The Frontier Line

Thought leadership and insights from Frontier

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Buy Now Pay Later: responsible investment regulation ahead

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $500 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Nam joined Frontier in 2017 and is a Senior Consultant within the Debt and Currency team. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years. Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney and is a CFA Charterholder.

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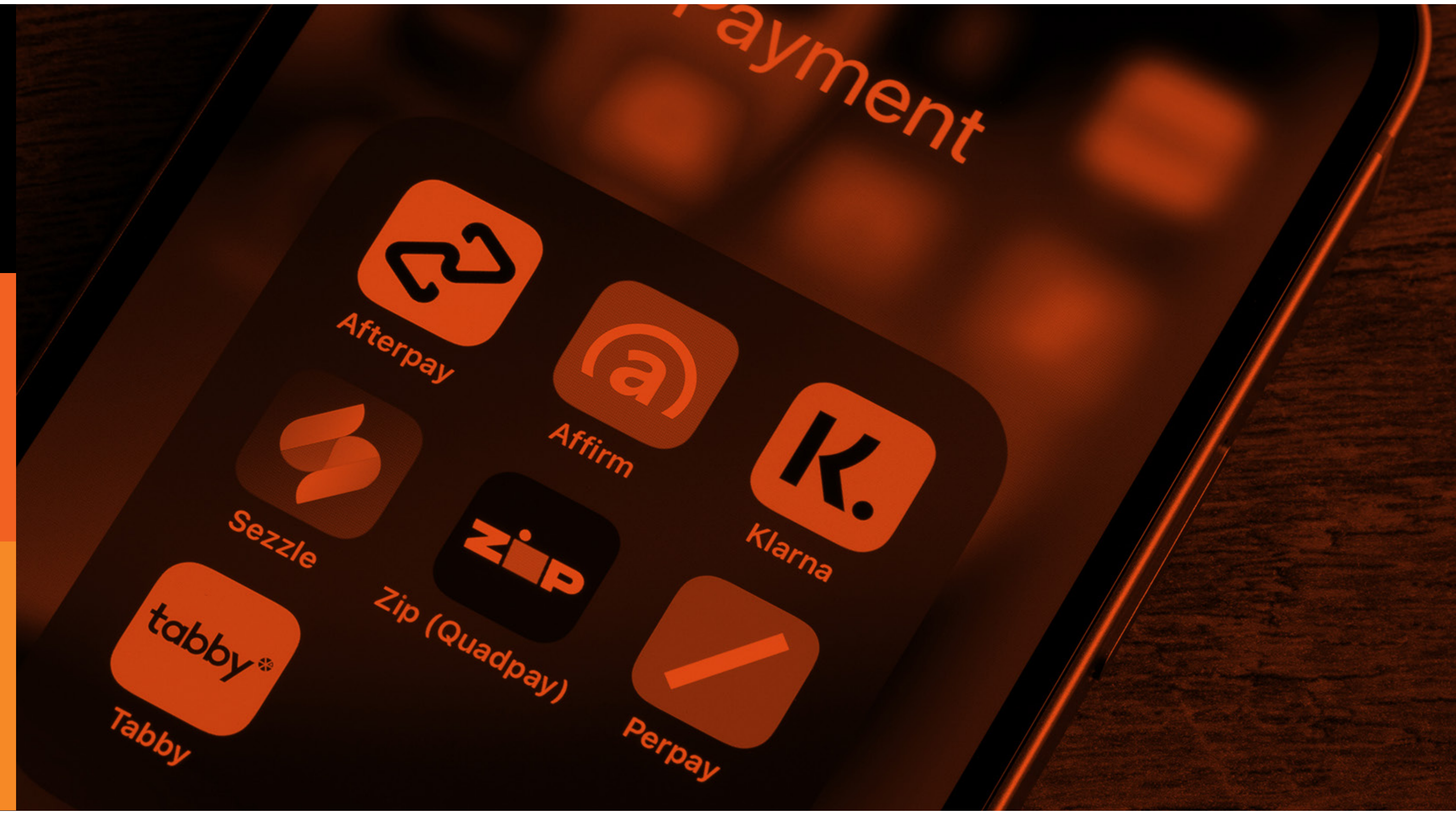
Introduction

The Buy Now Pay Later (BNPL) phenomenon has seen tremendous growth in the past few years across the world with significant adoption by consumers.

