The Rise of Buy Now, Pay Later Plans

A fast-growing alternative to credit cards encourages consumers to spend and borrow more

BY AVANI PRADHAN

Chances are, while shopping at an online retailer, you might have encountered buy now, pay later (BNPL) payment options such as Klarna or Afterpay at checkout. Maybe you've even used BNPL before — after all, smoothing out a large-haul purchase over time sounds a lot nicer than paying all at once. This relatively new form of credit differs from traditional credit cards and their revolving lines of credit through its spread-out installments, usually fixed at four. BNPL requires an initial down payment with loans typically between $50 and $1,000 and is offered through specific retailers, tying it to the purchase of a particular product. The general idea has been around for a while, sharing notable similarities with layaway — a pay-over-time payment scheme that allowed consumers to reserve an item until it was paid off in full. Layaway remained popular throughout the 20th century until it started to decline in the 1980s due to competition from credit cards.

Prior to the pandemic, BNPL was a minor part of consumer finance. It exploded in growth over the past five years. According to a Consumer Financial Protection Bureau (CFPB) Market Report, the number of BNPL loans in the United States grew more than tenfold from 16.8 million to 180 million from 2019 to 2021. In terms of the dollar volume, it went from $2 billion to $24.2 billion, with a large concentration of these loans occurring within the apparel and beauty industries.

"It was the height of the pandemic — consumers were stuck at home and willing to indulge on items," says Julian Alcazar, a senior payments specialist for the Office of the Chief Payments Executive for Federal Reserve Financial Services.

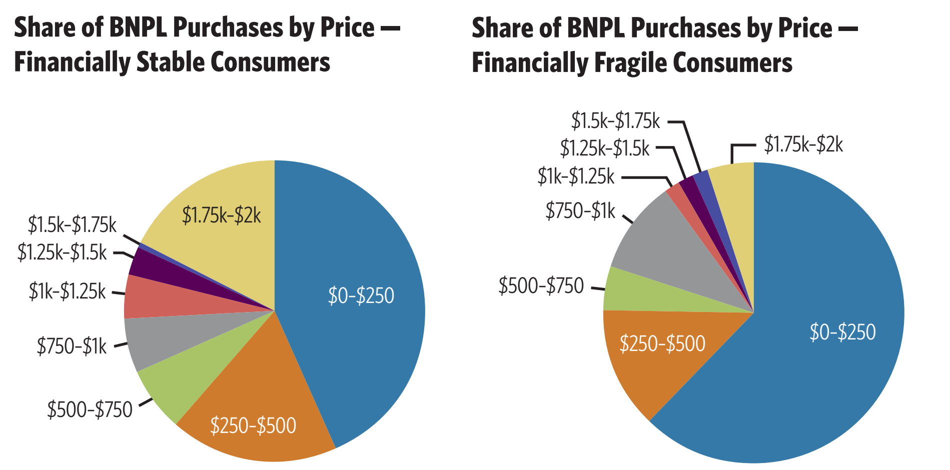
BNPL offers have remained high after the pandemic. In the June 2023 Survey of Consumer Expectations (SCE) Credit Access Survey, the New York Fed found that 64 percent of respondents were offered BNPL services when making a transaction, with nearly a third of those offered reporting use of BNPL in the past year.

This usage also tends to be repeated. In the October 2023 SCE survey, in which researchers differentiated between financially stable and financially fragile consumers through factors such as low credit scores, loan delinquency, and credit application denials, the New York Fed discovered that 72 percent of financially stable users and 89 percent of financially fragile users made purchases with BNPL more than once in a year time frame. While the vast majority financed these installments through debit, bank accounts, or prepaid cards, 10 percent of BNPL users rolled over their credit by paying with a credit card; this debt accumulation is a major area of concern for regulatory agencies such as the CFPB.

WHY CONSUMERS AND MERCHANTS LIKE BNPL

Consumers value this type of credit for a number of reasons. Terri Bradford, an advanced payments specialist at the Kansas City Fed, studied dominant consumer attitudes toward BNPL along with Alcazar in a 2021 Payments System Research Briefing. They noted that a consumer's ability to use traditional credit requires a hard credit score pull, while BNPL requires only a soft credit pull, which limits verification to factors such as credit history, age, and salary and does not impact credit scores. As a result, consumers can be approved for a BNPL loan within seconds and granted immediate possession of a service or good. "BNPL exists as an alternative to a credit card without the steps and requirements," says Bradford.

