# Buy Now, Pay Later – New? Old? Better?


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It is inevitable that this whitepaper will be out of date as soon as it is published, as the speed of change in this sector (in new entrants, new products, competitive positioning, usage numbers, regulation, etc) is faster than most. However, at the time of publishing, we hope that we have captured the current state of play.

# Is BNPL new?

Getting it out in the open now, the answer is "No" – Buy Now Pay Later ("BNPL") has been with us for decades.

Latitude (formerly GE Money), Flexigroup (formerly Flexirent) and HSBC have been supporting retailers such as Harvey Norman, Bing Lee and JB HiFi for many years with the likes of "up to 60 months interest free" and "nothing to pay for 6 months" offers on large purchases.

At the smaller end, many of us (and our parents) would have experienced the David Jones and MYER card "Christmas Option" where you walk out of the store with your purchase, but repayment is delayed for 3 months. In fact, one of your authors remembers a 1983 American Express Merchandise Sales promotion offering the "Vendome Ring" for $600 or "10 equal monthly instalments automatically charged to your American Express Card" (and it was a big seller!).

So, why all the excitement now? What's different? What's better?

The "sweet spot" that the newer BNPL providers, such as Afterpay and Zip, have found is to deliver digital, mobile optimised, fast approval, small amount and easy to use (both online and at POS) finance that can be quickly repaid to a (generally) younger market.

Combine these features with a youth market having little credit history, who are eschewing credit cards (as they prefer to use their own funds via a debit card), low interest rates and a benign credit market, and you have a perfect match. And what a match, with industry sources suggesting that the BNPL market grew 250% in 2018[1] and that the number of users has grown by more than 5 times in the past 2 years[2].

> ***Flexirent was established in Australia in 1988 and has a market cap of $0.78 billion. Afterpay commenced in 2014 and has a market cap of over $9.0 billion[3], but has been known to move by over 10% either way in one day.***

# Who provides "new" BNPL in Australia?

The best known new providers of BNPL in Australia are Afterpay, with 4.6 million active customers, and Zip, with 1.3 million[4]. OpenPay is a smaller provider and has put effort into specific categories such as healthcare, dental and automotive.

Flexigroup relaunched its BNPL service in 2019 as "Humm" and is growing quickly. Splitit entered the Australian market

[1] Flexigroup in the Sydney Morning Herald, August 27, 2019
[2] ASIC review of buy now pay later arrangements (2019)
[3] As at September 26, 2019
[4] Zip and Afterpay August 2019 results announcements.

in 2019 and has focussed on online sales, and Latitude has announced that it will be launching a product to compete directly with the new BNPL providers during 2019.

Cards, such as the Harvey Norman Go Mastercard from Latitude, give users the option to choose a number of payment plans such as Interest Free, BNPL and Interest Free with a lump sum payment over different terms at a limited number of retailers. The Gem Visa card, also from Latitude, offers similar plans for purchases over $250 at thousands of retailers. But, they are not free - the Go Mastercard has an establishment fee of $25 and a monthly account keeping fee of $5.95 (on balances more than $10). On a purchase of $500 paid off over 12 months, the user will pay fees of $96.40, which is equivalent to an interest rate of 19.28%.



And that is before you consider the proposition of new entrants such as Flexigroup's Mastercard based "Bundll", where the first two weeks are free, customers are then charged a flat fee of $5 to extend payments for another two weeks. A Superbundll option is then available to extend payments to six fortnightly payments, with customers charged 5 per cent of the total balance.


American Express offers Payflex to its cardholders allowing cardholders to pay for purchases (minimum $300) over 3, 6 or 12 months interest free. Citibank cardholders can choose payment terms of up to 60 months interest free.


There are less well known providers who specialise in specific categories, such as Denticare offering interest free instalment payment plans for dental and orthodontal patients, Vetpay for Pet Owners, Brighte for home solar systems, and Art Money for purchasing art.

VetPay KEEPING VETERINARY CARE AFFORDABLE

artmoney

DentiCare PAYMENT SOLUTIONS

brighte

***The "new style" BNPL providers launched with online retailers, but are aggressively increasing physical point of sale purchases. However, today most revenue is still online[5], 68% of Zip's revenue across its 16,000 merchants and 79% of Afterpay's across its 35,000 merchants.***

# Is all BNPL the same?

No. Whilst all providers tend to be treated the same in the media, there are many different models based on:

- Who pays for the service and how;
- How a BNPL purchase can be initiated;
- How much can be spent;
- The method of repayment;
- The term and frequency of instalments;
- The target market.