Australia, together with a number of European countries, has led the growth of the BNPL sector. Stories about BNPL (both positive and negative) are pervasive, and capital markets support for the sector seems abundant. Investors in the BNPL sector have enjoyed very attractive returns with shares of some listed BNPL companies such as Afterpay and Zip rising significantly over the last few years.

Against this backdrop of strong user and investor interest in this sector, this paper looks more closely at the BNPL sector, examines its growth, and reflects on BNPL as an investment within portfolios. We then explore the importance of responsible lending in BNPL, some potential ESG headwinds looming, and how investors should consider this issue in this fast-growing sector.



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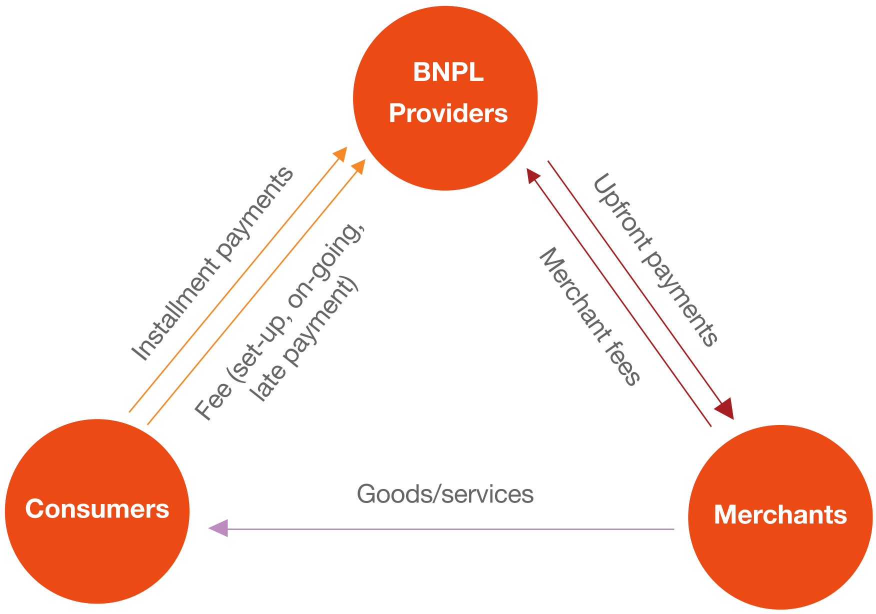
What is a BNPL arrangement?

BNPL arrangements allow consumers to buy and receive goods and services immediately from a merchant and repay a BNPL provider over time. These arrangements have been embraced by many consumers as a convenient payment option.

Chart 1: BNPL arrangement illustration



Source: Frontier

The key difference between BNPL and other forms of consumer borrowing (such as credit cards and personal loans) is that a BNPL arrangement is currently not a form of regulated credit. BNPL providers are therefore not subject to consumer credit obligations applicable to licenced credit providers (such as banks and credit unions). These include responsible lending conduct obligations which are specifically designed to ensure suitability for the consumer and protect their interests.

