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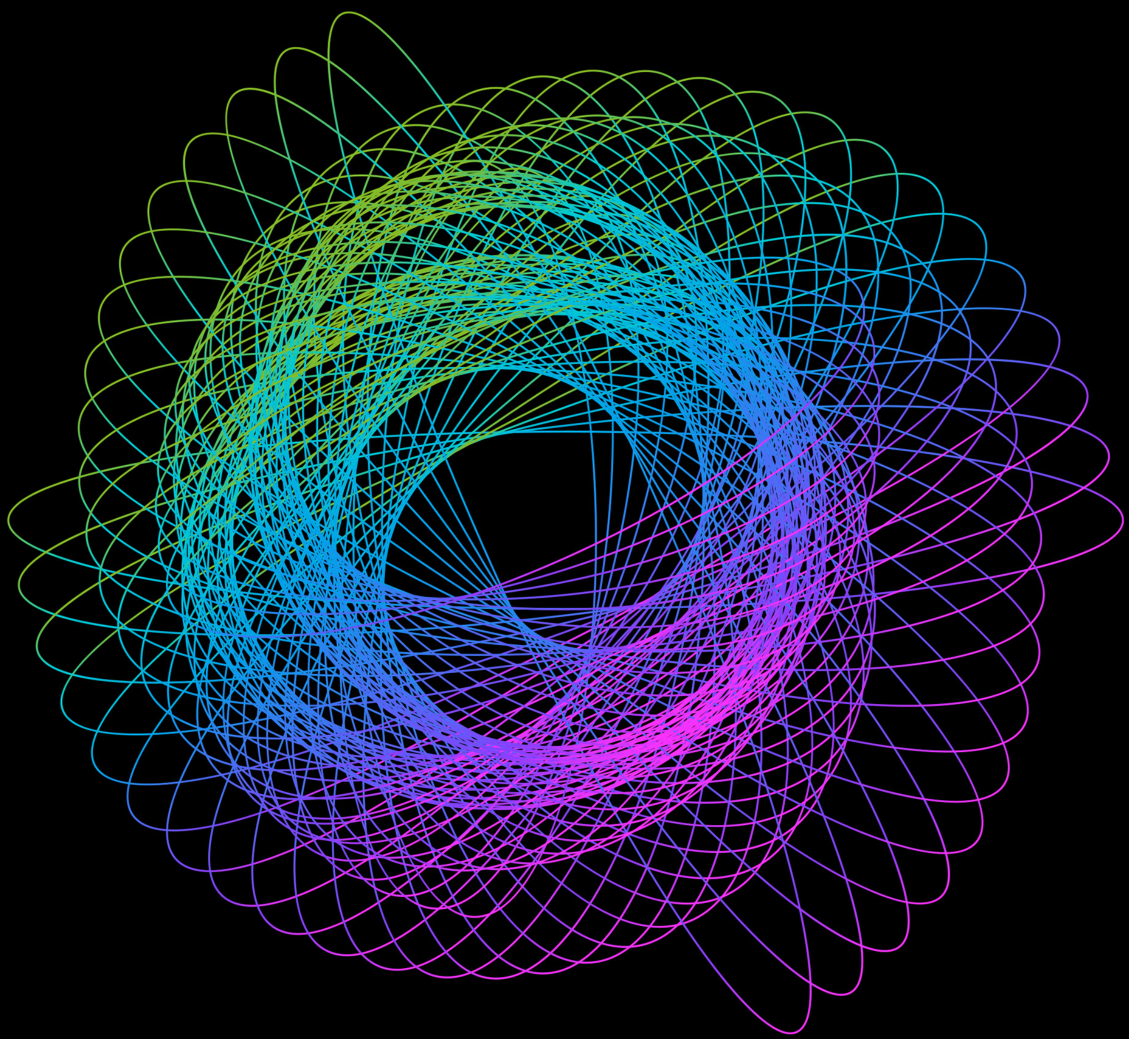


The now and later: How consumers' use of Buy Now, Pay Later fits into the evolving regulatory landscape

Buy Now, Pay Later (BNPL) is a new spin on installment lending, one of many changes currently happening in the consumer banking sector. The BNPL loan allows consumers to take instant possession of a purchase, with or without a down payment, while often committing to make up to four future payments until the item is paid for in full.[1] The immediacy and ease of initiating this loan type has been attractive to consumers as it allows them to increase their spending power and access to goods and services, as BNPL options increase access to credit.

