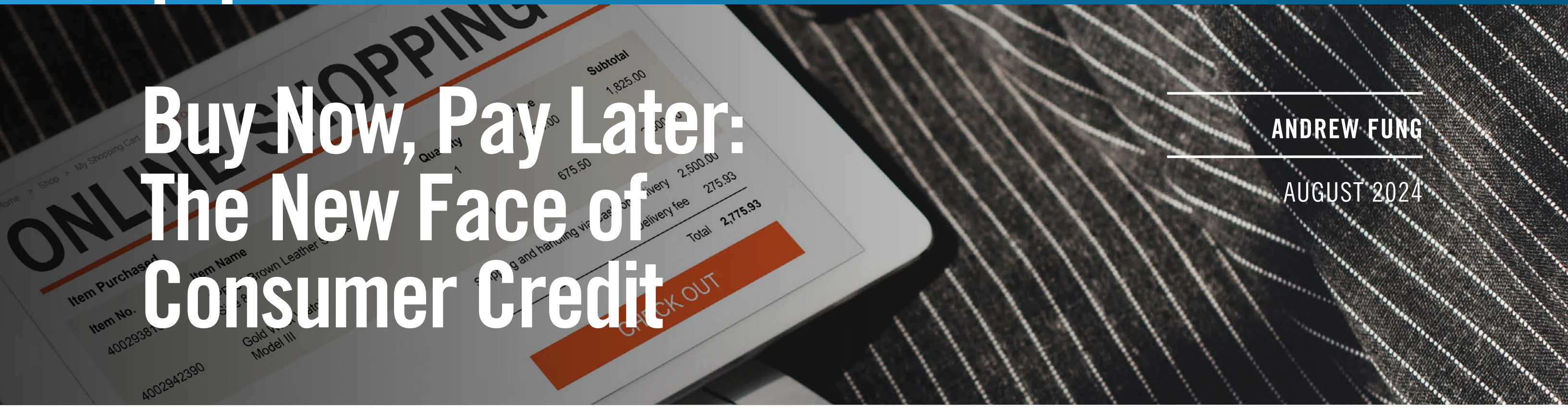
AUGUST 2024



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INTRODUCTION

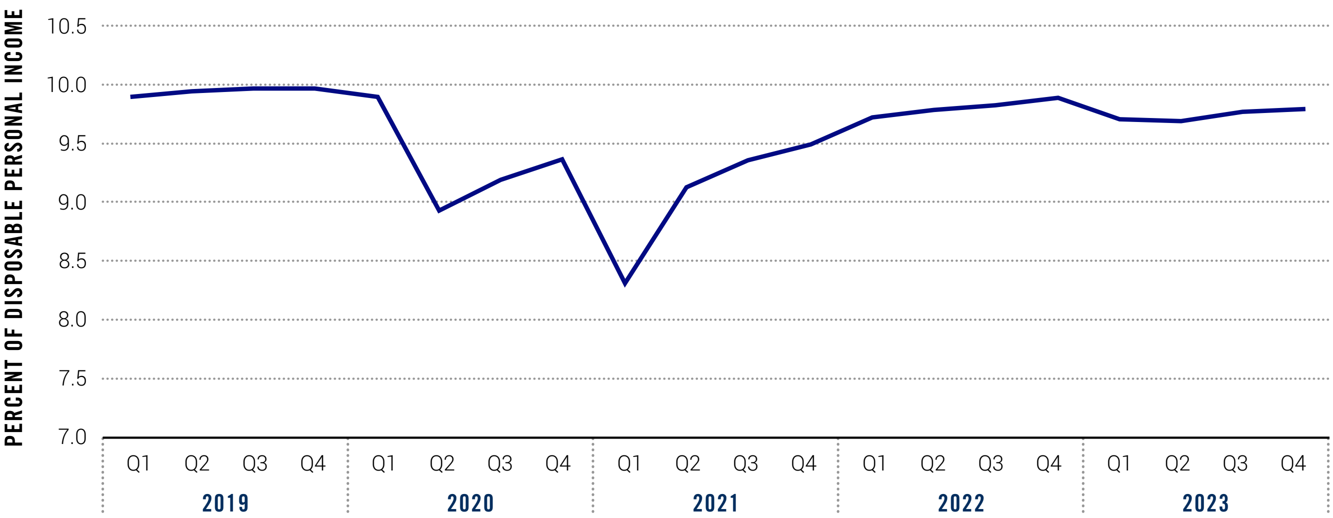
Consumer credit plays two essential roles in our everyday lives. Instruments like credit cards make it possible for Americans to purchase everything from their daily latte to groceries and furniture with less friction, even if we have enough money in the bank. Beyond these smaller purchases, consumer credit also allows us to borrow to pay for bigger ticket items that may be too expensive to buy with their current resources. The second scenario can lead to a potentially dangerous expansion of household debt, which can trap some households in a debt spiral that's hard to escape or have larger systemic effects.