## Who pays for the service and how?

1. Merchant funding predominates. Afterpay, Zip, Humm, OpenPay, Splitit all charge merchants a percentage of the transaction value. For example, Afterpay charges the merchant a per transaction fee plus up to 6% of the purchase value, although we have heard of rates as below 2%. Zip's average charge to merchants is 4% of the purchase value, and we are told that there are rates as low as 1% in the market, which may be for specific merchants and purchases sizes.

   Why are retailers happy to pay such high fees (particularly compared with the costs of accepting credit cards, which the same merchants usually complain are too high)? The pitch focuses on incremental sales, larger purchase size, access to new customers and increased incidence of repeat purchases. These predictions have, to an extent, been proven particularly by Afterpay and Zip for online shopping. However, competition amongst BNPL providers is now leading to retailers being more prepared to negotiate a reduction in the fees being charged.

   The high fees have made BNPL more acceptable for higher margin retailers and/or products, where the merchant can afford to absorb the additional cost. Female fashion, jewellery and similar categories were early targets.

2. The Buyer. Credit card BNPL from Amex and Citibank are not dependent on merchant fees, which means that cardholders can apply for BNPL on any transaction above the transaction size threshold. However, this means that the cardholder pays. Whilst they are "interest free", an account fee is charged either up front or with each repayment. For Amex this is an "establishment fee", which ranges between 2% and 4% of the value of the purchase.

3. Both. BNPL can be free to users, however if you miss a payment most will pay a penalty fee. If you carry a Zip balance over the end of the month (after the initial 60 days), then there is a

[5] Zip and Afterpay August 2019 results announcements.

$6 monthly account fee. There is a monthly fee for some Humm options, as well as an establishment fee for some types of OpenPay purchases.

It may not be as complicated as comparing mobile phone plans, but it remains worthwhile to look into the detail!

## How a BNPL payment can be initiated

Merchants need to integrate their online shopping cart and/or their in-store POS to be able to offer Afterpay, Zip, Humm, OpenPay and Splitit. The user can initiate a purchase using an app, and can only make the purchase with merchants who have signed up direct with the BNPL provider.

At the other end of the spectrum are the credit card offers from Amex and Citibank, where the cardholder can select BNPL options for all transactions over a prescribed threshold at their account online after the purchase is made at any merchant.

## How much can be spent

There are significant variations which can change based on the merchant, the products being purchased, the user's tenure and their repayment performance. For example, a new Afterpay user is limited to $300. The maximum for Afterpay is $1,500 (average purchase is reported as $150); Zip Pay $1,000 (average purchase $217); Zip Money $50,000; Humm "little things" $2,000 (average purchase $382) and Humm "big things" $30,000 (average purchase $3,740). Credit card based offers are generally limited to the users available credit limit.

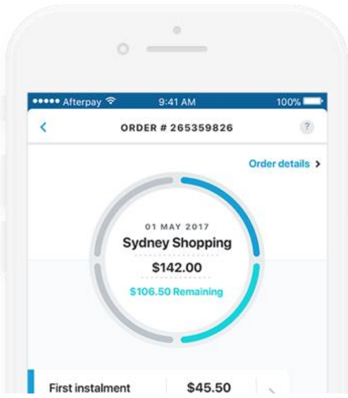
## Method of repayment

On credit card based BNPL, repayment is via normal credit card statement methods.

With other BNPL providers, users can choose to have their repayments linked to a debit or credit card, with debit cards proving to be the most popular: 85% of Afterpay repayment transactions are via debit cards[6].

## Term and frequency of instalments

Afterpay is the only provider that offers no repayment period flexibility – new users will pay their first instalment when they make the purchase and thereafter 3 fortnightly instalments. On subsequent purchases, the first of these payments is 2 weeks after the purchase and then 3 more fortnightly payments to complete.




Zip is fee free for 60 days, so if repayments are made on time within 8 weeks the outcome is the same as Afterpay.

All other providers offer variations in repayment terms, and other than for Splitit, these can result in establishment fees, account keeping fees and combinations of the two.

[6] Afterpay August 2019 results announcement.

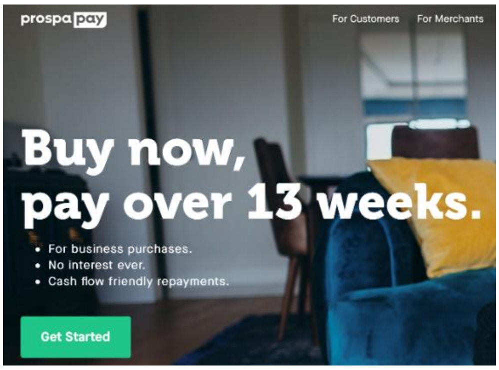
## Where it is offered?