However, this type of lending presents a unique set of risks and challenges to consumers, as well as to banks and non-bank lenders. Banks and non-banks offering BNPL products will need to ensure that the appropriate level of risk management is in place for this product, and that board oversight is sufficient to monitor and manage ongoing and emerging product and compliance risks.[2] To the extent that banks are considering BNPL loans as a new product, the new product approval process, ongoing product monitoring, and compliance and operational risk management will be critical aspects of the offering process.[3]

In this paper, we present our understanding of BNPL as a product, the nature of the current market, regulatory interest, potential challenges, and areas of focus for existing and potential providers.

The BNPL market is growing with consumer spending

Between January 2020 and April 2021, US credit utilization rates declined across all age groups;[4] however, overall consumer expenditures between Q1 2020 and Q1 2021 were up 15.7%.[5] While credit utilization was down and consumer spending was up, e-commerce sales in North America for 2021 totaled $870 billion,[6] and BNPL accounted for approximately $33 billion of that amount, or 3.8%, which is up from 1.6% the year prior.[7] Increased usage of BNPL among Gen Z is up, primarily due to social media trends that embrace consumerism and related debt acquisition.[8] By 2025, it is expected that the dozens of BNPL firms competing in the US market will represent 9% of the share of e-commerce, a value of nearly $180 billion.[9]

Consumers' understanding lags market growth

Meanwhile, 11% of American adults are considered unbanked or underbanked, with lending rates high among adults with lower income, less education, and Black and Hispanic adults.[10] These unbanked and underbanked populations are at risk of high-interest, predatory loan schemes and revolving credit to meet their financial needs.[11] For financially vulnerable households, the most common banking issue is unexpected credit card fees.[12] While those with high credit card balances would enjoy some of the greater benefits of BNPL products by avoiding the revolving debt credit card products can create, debt accumulation is something that concerns regulators, consumer protection advocates, and the public. The lack of customer awareness of how BNPL products work (and their near-instantaneous approvals) has led to riskier consumer behavior. A study by Qualtrics on behalf of Credit Karma found that 34% of those who have used BNPL have fallen behind on one or more payments, and that younger generations are more likely to miss payments.[13]

Unlike credit cards, where a consumer fills out an application and awaits a decision on the card itself, BNPL products offer approval on a purchase-by-purchase basis. With multiple BNPL providers offering their loans at the point of sale, it can be easy for consumers to take on debt, as each BNPL provider has different repayment terms, and without a dashboard to assist with providing the full picture, consumers can accumulate debt quickly. Depending on the servicer, late fees, interest, credit reporting, collections, and the possibility of arbitration or court proceedings can also negatively impact the consumer.

While credit card companies, car loan services, and other lenders are required to provide interest rates and the total cost of the loans in a clear manner based on the Truth in Lending Act (TILA), in addition to consumer protections around disputing fraudulent charges, TILA only applies to loans with at least five installment payments. Most BNPL loans are set up to require four payments, leaving it to the BNPL providers of these pay-in-four loans to establish their marketing materials and disclosures as they see fit.

BNPL is looking ahead

To sustain the growth trajectory, BNPL providers will need to account for upcoming and current challenges in the regulatory landscape, both domestic and internationally. There is a need from customers to have a robust experience when engaging with BNPL as a service. Over time, balanced regulations are likely to follow and lead to products in the BNPL space that are financially inclusive and adhere to consumer protection regulations. This customer experience starts with BNPL providers having strong risk management programs, with risk and compliance controls that protect the consumer.

