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Analysis of CFPB Developments Regarding the BNPL Industry

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Since the early 2010s, there has been explosive growth in the Buy Now Pay Later ("BNPL") space. One of the early players—Affirm—was founded in 2012 by a co-founder of PayPal. By 2022, there are dozens of players in the BNPL space with additional attempts by both existing retail and payments companies (PayPal Pay in 4; Amazon BNPL) and the legacy card networks (Visa BNPL; Mastercard Installments) to compete. The U.S. Consumer Financial Protect Bureau ("CFPB"), which recently wrapped a market monitoring report on the industry and found that BNPL at these five large companies (Affirm, Afterpay, Klarna, PayPal, and Zip (formerly Quadpay)) saw 970% growth from 2019 to 2021.

Fundamentally, the BNPL space was drafted under a provision of the federal Truth in Lending Act that does not require formal loan disclosures for loans where: (i) there is no interest assessed; and (ii) there are four (or fewer) payments. Though this does not address whether BNPL is state-regulated lending, it significantly simplifies disclosures at the federal level. Thus, most BNPL products have no interest rates, have four payments, and only have a late fee that applies if a payment is not made on time. Because of the ease of disclosure, the product is ubiquitous and is readily integrated by merchants onto websites or at points-of-sale ("POSs"). Most BNPL providers use some form of credit history check, even if it does not include a formal credit score.

A more recent trend is credit card companies offering cardholders the ability to “spread out” payments for a given purchase, in essence, a back-end BNPL. In addition, some BNPL lenders require a consumer to provide banking information through screen scraping or “open banking” platforms—another target or recent CFPB inquiry.

BNPL providers cover the costs of these programs and make their money through merchant discounts. Just like credit card companies (that can charge up a 3.5% discount to a merchant—from Nilson Report data), BNPL providers send funds to merchants in an amount less than the “cash price” listed on the merchant’s website. Depending on the program, the BNPL discount can range from as low as 2% to upwards of 20%. Depending on the profit built into a product by the merchant and the number of new buyers that will be compelled to buy, even these higher discount rates can still be attractive.

CFPB “Observations”

In a recent trend at the CFPB, the Bureau issues reports and advisory opinions. This avoids formal rulemaking and is largely being used to “put the industry” on notice of concerns. A similar “advisory opinion” was issued in late June regarding “Pay to Pay” and “Junk Fees.” These do not carry the force of a regulation, but do show the internal thinking of the CFPB and is generally a warning shot to the industries referenced. The CFPB hit on a number of issues in the BNPL space that they classed as “potential consumer risks.”

1. **Lack of clear disclosure of the terms of the loan:** There is no model disclosure for BNPL loans at the federal level as this falls outside of the Truth in Lending Act and Regulation Z disclosure forms. In addition, reading between the lines, many consumers are complaining because BNPL *does not operate like a credit card*.

2. **Difficulties when consumers try to file disputes over charges or make returns:** Generally, BNPL lenders require a consumer to return goods to the merchant that sold it. The merchant then notifies the BNPL lender, who credits the BNPL for the amount of the return. 13.7% of BNPL loans involved a return or dispute (likely given prevalence in apparel sales, which is >50% of BNPL purchases). If the merchant refuses the return, the borrower has the contact the BNPL lender to dispute the amount. *Unlike a credit card*, there is no requirement to recredit funds to an account while a dispute is pending. BNPL payments may still be due during this process.

3. **Late Fees:** Some BNPL providers assess a late payment charge, even if no interest is charged on the BNPL loan. 6.7% of loans had a late payment and incurred a late fee. Under the Truth in Lending Act, this is not considered a finance charge and is not considered interest.