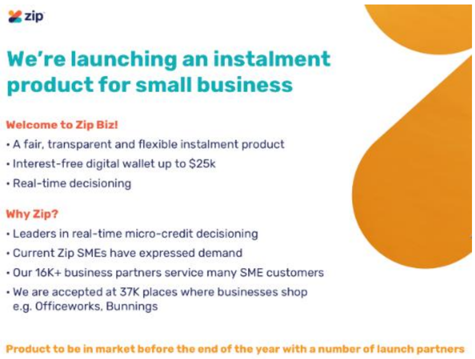
"New" BNPL started with online retailers (in higher margin product categories), then expanded to instore at retailers, and most are now undertaking strategies to enter other verticals where there are payments that users would like to split and defer – such as travel, healthcare, dental and orthodontal.

## The target market

Most of the activity has focussed on consumers in discretionary retail.

However, the quest for continuing rapid growth means that BNPL is now entering the SME segment. Prospa has launched "Prospa Pay", offering 13 weeks interest free for business purchases, and Zip has announced "Zip Biz", to be launched before the end of 2019.




# The regulators


The trend in payments over recent years has been to increase convenience at the expense of payments security, with payment providers moving to deliver "frictionless" payments (where friction has often been previously inserted for increased security). BNPL is no stranger to this – a key factor in its exponential growth has been due to removing friction – making it easy and fast to apply, to be approved and to start making purchases. Limited information might be collected, credit and identity checking might be limited, and minimal (if any) licencing is sought (sometimes on the basis that no "credit facility" is being provided).

From the BNPL provider's point of view, this approach works in a safe credit environment (e.g. Australia in the last few years), but can potentially open the service up to higher levels of fraudulent use. From the user's point of view, particularly those who may have a lower threshold for credit stress, it can make it easier to get into debt: it has been easier to get access to money from a BNPL provider than, for example, a credit card issuer, and it is possible for the user to access funding from multiple BNPL providers (who are not set up to check up on the existence of other competitor BNPL accounts).

This has been of concern to the regulators, to the extent that there was a Federal Senate enquiry in 2018, which published the following (non-binding) recommendations:

1. All BNPL credit providers should verify the income of their consumers and ensure their minimum repayment commitments with that BNPL provider do not account for more than 10% of their post-tax monthly income at time of application.

2. All BNPL providers should ensure that customers entering into a BNPL arrangement read the full contract and provide affirmative consent that they have read the agreement and understand the terms of the contract.
3. All BNPL credit providers should perform credit checks on new applicants.
4. All scheduled BNPL contract repayments should be made from a bank account (e.g. direct debit, debit card or direct transfer) and not from a credit card.
5. All BNPL credit providers should have hardship policies in place that are readily available and be members of an approved external dispute resolution scheme.
6. All BNPL product late fees should be capped at the lesser of $10 per month or 10% of the aggregate monthly repayment due (not the account balance).
7. All BNPL products should have a standardised key fact sheet detailing the core product features readily available at the time of sign-up.
8. All BNPL product providers should hold an ASIC credit licence.
9. All BNPL products that offer purchasing capacity of over $2,000 should be fully regulated under the NCC.

From April 2019, ASIC was granted product intervention powers by Federal Parliament which apply to the BNPL sector. This might be interpreted as guidance for the industry to self-regulate or face the possibility of regulation and/or new legislation.

In addition, in June 2019 AUSTRAC ordered the appointment of an external auditor to Afterpay in order to examine its compliance with the Anti-Money-Laundering and Counter-Terrorism Financing Act 2006. At the time of writing this paper, the interim audit report had been completed and submitted to AUSTRAC. Whilst the report is not public, Afterpay has advised that "Afterpay has not identified any money laundering or terrorism financing activity via our systems to date."

Another change to the industry is the Banking Royal Commission's recommendation to abolish the "Point of Sale Exemption" that allows retailers to introduce borrowers to lenders for regulated credit without needing to hold an Australian Credit Licence (ACL), or be authorised as a Credit Representative. The removal of the exemption would mean that vendors must hold an ACL, or be appointed as a Credit Representative, and must carry out a responsible lending assessment prior to assisting consumers to apply for a loan. This may not mean that retail staff members are all required to hold an ACL - a more likely outcome is that there needs to be an accredited "Responsible Manager" appointed at the retail outlet and/or the relevant BNPL solutions become even more digitised if and where they do not comply with new requirements. It may also not apply to interest free products.

Regardless of what transpires, the industry is being put on notice that the regulators and legislators are watching.

## The overseas landscape

There is plenty of activity outside Australia that is not limited to the well-publicised global expansion of Afterpay and Zip.