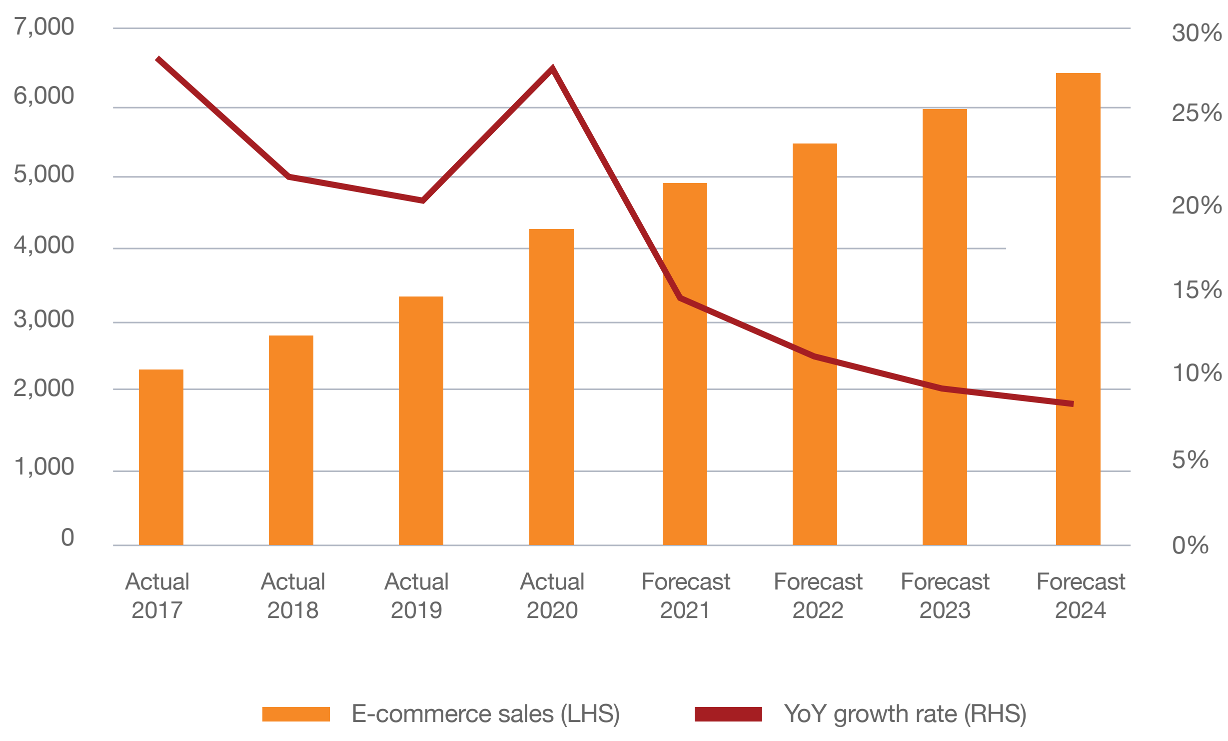
However, given the BNPL providers take on the non-payment risk from consumers, we believe BNPL arrangements can ostensibly be considered to operate in the same way as traditional borrowing and lending. In this case, consumers effectively ‘borrow’ an amount equivalent to the value of the goods at time of purchase and make repayments over time. Conversely, the BNPL provider can be seen as a ‘lender’ in this scenario. As such, given the importance of environmental, social and governance (ESG)-related risks, the question of whether responsible lending has been given appropriate attention by investors in BNPL providers remains unanswered.

What's driving BNPL growth globally?

BNPL growth is linked to the rise of e-commerce, which creates consumer demand for convenient payment methods. The COVID-19 pandemic seems to have further strengthened the secular online purchase trend, the year-on-year growth of e-commerce in 2020 jumping by a strong 28% from about 20% in 2018 and 2019.

High growth in e-commerce was seen across different regions in 2020, ranging from 20% in the Middle East and Africa (lowest growth region) to 36% in Latin America (highest growth region). Chart 2 shows that e-commerce is expected to grow further in the foreseeable future. While the growth rate in the next few years is expected to taper off from recent dramatic rises, it is expected to remain robust at around 10% p.a.