This paper will consider the economic and policy ramifications of the current rapid expansion of one form of consumer credit, known as buy now, pay later (BNPL). Buy now, pay later loans serve as an alternative to traditional payment methods like credit cards when shopping online, allowing consumers to break up the cost of their purchase into several installments to be paid over the course of a few weeks or months, often with very low or zero interest. Understanding how this new form of consumer credit fits into the larger American economy is important, and this paper will explain why BNPL falls under the first category of consumer credit but does merit scrutiny and potential regulation as it continues to develop.

DEBT AND THE POST-PANDEMIC ECONOMY

From a macro perspective, the consumer debt picture is reasonably positive, with some signs of stress. At the end of 2023, the share of disposable income Americans were putting towards paying their outstanding debt was nearly identical to the same figure four years prior. Importantly, these numbers appear stable at just below 10%, providing evidence of a healthy post-pandemic recovery.

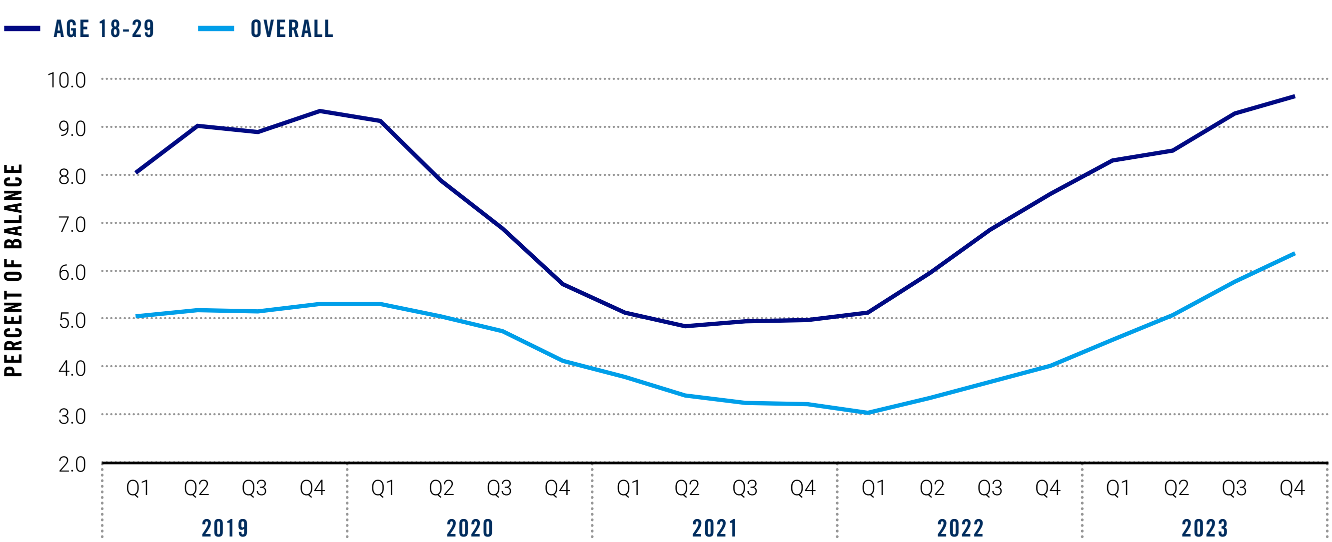
FIGURE 1: HOUSEHOLD DEBT SERVICE PAYMENTS AS A SHARE OF DISPOSABLE PERSONAL INCOME