Consumer Financial Protection Bureau (CFPB) interest

The CFPB has taken an interest in BNPL lenders and servicers. The agency's December 16, 2021, market-monitoring inquiry sought to gain insight into BNPL by issuing a series of orders to five firms operating in the United States that offer the BNPL product.[14] In the inquiry, the CFPB stated that it is particularly concerned with accumulation of debt, regulatory arbitrage, and data harvesting. The CFPB's concerns highlighted in the inquiry tie back to articles published by the agency ahead of its inquiry to help educate consumers on the potential impacts BNPL loans can have on their credit.[15]

Table 1. CFPB areas of interest[16]

Business model/metrics
Loan performance metrics
Consumer protections
User contacts and demographics
Data harvesting
Data monetization

Additionally, on January 24, 2022, the CFPB invited public comment from anyone interested in this market, including families, small businesses, and international regulators, to "help [the CFPB] understand how people interact with these providers, and how the providers' business models impact the broader e-commerce and consumer credit marketplaces.[17] The agency requested responses to six questions by ore before the close of the public comment period on March 25, 2022. It is highly likely that the agency's monitoring and collections will be followed by enhanced or product-specific regulation.[18]

Table 2. CFPB questions for comment[19]

What is the consumer experience with BNPL products?
What are the benefits and risks to consumers from BNPL products?
What is the merchant experience with BNPL products?
What perspectives do regulators and attorneys general have with respect to BNPL products?
Are there ways in which the BNPL market can be improved?
What is the consumer experience with BNPL products?

More recently, on April 25, 2022, the CFPB announced it is invoking a provision of the Dodd-Frank Act to examine non-bank financial companies that engage in conduct that poses a risk to consumers, with the aim to also level the playing field between banks and non-banks.[20]

The CFPB continues to place emphasis on its oversight of fair lending and other consumer-related matters that are directly related or tangential to BNPL.[21] Of note in their revised supervisory framework is the placing of additional emphasis on Unfair, Deceptive, or Abusive Acts or Practices (UDAAP).[22] While as of this article's publication, the CFPB does not regulate BNPL lending, providers should have an awareness of the existing regulatory framework for consumer lending and compliance management system expectations. Providers should be prepared to adapt to emerging supervisory guidance and/or regulatory requirements to maintain compliance and stem enforcement actions. This would include having a regulatory change management process in place to actively monitor law, rule, and regulation changes.

Regulatory considerations

With increased regulatory scrutiny, BNPL providers are finding themselves in a grey area with how they approach regulation—each faced with a choice of how to confront a rapidly evolving regulatory landscape. BNPL providers must take into account existing regulatory themes and trends, plan for key regulatory considerations, and prepare for any additional scrutiny from regulators in light of the evolving regulatory landscape. Any future legislation would likely emphasize transparency and responsible consumer lending, requiring clear BNPL product terms and extending the protections of existing consumer lending legislation to cover BNPL in the market. As BNPL providers continue to develop and enhance their product offerings, regulatory and compliance implications should be considered throughout the development and lifetime of the product offerings.

Key themes in the regulatory environment include:

- **DISPARATE STANDARDS** – Some BNPL providers fall outside of the regulatory boundaries applied to traditional lenders, including those requiring creditors to evaluate a customer's ability to repay.[23]
- **CONSUMER AWARENESS** – Consumers may not view BNPL products as credit or may wrongly believe all BNPL products carry credit protections, leading to riskier consumer behavior.
- **GROWING SCRUTINY** – Regulatory bodies are vocalizing intent to investigate and intervene in BNPL, recognizing that this nascent market could be developing counter to consumers' best interests.
- **FRAGMENTED LANDSCAPE** – BNPL providers face scrutiny from federal and state governments, leveraging a patchwork of existing consumer lending and consumer protection laws.

Key regulatory considerations impacting BNPL include:

- CFPB inquiry of BNPL industry practices as a market-monitoring effort, which is supported by a coalition of 17 state attorneys general[24]
- State regulators and subsequent settlements that include refunds, administrative fees, and license requirements
- Collections and credit reporting requirements impacting servicers
- Disclosures required throughout the product lifecycle
- Complaints management

Tailoring the approach to differences in the US market's regulatory landscape

The existing federal regulatory framework, along with fragmented state requirements, presents opportunities and challenges for BNPL providers.