4. **Required use of autopay:** Regulation E generally prevents a creditor from conditioning a loan on a consumer’s consent to repay the loan using electronic funds transfers (debit card or ACH payments). However, Regulation E does not restrict a requirement to “pay by card” as credit cards do not fall within this definition. Many BNPL providers require consumers to use a card (debit or credit) for the down payment or for subsequent installment payments. CFPB data showed that 89% of payment to BNPL lenders were on debit cards with 10.1% on credit cards. Less than 1% of payments were made by ACH (bank transfer) or check.

5. **Credit for Credit:** Some card networks limit the ability to pay a loan with another loan—*i.e.*, using a credit card to make loan payments to another lender. The card networks generally have exemptions available for certain interest free installment plans—allowing a lender making 0% loans to take a credit card as payment.

6. **Use of consumer data for cross-marketing of other products;**

7. **Loan stacking:** Most credit card companies report on a cardholders credit report. This lets other lenders see and evaluate this line of credit. BNPL lenders generally don’t do a hard credit pull and don’t see other debts. Similarly, they do not report on credit so other BNPL lenders or creditors don’t see BNPL balances.

8. **Inability to meet non-BNPL obligations:** If a borrower defaults, they are usually cut off from further purchases. The CFPB cites concerns with ever-increasing availability of higher limits

for the BNPL borrower. In addition, given the prevalence of autopay enrollment (sometimes mandatory), BNPL has a *high relative priority* compared to other lenders. Also, because the amounts due are generally smaller, it is more likely that a consumer will pay the amount with a small excess personal cash flow that would never be enough to satisfy a delinquent rent, mortgage, or auto payment.

9. **Opaque Spending Limits:** Unlike a credit card with a limit, BNPL provides some guidance on spending power; however, each transaction is approved individually. Consumers complained about confusion as to this process and reported "arbitrary decreases" in spending power.

Market Advantages of BNPL

1. **Consumer Demographics:** One of the business advantages of BNPL is that it has caught on with younger demographics, with 18-40 year old consumers significantly over-represented in the BNPL industry.

2. **Down Payment:** Unlike credit cards, BNPL lenders generally obtain a 20% to 25% down payment, significantly lowering the risk of "first payment defaults."

3. **Transaction Approval:** Unlike a credit card where a consumer can spend at any merchant (on the card network) at any time, up to the card limit, BNPL lenders separately approve each transaction. They generally approve a "spending power" or "pre-qualified amount" but this can change dynamically and each merchant transaction is approved separately.

4. **Higher Approval Rates:** BNPL has a very high approval rate (73%) compared to unsecured consumer credit cards (high 30%s per CFPB report)—this may be largely due to de-risking of the transaction by requiring the consumer to "put money down" on the transaction and maintaining a short payment term (3 or 4 payments in 1 to 4 months).

5. **Payment Likelihood:** Many BNPL default to (or have methods to preference) the use of cards (debit or credit) to make payments on the BNPL loan. In addition, they generally default to autopay—significantly increasing the likelihood of payments processing on time. The CFPB data shows a "failed payment" impacted only 4.1% of accounts/7.5% of borrowers. Only 2.39% of loans were charged off/3.79% of borrowers. This is comparable to credit cards (~1.0% delinquency rate in 2021) with much broader underwriting.

6. **Adoption & Engagement:** Usage of the surveyed lenders' apps has multiplied 12x from 2019 to early 2022. This is one of the leading drivers of consumer financial product usage. BNPL also reflects the focus in financial services on "Point of Decision" availability—the theory that the financial product that is presented as closely to the moment the consumer decides to make the purchase will be the lender/financial product that the consumer selects. BNPL lenders report high app engagement—at rates much higher than merchant-specific apps.

7. **App-Based "Push" Model:** Whereas initially BNPL required a network of merchants that would offer BNPL to consumers to "pull" them through the checkout process, many have switched to an app model—the BNPL lender is the start of contact and then the BNPL lender "pushes" the consumer out to the merchant network. Whereas the "push" model was 11% of

the market in 2016, it is now 19% in 2021.