Source: Federal Reserve Bank of St Louis

However, other measures of consumer debt show signs worthy of caution. Since 2019, the number of serious delinquencies has not only risen but has been trending steadily upward since reaching its nadir at the end of 2021. This trend is particularly pronounced among younger Americans, whose delinquency rates were already roughly 50% higher than the broader population pre-pandemic and have also increased rapidly since. Serious delinquencies represent only a single aspect of financial well-being and credit, but they should be noted and monitored when evaluating the health of American consumers and their debt.

FIGURE 2: TRANSITION INTO SERIOUS CREDIT CARD DELINQUENCY (90+ DAYS)



Source: Federal Reserve Bank of NY

THE RISE OF BUY NOW, PAY LATER

Over the last several years, shoppers have seen a new choice appear when it's time to check out at various sites online, offering an option to split their purchase into several payments with low or zero interest. This practice, known as buy now, pay later, rose to prominence throughout the pandemic during a period of rapid consumer spending and extra cash from government stimulus programs. It offers consumers a new way to access and utilize credit, adding to the existing plethora of options like credit cards, retail cards, loans, and mortgages.

Companies like Affirm, Klarna, PayPal, and the Block-owned Afterpay offer consumers a new way to buy products online that they may not have had access to before, most frequently by splitting purchases into biweekly or monthly payments completed after purchase. Retailers from Amazon to Nike to Sephora have partnered with these firms, presenting shoppers with a new option, serving as an alternative to traditional methods like credits. These options have grown rapidly, becoming particularly popular with young people, for whom BNPL represents an attractive alternative to traditional credit options like credit cards.

During a period of evolving consumer debt, it is critical to consider the impact of buy now, pay later systems in the broader context of credit and the modern economy. As this piece will discuss, BNPL loans have several structural advantages that may help to prevent large-scale debt accumulation or wider systemic risks while granting shoppers added flexibility to make purchases. However, policymakers should remain wary of the risks of financial overextension, loss of liquidity, and the damage to long-term credit access that can stem from misuse of BNPL options. Putting in place the necessary guardrails and giving consumers clear and concise information to make informed decisions when choosing to use credit is critical moving forward.

HOW BNPL WORKS

Buy now, pay later services differ from traditional consumer credit options in several ways. Unlike credit cards, which offer general monthly credit lines with a limit, BNPL offers are made on specific items and often require only a soft credit check or no credit check at all to be approved. For young and low-income people, many of whom are wary of the risks associated with credit cards or have low credit scores, the ease of access and high probability of approval compared to traditional credit options are a major draw. Further, the nature of BNPL as a line of credit with a defined end date and balance to be repaid means that these loans are, in many ways, less dangerous than credit cards, which can incur revolving balances and indefinite payments. However, the market remains largely unregulated, lacking many of the same protections required of credit cards, exposing consumers to new risks.

BNPL companies argue that their programs give additional flexibility to individuals who may not have the money needed to purchase the goods and services outright, providing them access to more products while charging minimal additional fees (if paid on time). However, critics have raised concerns about these services making overspending easy as shoppers take on future payments they may be unable to make, particularly as payments on financed items accumulate. These services are particularly popular among young and low-income individuals due in part to the ease of getting approved and the minimal interest associated with the loans.