As the CFPB noted in its May 16, 2022, announcement of the Consumer Financial Protection Circulars, there is a risk that companies can encounter inconsistent enforcement strategies and approaches, and "consistency is also imperative to creating a level playing field between companies that compete in the same market but are subject to the jurisdiction of different enforcers"—which is why the CFPB launched this new system to promote consistent enforcement of consumer financial protections.[25]

Table 3. Key federal fair and responsible lending regulations
Unfair, Deceptive, or Abusive Acts or Practices (UDAAP)
Equal Credit Opportunity Act (ECOA)
Truth in Lending Act (TILA)
Electronic Signatures in Global and National Commerce Act (E-Sign Act)
Fair Credit Reporting Act (FCRA)
Gramm-Leach-Bliley Act (GLBA)
Servicemembers Civil Relief Act (SCRA)

State' laws address BNPL loans in a variety of ways, creating a wide variety of obligations for BNPL providers to grapple with as they target consumers across the country. Depending on the state, and how a provider has structured its product, it may be subject to state requirements for licensing, loan terms, disclosures, and servicing. Several states have reached settlements with BNPL companies, requiring refunds to be issued, administrative fees to be paid, debt repair, and licenses to be obtained to operate in the states.

While several aspects of BNPL lending are regulated at the federal level (e.g., extending credit, credit reporting, contacting customers via phone), there is still no federal law or regulation that addresses BNPL holistically. Information on the CFPB's site calls attention to the lack of dispute protections, the potential for debt accumulation, and the consumer's responsibility to read the details of a loan to understand how their credit may be impacted, while the Federal Trade Commission's site offers questions for consumers to consider before obtaining a loan.

Expected challenges

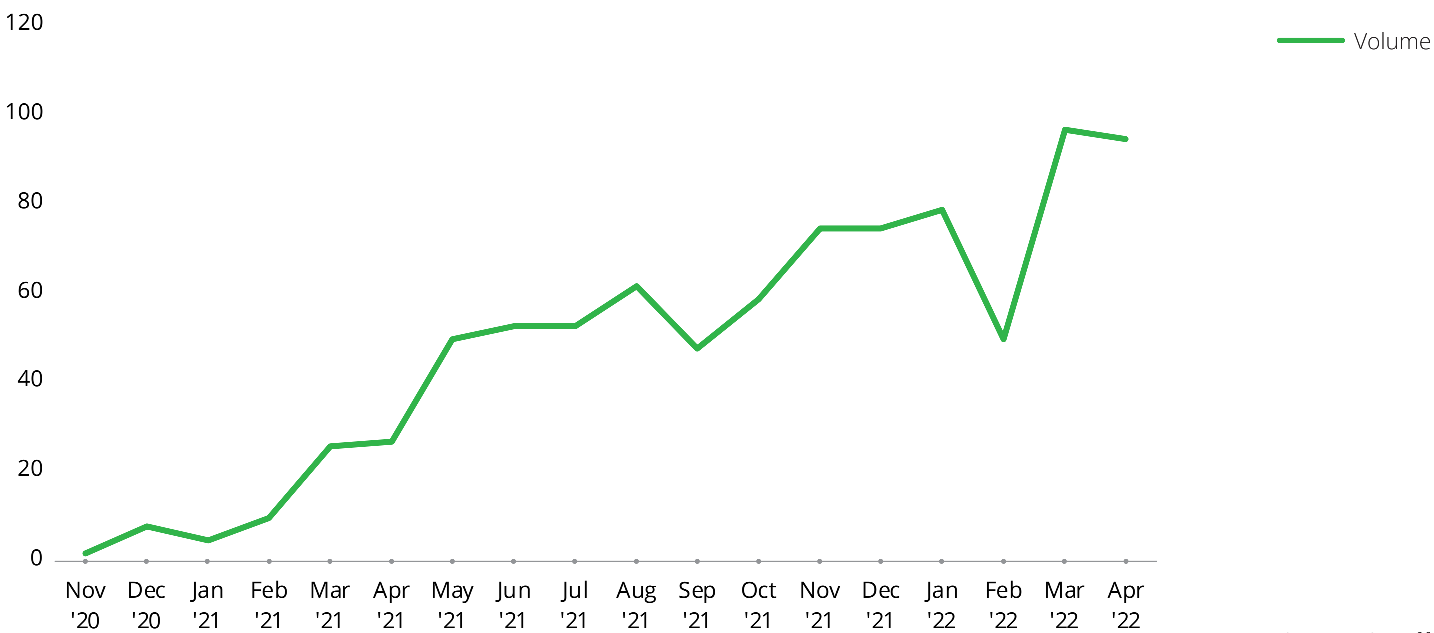
Despite being an attractive market, there are both existing and potential future challenges that will test providers' adaptability. BNPL providers should be mindful of the following regulatory, economic, and operational considerations appearing on the horizon within the next 12 months:

- **Regulators to increase scrutiny** – The federal financial regulatory agencies are directing focus toward consumer protection, including the CFPB.
- **Competition to intensify** – BNPL providers are struggling to differentiate in a crowded market where both digital upstarts and legacy players are launching new products and forging new partnerships.
- **Banking partners turning cautious** – Banking partners may be looking to de-risk their relationships with BNPL providers and reevaluate their role in the BNPL segment if default trends are unfavorable.
- **Impacts of historic inflation** – Rising interest rates increase the attractiveness of BNPL loans to consumers, but also put pressure on BNPL providers' business models when lending interest-free.
- **Bureau reporting wake-up call** – With the major credit reporting agencies now set up to ingest BNPL data, consumer behaviors may change once credit report impacts of delinquent BNPL loans are felt.

Adding complexity to market growth is corresponding growth in fintech competition. BNPL providers can differentiate their product in a crowded market despite ongoing competition. Those providers with a continued focus on innovation beyond only installment lending will likely be the most successful. For example, many BNPL providers have developed versatile toolsets targeting the end-to-end experience. Regardless of the respective level of engagement a firm decides to take in the BNPL market, the board will need to ensure alignment between the firm's underlying strategy and its risk appetite. Similarly important is the board's vigilance regarding oversight responsibilities and monitoring of business performance within prescribed risk tolerances.

While BNPL providers should have a pulse check on credit risk for their bottom line, and keeping merchants motivated, they must also keep consumer protection top of mind. As part of their approach to navigating these challenges, BNPL providers should develop risk management programs that consider consumer protections and address these in their policies and procedures, including but not limited to complaints management, credit reporting, marketing materials, disclosures, merchant oversight, fair and responsible lending programs, and fraud risk management.

Figure 2. Complaints by date received by the CFPB for three large BNPL providers in the United States



Source: CFPB[26]

Going forward

With these challenges within view, BNPL providers should consider refocusing on their governance risk and compliance, compliance management systems (CMS) and related federal consumer protection laws, regulations, and guidance.[27] **BNPL providers should focus on the following:**

- Create an inventory of applicable laws, rules, regulations, and guidance for the jurisdictions you will be operating within.
- Map applicable laws and regulations to the product life cycle, including the marketing and pre-underwriting stage, as well as underwriting, funding, servicing, and collections stages.
- Define operational procedures for the product life cycle.
- Create a regulatory strategy that allows for the growth of your risk management and compliance programs as your BNPL portfolio grows.
- Enhance second-line compliance testing and assurance by independent audit.

As the BNPL market continues to grow and attract regulatory scrutiny, we will be closely monitoring any developments, including new rulemaking and guidance.

Contacts

James Siciliano
Managing Director | Deloitte & Touche LLP
jasiciliano@deloitte.com

John Graetz
Principal | Deloitte & Touche LLP
jgraetz@deloitte.com

Paul Sanford
Independent senior advisor to Deloitte & Touche LLP
pasanford@deloitte.com

Gina Primeaux
Principal | Deloitte & Touche LLP
gprimeaux@deloitte.com

Monica Nguon
Senior Manager | Deloitte & Touche LLP
mnguon@deloitte.com

Samantha Robinson
Senior Consultant | Deloitte & Touche LLP
samrobinson@deloitte.com

Adrian Lucas
Senior Consultant | Deloitte & Touche LLP
adlucas@deloitte.com

Deloitte Center for Regulatory Strategy

Irena Gecas-McCarthy
Principal | Deloitte & Touche LLP
igecasmccarthy@deloitte.com

Michele Jones
Senior Manager | Deloitte & Touche LLP
michelejones@deloitte.com

Kyle Cooke
Senior Consultant | Deloitte & Touche LLP
kycooke@deloitte.com

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