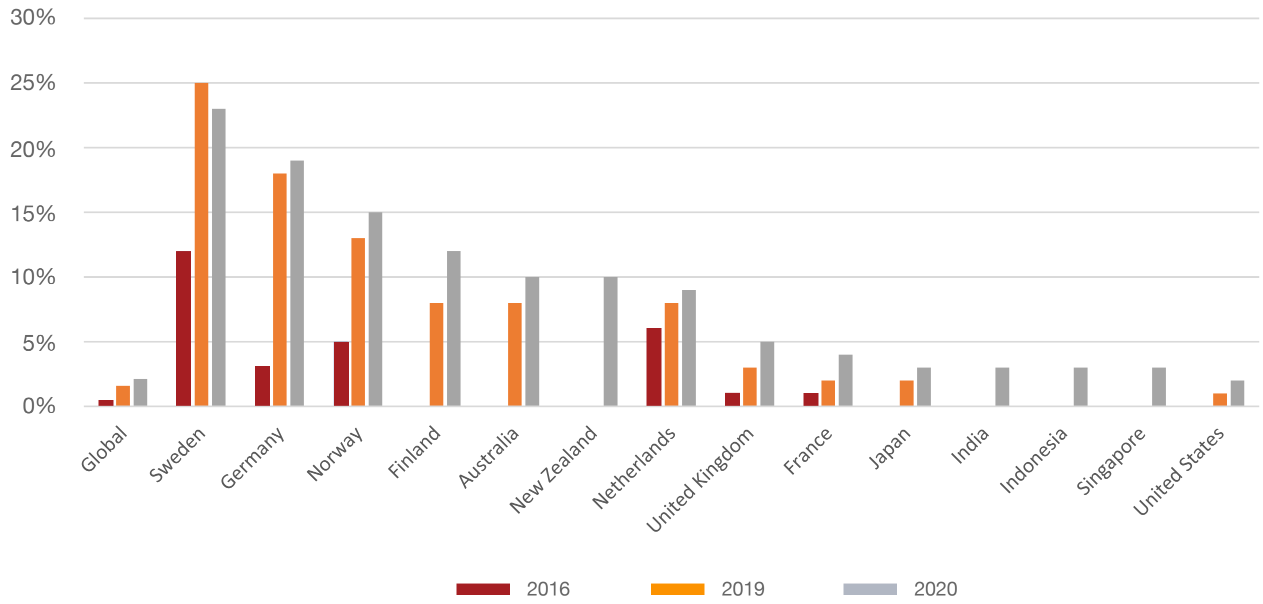
Chart 2: Global e-commerce (US$ billion) driving BNPL growth



Sources: Shopify, eMarketer, FT Partners

As illustrated in Chart 3, BNPL is still a relatively new global phenomenon with minimal adoption back in 2016, when BNPL accounted for only 0.4% of global e-commerce payment methods and adoption was only seen in a few countries. Fast forward to the present time, BNPL has become well-entrenched as a payment method for e-commerce in many countries across Europe, Asia Pacific (including Australia and New Zealand) and the US. The rate of adoption has varied considerably by region with some European countries, Australia, and New Zealand leading.

Chart 3: BNPL share of e-commerce payment methods in select countries



Source: Statisca, FIS

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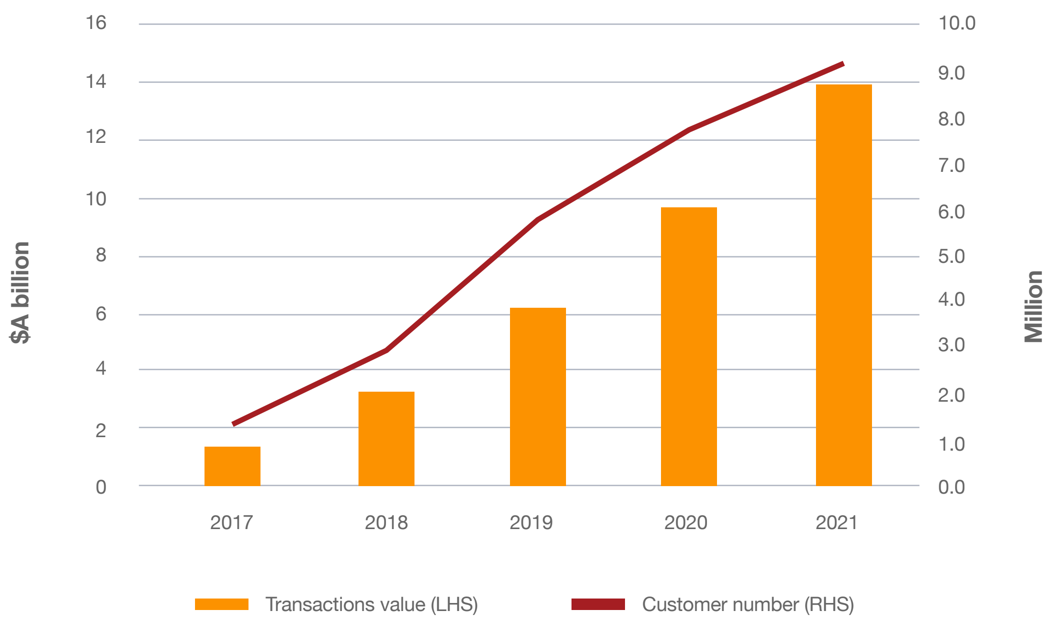
BNPL's substantial growth in Australia