One challenge for shoppers is understanding the diverse structure and costs of BNPL arrangements. Though these short-term, single-item credit deals are broadly referred to under the same buy now, pay later name, the length, fees, and interest rates they carry can vary widely. The most common structure for BNPL involves four interest-free payments made every two weeks after purchase, often advertised as "no fees and no interest." However, many BNPL also offer other options, such as spreading payments out over months or years with differing terms.

Some providers, like Klarna and Afterpay, impose late fees on their zero-interest pay-in-four programs up to $35 and $68, respectively.[1,2] Other providers, like Affirm, do not have late fees but do charge interest — for example, monthly finance purchases made through Affirm on Amazon have rates between 10% to 36% APR.[3] Further, some services, like Affirm and Klarna, report late payments to credit bureaus, while others, like Afterpay, do not.[4,5,6] Consumers attracted to BNPL programs by marketing slogans like "no interest, no fees" or "no surprises" must be vigilant because the specific structure and terms of their loan are not available until they have applied and can vary greatly.

While credit cards are financed through a combination of fee income, interest income, and interchange fees, BNPL services differ by earning a sizable share of their income through larger charges to retailers — typically between 4% and 9.5% compared to 2% and 4% with credit cards.[7,8] By arguing to retailers that financing options attract customers who otherwise would not have made purchases, BNPL companies generate the necessary funds to support minimal interest rates that attract buyers to the service.

These retailer fees are a key differentiating component between BNPL and traditional options like layaway or retailer-backed installment plans. Unlike layaway plans, consumers receive their products or services upfront with BNPL rather than after all payments have been completed.

Traditional installment plans, in which loans (and their associated risk) are provided by retailers themselves rather than a middleman BNPL firm, typically have higher interest rates than BNPL arrangements. Buy now, pay later options are appealing to retailers because they can reach customers who require flexible financing options without having to take on the risk of non-payment and the cost of collections themselves — in exchange for higher fees than credit cards. This has allowed smaller retailers, who may not have the number of customers or capital available to support their own installment program, to offer BNPL options.

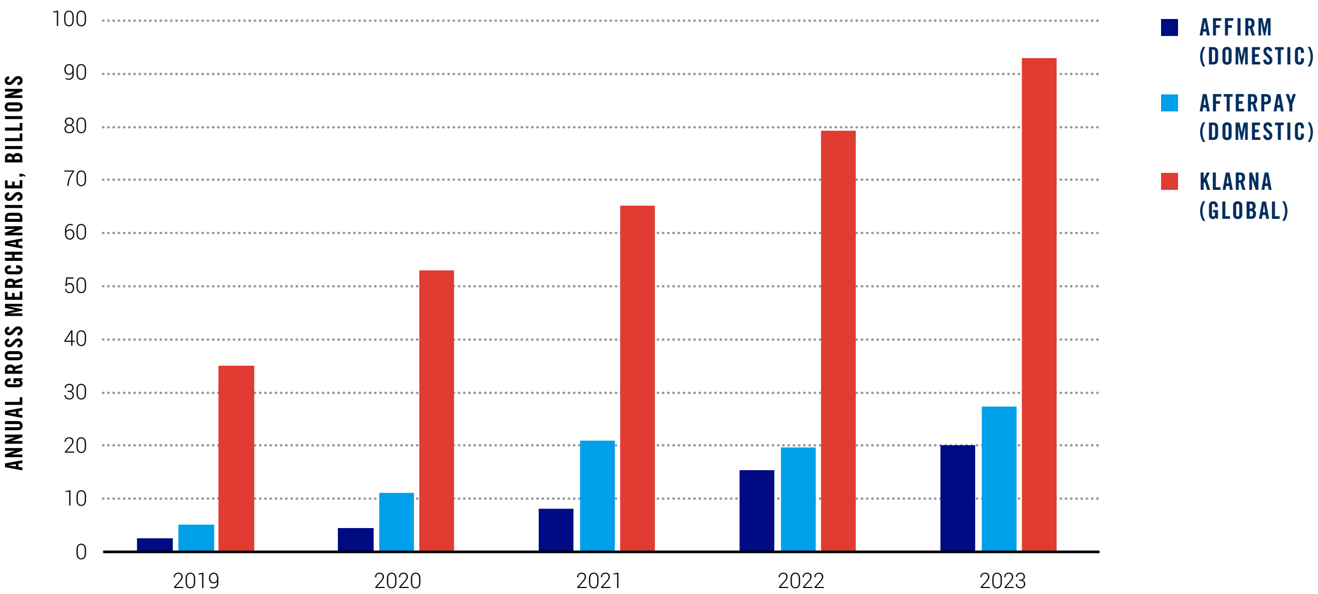
On top of revenue from transaction fees, BNPL companies are able to offer lower interest rates because they distribute risk amongst a larger pool of borrowers than would be possible with a single retailer's installment program. This means prices are often lower for consumers using BNPL than retailer-backed installment plans, while simultaneously eliminating risk for retailers.