BNPL also boasts less harsh lending terms that are especially attractive to financially fragile consumers, consumers who are wary of the high interest rates attached to credit cards, and those who may simply lack access to traditional credit. Most BNPL services lend with zero interest



NOTE: "Financially Fragile" includes purchasers who have a credit score below 620, were declined for a credit application in the past year, or have fallen 30 or more days delinquent on a loan in the past year. "Financially Stable" refers to all other purchasers.

SOURCES: SCE Credit Access Survey; Aidala, Felix, Daniel Mangrum, and Wilbert van der Klaauw, "How and Why Do Consumers Use 'Buy Now, Pay Later'?" Federal Reserve Bank of New York Liberty Street Economics, Feb. 14, 2024.

and impose minimal late fees on consumers who miss installments. According to the CFPB, the average late fee was $7 on an average loan size of $135 across major BNPL providers. Unlike with credit cards, occasional missed and late payments typically don't appear in credit histories, a comforting fact to those with poor credit experiences.

By providing a borrowing alternative to traditional credit cards, BNPL has increased financial inclusion for financially fragile consumers. The New York Fed found in its October 2023 SCE Survey that financially fragile consumers were more likely than financially stable users to state that BNPL allowed them to make a purchase they wouldn't have been able to afford otherwise. Additionally, financially fragile users showed a high probability of having a smaller average loan size of $250 or less, suggesting that they use it similarly to a credit card in making small to medium-sized purchases they can smooth over a time frame instead of paying all at the end of the month. (See chart.)

In terms of overall demographics, BNPL appears to be offered more frequently to female and younger consumers. BNPL usage tends to decrease with income and tends to be higher among women than men. The New York Fed did not find significant variation in BNPL usage based on age.

Smrithi Tirumalapudi, a rising senior at UNC Chapel Hill, says she appreciates the flexibility of BNPL options.

"I work a student job with extremely variable hours and have an idea of my minimum paycheck each period," she says. "When thinking about concerts or other experiences, it makes more sense for me to split that payment over four months. I'm grateful that I can spend this on entertainment. I do know students who have used BNPL for items they need, like refrigerators, but they aren't making enough in one or two paychecks to cover it."

On the merchants' end, they face many incentives to adopt BNPL as a payment option for customers. Through BNPL, merchants can reach a broader audience and expand their profit margins. According to a 2021 *Payments Journal* article, though consumers spread out their payments, merchants are still paid shortly after the purchase of a product. Affirm and Klarna reported an 85 percent increase in average order value, as well as a 20 percent repeat purchase rate in 2021.

"I would normally pay $20 for one shirt at J.Crew, but with BNPL, I can spend $20 over several weeks for three shirts — BNPL leads to larger purchases and lower cart abandonment," says Alcazar.

Tobias Berg of Frankfurt University and other economists studied these benefits through randomized controlled trials, comparing BNPL to alternative point-of-sale payment options. They discovered that merchants increased their sales by 20 percent when offering BNPL as opposed to PayPal. They also found that providing BNPL to customers with lower creditworthiness had a greater effect on sales than when it was provided to customers with higher creditworthiness. Not only does BNPL increase the quantity of a firm's products demanded by existing customers, but it also opens their offerings to entirely new customers who were not previously in their target demographic.

RISKS OF CONSUMER HARM

Just like all other forms of credit, BNPL is not without risk. In 2021, the CFPB highlighted three major areas of consumer harm: inconsistent consumer protections, data harvesting and monetization, and debt accumulation and overextension. Since then, CFPB has sought to address some of these issues, with an interpretive ruling in May formally classifying BNPL services as credit card issuers and expanding regulation.

Minimal dispute resolution rights seemed to be the most pressing of the inconsistent consumer protections. Due to the lack of standardization in this sphere, when consumers returned or disputed a purchase, they used to have to pay remaining installments while resolution was pending. This wasn't a rare occurrence: In 2021 alone, buyers disputed or returned $1.8 billion in BNPL transactions, according to the CFPB. More than 13 percent of BNPL transactions involved a return or dispute.

Alcazar elaborates on the J.Crew example, illustrating the drawback of BNPL: "Traditionally, when returning a product, you get credit back from J.Crew within seven business days — with BNPL, there's a disconnect, as you return that shirt to J.Crew, but the credit is coming from another firm instead."