Swedish Fintech Klarna, established in 2005, has 60 million customers and 170,000 merchants across 17 countries. Klarna claims 40% of all e-commerce transactions in Sweden and a 10% market share across northern Europe. It offers a range of BNPL options:

- no fee, interest free "Pay later" (pay either 14 or 30 days after the purchase);
- no fee, interest free "Pay in 3" (pay 3 equal instalments on days 1, 30 and 60);

- “Slice it” where the user can make equal monthly payments for terms from 3 to 36 months at a maximum APR of 18.9%.

Klarna is of particular interest in Australia given that our largest payment card transaction acquirer, Commonwealth Bank of Australia (CBA) has announced a $100 million investment in Klarna and its intent to make Klarna services available to CBA merchants. Another notable investor in Klarna is Visa.

***CBA-Klarna could be a significant disruptor in the sector, with Klarna’s lower merchant fee (2.3%) and CBA’s merchant reach as the largest acquirer in Australia.***

The theme of acquirers offering BNPL services on their platform continues with BNPL options being offered to merchants who use Square, Stripe and PayPal.

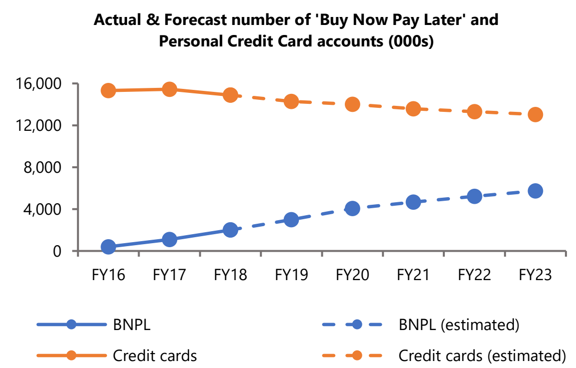
Adding some credence to the growth and sustainability claims by the BNPL industry, Visa and Mastercard have indicated that they will not be left behind, with Visa announcing in July 2019 that it is trialling instalment payment capabilities that could be used by Visa card issuers, and in April 2019 Mastercard announced the acquisition of BNPL platform Vyze.

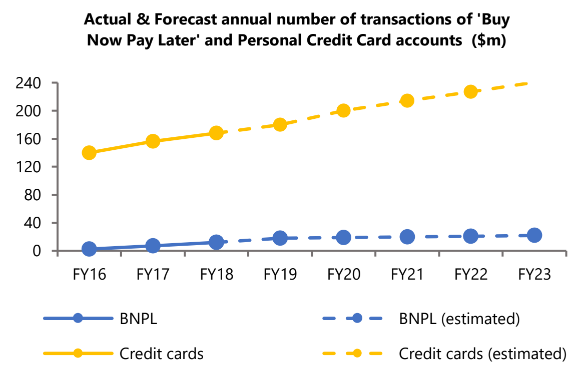
# What might it mean for cards and banks?

Whilst credit card spend continues to rise at a modest rate, the number of credit card accounts in Australia is falling (driven by a decline in consumer card accounts). At the same time debit cards are booming, both in accounts and transactions - younger shoppers are preferring the use of debit cards and are less likely to migrate to credit cards as their lives and careers progress than their predecessors.

The net result is that the overall use of payment cards is increasing. In fact, BNPL can multiply the number of card transactions in the economy. For example, an Afterpay purchase (recall that 85% of Afterpay repayments are on debit cards) replaces a single POS or online shopping cart payment with four debit or credit card transactions, albeit at ¼ of the value for each transaction.

Whilst the growth of BNPL has been significant, in terms of its impact on the economy and payments one should not ignore the fact that BNPL still represents a very small percentage of total value of spend, as demonstrated in the following diagrams[7]:




[7] RBA Data and TIG Estimates

Some new developments include:

- The possibility that BNPL providers may move away from card use. Zip has publicly stated its objective of replacing card payments with Zip transactions drawing from a Zip line of credit, initiated using QR codes. Whether or not this is a success and how long it may take is, as yet, unknown.
- Card schemes such as Visa and Mastercard are entering the market by buying BNPL providers, as well as delivering functionality that assists their card issuers, such as the banks, to offer BNPL on their existing card products.

# Conclusion

Whilst not new to Australia, the digitally driven “new” form of BNPL is growing quickly and appears here to stay. It is meeting a consumer need and is delivered via the ubiquitous mobile phone – the medium with which younger generations are most comfortable.

However, the possibility of a more regulated future, the potential of a tougher credit market with higher levels of bad debts, and increased competition are all likely to force changes to:

- The format of BNPL and the way it is delivered;
- The price that merchants and users have to pay for the service; and
- The number and type of providers in the market.

The Initiatives Group

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