Using publicly available information from a number of key ASX listed BNPL providers (Afterpay, Zip, Humm Group and Openpay), we have observed rapid growth in the Australian BNPL market since its recent inception.

The number of consumers using BNPL has increased seven-fold (from over one million to nine million consumers) while the value of underlying transactions has increased over ten times (from just over A$1 billion to almost $14 billion) over the period between financial years 2017 and 2021. Our findings are similar to those observed by the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) in their review of the BNPL sector (ASIC - Buy Now Pay Later report 672, November 2020, and RBA Developments in the Buy Now Pay Later market report, March 2021).

Chart 4: Growth in BNPL customer numbers (million) and value of transactions (A$ billion)



Source: Frontier, company reports. Year is financial year ending June.

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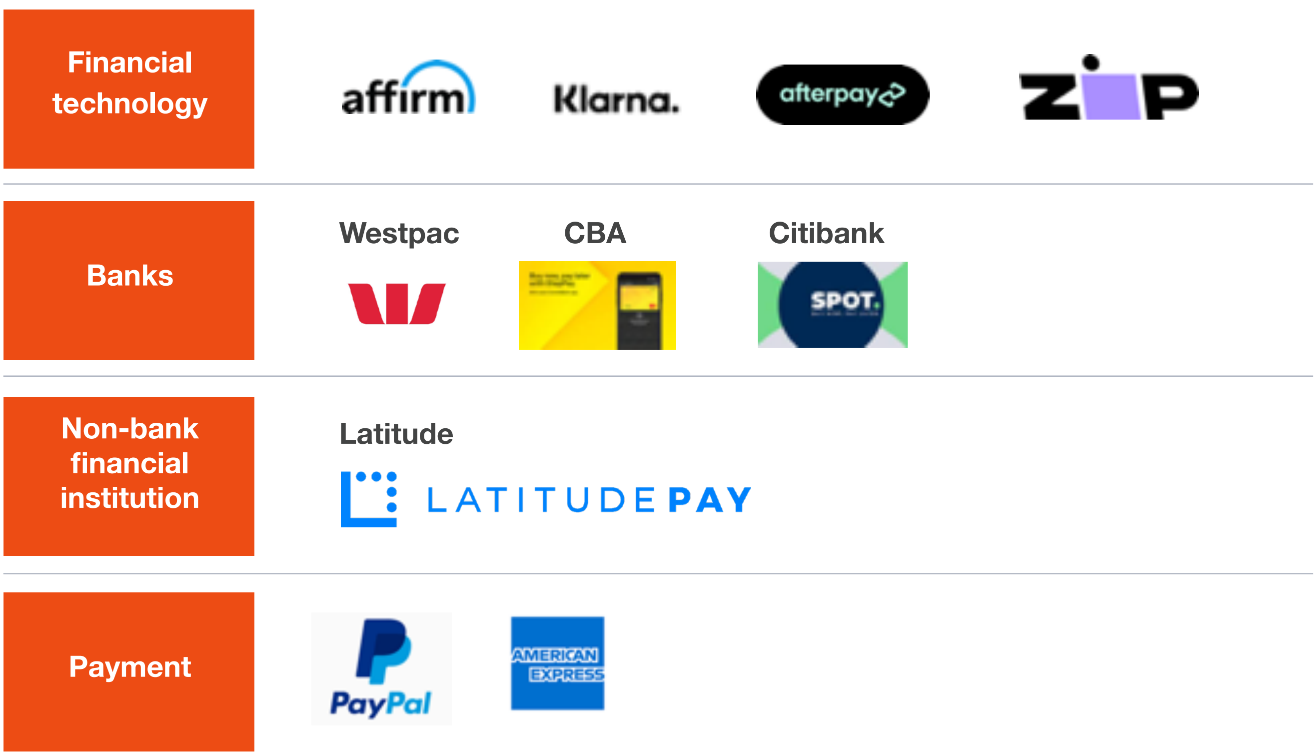
A diverse range of players