WHO USES BNPL?

Though several BNPL companies were established in the 2000s, it has not been until the last several years that they have seen rapid growth. Gross merchandise volume (GMV), which describes the total value of loans extended to consumers through BNPL purchases, is shown for three of the largest merchants in Figure 3 below. Between 2019 and 2023, Affirm's U.S. GMV grew from $2.6 billion to $20.2 billion

— a more than 675% increase that is trailed closely by Afterpay and Klarna's 420% and 165% increases, respectively. In the context of the broader American economy, in which Americans carried credit card balances of $1.13 trillion at the end of 2023, BNPL remains a comparatively minor factor.[9] However, its rapid growth and differences from traditional credit methods merit further examination of its users and structure.

FIGURE 3: BNPL MERCHANT GROSS MERCHANDISE VOLUME



Source: Financial Reports (Affirm, Afterpay, Klarna)

Beyond its popularity among young people, BNPL use is particularly widespread among users with a different profile than those who use credit cards and other traditional credit options. According to a 2023 study by the Consumer Financial Protection Bureau (CFPB), BNPL use is most common amongst Black, Hispanic, and female shoppers, as well as those with household incomes between $20,000-$50,000 per year, and least common among white, non-Hispanic, male borrowers with higher incomes.[10] Interestingly, the majority of BNPL users surveyed did have access to traditional credit and were more likely to use traditional credit products like credit cards, personal loans, auto loans, and student loans than non-users. Only 17% of consumer borrowers reported using buy now, pay later products in the year prior to the survey.

Several signs in the CFPB's 2023 survey indicated that these BNPL users faced higher levels of financial distress than non-users. Compared to non-users surveyed, users had lower liquidity and savings, higher credit card debt and utilization rates, higher likelihoods of over-drafting, and higher likelihoods of revolving on their credit cards. Consistent with prior surveys on the subject, many of the groups that the CFPB identified as more likely to use BNPL are associated with lower financial literacy scores.[11]

POLICY CONSIDERATIONS

Considering BNPL's popularity with young people and other groups with low financial literacy alongside other concerning signs like rising credit card delinquency rates, there is reason for potential concern about the financial impacts of the BNPL industry. Despite these concerns, however, BNPL can play a legitimate role in helping those with limited financial access and literacy be able to participate in the economy with less friction and reasonable cost. As such, policymakers should consider the role that regulation should play in the industry moving forward to encourage sensible and safe growth.

An essential component in a decision to intervene with regulation is the risk of systemic failure. BNPL financing arrangements have several structural advantages that prevent some forms of debt accumulation that are possible with other financial instruments like credit cards or payday loans. More specifically, buy now, pay later loans have pre-determined principal amounts with a set end date — a distinct contrast from credit cards, which grant borrowers a perpetual, widely usable credit line to spend on. Though BNPL borrowers can accumulate late fees and interest if they miss their payments, the principal payment amount will never grow, and even if they fall behind on payments, they cannot end up in the revolving trap of growing interest and carried balances that plague many credit card borrowers. Further, BNPL issuers may be hesitant to issue further loans to individuals who have missed payments, preventing debt accumulation. This, in addition to the relatively small scale of purchases made through BNPL compared to the broader economy, helps to minimize the risk of broader systemic failures originating from the credit system, like the subprime mortgage crisis that spurred the Great Recession.