Due to the CFPB ruling, BNPL providers are now required to investigate disputes initiated by customers and pause payment requirements during the dispute process. Some other changes include a requirement to refund canceled services, credit the refunds to consumers' accounts, and provide periodic billing statements like the ones received for traditional credit card accounts.

Other risks, such as data harvesting and monetization, remain potential future problems. BNPL providers are shifting their business strategies toward proprietary app usage — building and streamlining a digital profile of individual users' shopping preferences and behaviors. Potential harvesting and selling of this data could lead to major consequences to consumer privacy as well as market power consolidation, concentrating consumer data in the largest BNPL companies.

As a credit model, BNPL rests largely on encouraging consumers to spend and borrow more. While this can be beneficial for merchants, it spells possible risks for BNPL users, many of whom take out multiple loans in a short time frame, a behavior known as loan stacking. Researchers at Harvard Business School studied the effect of BNPL on consumer spending. They found that first-time BNPL use was associated with total spending increases of around $130 and remained elevated over a 24-week period following that first use. In terms of spillover effects, the researchers reported that BNPL use was associated with an increased likelihood of dipping into savings and incurring overdraft, nonsufficient funds, and other late fees. Due to these risks, the CFPB remains concerned with how BNPL providers' strategies center on increased consumer borrowing as overextension of loans can lead to long-term and different chains of debt that are difficult to pay back.

For researchers, both the regulatory issues associated with BNPL and the higher spending it tends to promote are of heightened concern. BNPL offers and usage tend to be heavily concentrated among vulnerable consumers with high rates of loan delinquency, high borrowing, and lower credit scores. The New York Fed found through its June 2023 SCE survey periods that those with lower credit scores are offered BNPL at a higher frequency than those with higher credit scores. In addition, BNPL users are less likely to rely on savings during economic crises: Only 42 percent of BNPL users reported that they would rely on savings when faced with a financial shock compared with 68 percent of all respondents. When the New York Fed examined this further in its October 2023 survey, it found that the financially fragile (those with a credit score below 620, who were declined for a credit application within the past year, or who recently fell delinquent on a loan) are almost three times more likely to have repeated BNPL use (five or more times) than financially stable consumers.

QUESTIONS OF REPORTING AND SCORING

The recent changes in regulation that categorize BNPL loans as credit loans are seen by some, like Alcazar and Bradford, as a win for consumers, but they believe there is still a major gap: lack of consistent reporting to credit bureaus. Though the three major credit bureaus — TransUnion, Equifax, and Experian — plan to include BNPL loans on credit reports, there are some potential complications regarding calculations of BNPL debts.

According to Alcazar and Bradford, BNPL companies, although now recognized as credit card providers, still aren't required to offer standardized data to the major credit bureaus. Credit bureaus struggle to accurately incorporate these data into their scoring models as calculations are primarily based on monthly paychecks and credit cycles, and BNPL breaks this equation through its atypical payment cycle. Moreover, BNPL providers offer varying levels of data, making it more difficult to incorporate into traditional credit scores. Instead, credit bureaus are choosing to generate alternative BNPL credit scores, which will soon be included on credit reports and can be requested by lenders. In terms of next steps, industry leaders hope that BNPL usage can eventually be incorporated into traditional scoring models without excessively hurting consumers' credit scores. The Financial Technology Association, which includes members such as Klarna and PayPal, has said it supports efforts to modernize scoring models, expressing hope that more transparent and streamlined BNPL data reporting will allow prompt BNPL repayment data to enhance users' credit scores.

Without proper reporting and scoring, there could be a lurking debt problem where both BNPL lenders and other credit institutions are unaware of a borrower's current liabilities, according to the New York Fed. As BNPL continues to grow and branch out to different industries, moving beyond online apparel and cosmetics to everyday necessities such as groceries (with the CFPB noting a more than fourfold increase in these purchases from 2020 to 2021), Bradford believes its usage is becoming more important to monitor. Nonetheless, BNPL remains an attractive option to consumers and additional companies are entering the market, as evident with Apple's recent BNPL ventures and Cash App's acquisition of Afterpay.

Bradford suggests, "BNPL is not going anywhere. It's sort of a hybrid of layaway and credit cards — a model that has existed for a while but morphed over time. We're also seeing credit card providers adapt and gravitate toward it. BNPL may not look the exact same in the future, but fundamentally the model will still be there." **EF**

READINGS

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