The BNPL sector has seen a large number of players entering the market, reflecting the substantial underlying customer demand. This is most notable in Europe, Asia Pacific, and the US.

Another notable trend is that some players (such as Klarna, Affirm, Afterpay, Zip) have expanded internationally, either organically or through acquisitions, and have established operations in multiple countries.

BNPL providers also come from different industries and are not necessarily new or specialist businesses within the financial technology industry. Increasingly, large and well-established financial services businesses including banks and payment companies have also entered the market. This is illustrated in Chart 5 below.

Chart 5: BNPL providers come from different industries



Source: Frontier

Capital market support for BNPL players

BNPL players have attracted interest from a wide variety of capital providers.

The support of capital markets has come from both equity and debt investors in areas such as venture capital, private equity, listed equity, and public and private debt. It is likely that highly diversified institutional investors will have some exposure, either directly or indirectly, to the BNPL sector and these exposures will be found in multiple parts of an investor's investment portfolio.

Chart 6: BNPL supported by a variety of capital providers

Sample BNPL players	Equity capital	Debt capital (e.g. asset-backed securities / convertible debt)
Afterpay (ASX listed)	BlackRock, Hyperion Asset Management, Tencent 腾讯	nab, citi
Zip (ASX listed)	Regal Funds Management, Bank of America	Oaktree, Victory Park Capital
Klarna (Not listed)	Ant Group, Commonwealth Bank, SilverLake, GIC	
Affirm (NASDAQ listed)	Baillie Gifford, Wellington Management, GIC	Spark Capital, Lightspeed

Source: Frontier, company reports, managers' websites

Is there possible consumer harm in BNPL?

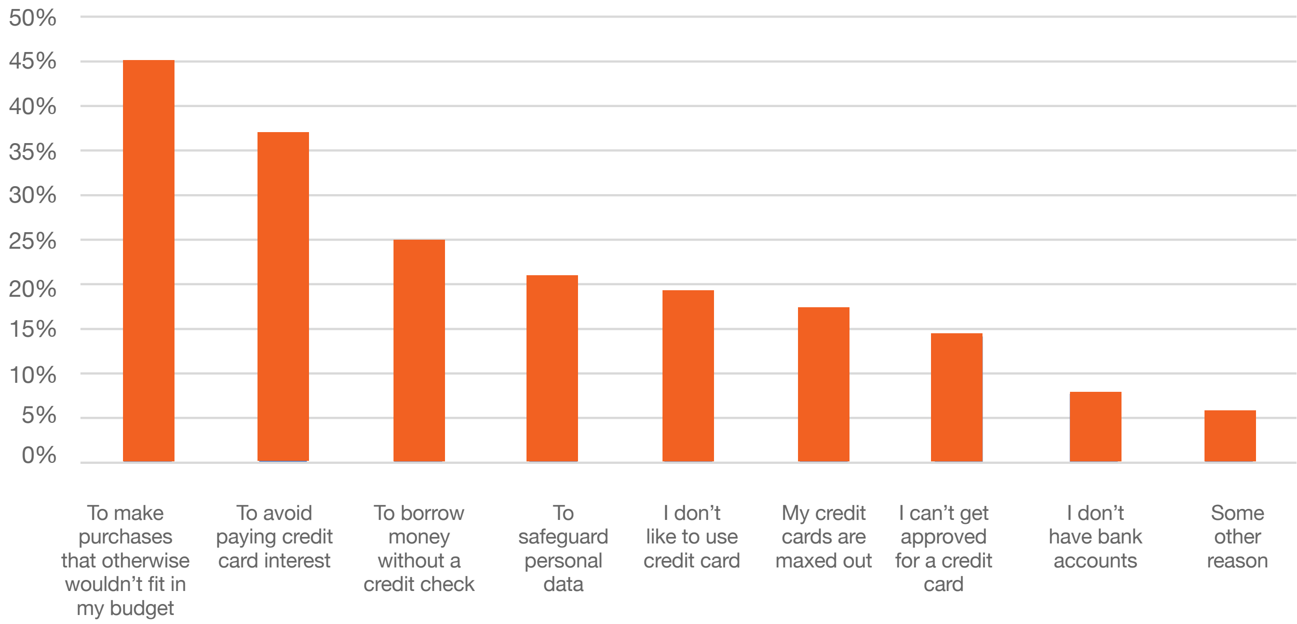
Proponents of the BNPL sector argue one of the main appeals of BNPL to consumers has been the ease of use and flexibility afforded to them when making purchases.