Nevertheless, as a largely unregulated market today, buy now, pay later still presents opportunities for risk to individual borrowers. Today, BNPL loans lack many of the consumer protections and disclosure requirements that are in place for other consumer credit options like credit cards. As a result, there are several areas for regulatory consideration that could help consumers make better-informed and safer decisions about whether to utilize BNPL payment services.

For one, giving consumers clear and concise information about the terms of a potential BNPL loan could help shoppers, particularly those with limited financial literacy, to make informed choices about their credit. This could take the form of a simple, single-page summary of the loan presented upon application, outlining monthly payments, their due dates, interest rates, and the exact cost of late fees if payments are missed. Importantly, if applicable, this summary could also outline potential impacts on credit scores, as disclosures about reporting to credit bureaus are often not well publicized and missed by many consumers because of the advertisement of no upfront credit check.

Another key consideration for potential regulation surrounds dispute resolution and return protections. Credit cards in the United States are heavily regulated, and these protections extend to disputes that may arise between consumers and the merchants with whom they transacted using their credit cards. These protections include guarantees that consumers can contest charges directly to their credit card issuer without having to contact the merchant and the right for consumers to withhold payment to the card issuer until a dispute is resolved, among many others.[12]

Today, there is no standardized dispute resolution process in place for BNPL services, and each company has its own policy. Often, consumers are required to reach out to merchants themselves before the companies consider disputes, and requests can take weeks or months to decide.[13] As the CFPB noted in its 2022 report, borrowers are often required to continue making payments on their loans during the dispute process and often do not consistently enforce their own stated policies.[14] Applying the same protections required of credit cards to BNPL loans could help borrowers receive fair and consistent treatment when issues arise.

Finally, enacting restrictions on extreme interest rates and late fees can also help borrowers to shop responsibly and avoid harmful, accumulating debt. Given the fact that many borrowers tend to take on multiple BNPL loans simultaneously — a common source of trouble for those who fall behind on payments — even relatively modest individual late fees can present significant financial hurdles when stacked across multiple loans. In addition, some BNPL loans, most frequently monthly financing for larger purchases, can have interest rates of more than 35%. Putting restrictions in place to ensure that BNPL companies can remain profitable while shielding borrowers from punishing rates is a complex balance to achieve, but one that is possible and will set the stage for sustainable growth of the industry.

CONCLUSION

With continued interest from both elected officials and the CFPB in buy now, pay later, the growing industry seems likely to face upcoming regulatory scrutiny of their practices and role in the consumer credit market.[15] Despite risks surrounding financial overextension, the structure of BNPL loans has several advantages that limit the potential for broader, systemic effects, particularly given the currently small share of total consumer spending that they represent. Nevertheless, regulations are needed to correct several current industry practices, particularly those surrounding dispute protections and transparency. These regulations should be light touch and still allow firms to grow and innovate, but critically, they also give consumers the guardrails and information that they need to make informed and knowledgeable decisions. By putting in place these regulations, buy now, pay later can continue to serve individual borrowers and provide opportunities for those who do not traditionally interact with financial institutions in a moderated setting. Balancing consumer protection, economic growth, and opportunities to involve more Americans in the financial system is a noble goal, and one that regulators and policymakers should use to guide their actions toward the industry moving forward.

ABOUT THE AUTHOR

Andrew Fung is an Economic Policy Analyst at the Progressive Policy Institute. His work focuses on the intersection of the economy, technology, and innovation. He graduated from American University with a Master's in Public Policy and bachelor's degrees in Political Science and Economics.

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