8. **Virtual Card Models:** Many BNPL lenders switched to a “virtual card” program that spins up a gift card for the merchant (or a virtual debit card) that a consumer can use to purchase a product at any merchant, regardless of whether the merchant has a relationship with the BNPL lender. This is less profitable (some discount on gift cards but no agreed discount with the merchant). Thus, many who offer this service assess additional fees for these “out of network” merchants.

9. **Valuable Data:** Like the card networks and large credit card issuers, BNPL generates significant user data regarding shopping, purchases, abandonment, and cross-shopping. This is hugely valuable to marketing alternative products or monetizing this data with merchants. Most BNPL can drive down to the product SKU level. This also enhances the value of advertising placements by merchants within the BNPL app and website. This also can circumvent certain “data harvesting” restrictions implemented by the handset providers.

10. **Merchant Value:** Various BNPL lenders have reported that their product increased average order value by up to 85% for a given merchant and shoppers spend 72% more at the retailer.

11. **Wide Adoption:** The range of merchants offering BNPL is increasing. It is now also offering BNPL for “necessities” purchases:

    1. 1,000% annualized increase in purchases for Education;

    2. 731% annualized increase in purchases of Groceries;

    3. 1,154% annualized increase in purchase of Insurance; and

    4. 885% increase in purchases of Utilities.

Takeaways

The CFPB report is unlikely to change the inherent “value” of BNPL to both merchants and the BNPL lenders. Though financial metrics are changing, it still has dramatic usage (especially among young Americans), high engagement, and significant approval rates (broad group that can be underwritten).

What is the CFPB Likely to Do?

- **Disclosure:** Given its prevalence, the CFPB could take steps to close the disclosure gap for the 0%, four (or fewer) payment loans. Generally, the CFPB lacks the ability to substantively regulate lending (reserved to the states), so the most likely path is through disclosure. However, the Truth in Lending Act exempts these types of lender from the definition of “creditor.” It could be hard to rule-make given the restriction in the TILA on this definition.

- **Dispute Resolution:** Reg Z requires open-end credit and credit card companies to provide dispute resolution rights. This does not extend to closed-end credit. The CFPB could try to push a dispute resolution rule for BNPL that mirrors the card program—though this is more difficult given the way this appears in the Fair Credit Billing Act. By law in the U.S. Code, the dispute resolution process only applies to “cards” and TILA-regulated lending (interest rate or payable in five or more installments).

- **Compulsory Autopay Use:** The Electronic Fund Transfer Act defines an “account” as an “asset account” and excludes credit card accounts. Thus, Reg E does not expressly apply to transactions by credit card (this is covered by the Fair Credit Billing Act). The prohibition on compulsory use is in the EFTA (debit cards and ACH) and not found in the FCBA (credit cards). Thus, when a lender requires “some card”—they are not requiring a Reg E transaction. If the CFPB wants to push this issue, it is more likely they lever the credit card networks to amend their rules to prohibit any “credit for credit” programs and not exempt 0% installment programs.

- **Late Fees:** Reg Z (TILA) prohibits credit card issuers from assessing multiple late fees for the same missed payment. The CARD Act requires such fees to be “reasonable and proportional.” Neither of these explicitly apply to BNPL and would require congressional action.

- **UDAAP:** Historically, when the CFPB views something as “wrong” but no law applies to it, they pursue enforcement claims under the Dodd-Frank Act’s prohibition on Unfair, Deceptive, and Abusive Acts and Practices. We have seen this in other contexts and is the most likely avenue to “back door” restrictions in other laws against the BNPL space even when the law does not apply.

- **State Action:** Some states regularly “partner” with the CFPB to substantively regulate lending. The CFPB could push states to crack down on BNPL, mandate disclosures, or prohibit certain billing practices. This could also drive a focus on state data-selling and data-harvesting restrictions. For instance, in the short-term, small-dollar industry, some states require reporting of loans to a database to avoid “multiple loans” at one time, even if the lender does not report to a national credit bureau.

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