This appears to be validated by results of consumer surveys. As highlighted in Chart 7, which is based on a survey of American consumers in March 2021, the three most common reasons consumers use BNPL are (1) as a tool for budgeting (45% of respondents), (2) a method to avoid paying interest on credit cards (37% of respondents), and (3) a way to borrow without having to be subject to a credit check (25% of respondents).

While the benefits of flexibility and spreading out payments at no cost are evident, the same survey also highlights BNPL, as an alternative form of lending, can be accessed by some customers who are already financially stretched, and we believe there could be unintended harmful consequences arising from this dynamic. The survey response shows 18% and 13% of respondents indicated they used BNPL arrangements because they were over their limits on their existing credit card or cannot get approval for a new credit card respectively.

Assessing whether consumers can be in financial stress due to BNPL is difficult although data from the NAB June 2021 Consumer Insights report (see Chart 8) which summarised survey outcomes from a sample of over 2,000 Australian consumers, noted a high 37% of respondents had missed a payment. The NAB survey also shows the impact is disproportionate among different consumer cohorts with men in the 18-29 year age group being most likely to miss a payment, with nearly 60% of respondents indicating they have missed a payment under BNPL loans.

Chart 7: BNPL has benefits but there is potential for consumer harm



Source: The Ascent survey of 2,000 American adults, conducted March 10, 2021. Chart shows percentage of respondents who use BNPL for this reason.

The fairly high occurrence of missed payments is consistent with ASIC's findings in its November 2020 report, where it was found between 2018 and 2019 missed payments fees earned by Australian BNPL providers were a hefty 40-45% of total consumer fee revenue.

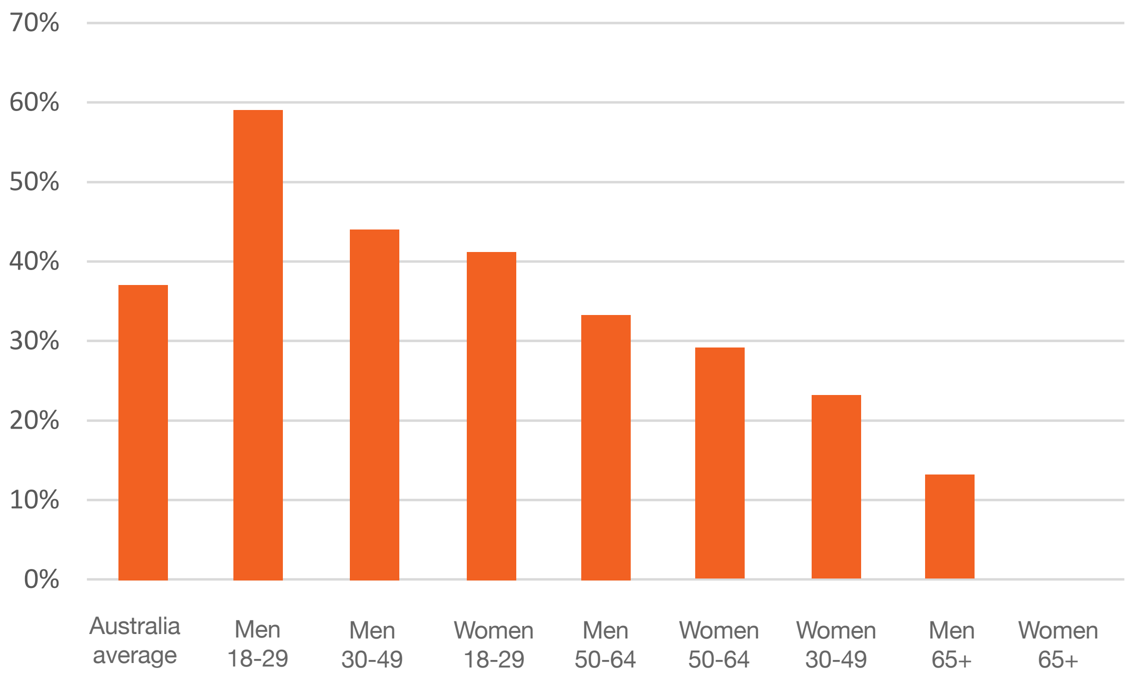
ASIC's report also notes there can be meaningful consequences for consumers as a result of falling behind in BNPL payments based on its survey of randomly selected consumers. These concerning statistics included:

- 20% of consumers surveyed said they cut back on or went without essentials (e.g., meals)
- 15% of consumers surveyed said they had taken out an additional loan to makes BNPL payments on time.

This data highlights that BNPL arrangements, if not used appropriately, can potentially be harmful for vulnerable consumers and lead to financial distress. This is more likely to happen to those already stretched financially or those not eligible for additional debt. As such, we believe additional strengthening of responsible lending practice is crucial in this sector, to ensure consumers are protected and the benefits of BNPL arrangements are maximised.

From an investor standpoint, there is a risk poor lending practices may become a headwind for the BNPL sector with associated reputation damage, regulatory scrutiny, or possible legal action, which could likely impact future return and create additional ESG-related risks for their investments.

Chart 8: Consumers falling behind BNPL payment schedules



Source: NAB consumer insights report, June 2021. Chart shows percentage of people with response to question "Have you missed a payment on your BNPL Loans".

Heightened regulatory actions

Following an initial period of largely being unregulated, we have seen regulators in different jurisdictions beginning to pay closer attention to how consumers are protected in BNPL arrangements.

In Australia, BNPL providers are not currently subject to the consumer credit obligations, including credit checks and other responsible lending obligations which are applicable to most credit providers under the National Credit Code. However, we are seeing regulatory changes coming. The first notable regulatory change for BNPL in Australia is the design and distribution obligations (DDO), which came into effect in October 2021. The DDO legislation, which was passed in 2019, was designed for financial products but ASIC has confirmed it will apply to BNPL arrangements as well. The DDO are intended to help ensure consumers only obtain financial products appropriate to their circumstances by requiring issuers and distributors to have a consumer-centric approach to designing and distributing products. The DDO requires issuers and distributors to develop and maintain effective governance arrangements to ensure consumers are receiving products that are likely to be consistent with their objectives, financial situation and needs. Issuers will also need to take steps to ensure their products are reaching the right consumers.

ASIC's efforts to increase regulatory scrutiny of the BNPL sector are not peculiar to Australia. A similar trend is evident overseas with the BNPL industry coming under greater regulatory focus in the UK and Europe. In February 2021, the UK's Financial Conduct Authority (FCA) announced the BNPL sector would be brought within the scope of its remit. This decision follows a review of the UK's unsecured credit market which recommended (amongst other things) that "as a matter of urgency, the FCA should work with the Treasury to ensure the necessary amendments to legislation are made to bring BNPL products within the scope of regulation".

In Europe in July 2021, the European Commission announced in a proposal for the amended EU Consumer Credit Directive, that BNPL schemes would be subject to the consumer credit directive, which aim to improve consumer protection and cover areas such as credit worthiness assessment, information disclosure, and fees.

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Assessing responsible lending within BNPL

It is clear to us, be it through regulations or otherwise, the question of responsible lending is a pertinent consideration for investors and fund managers with exposure to the BNPL sector.

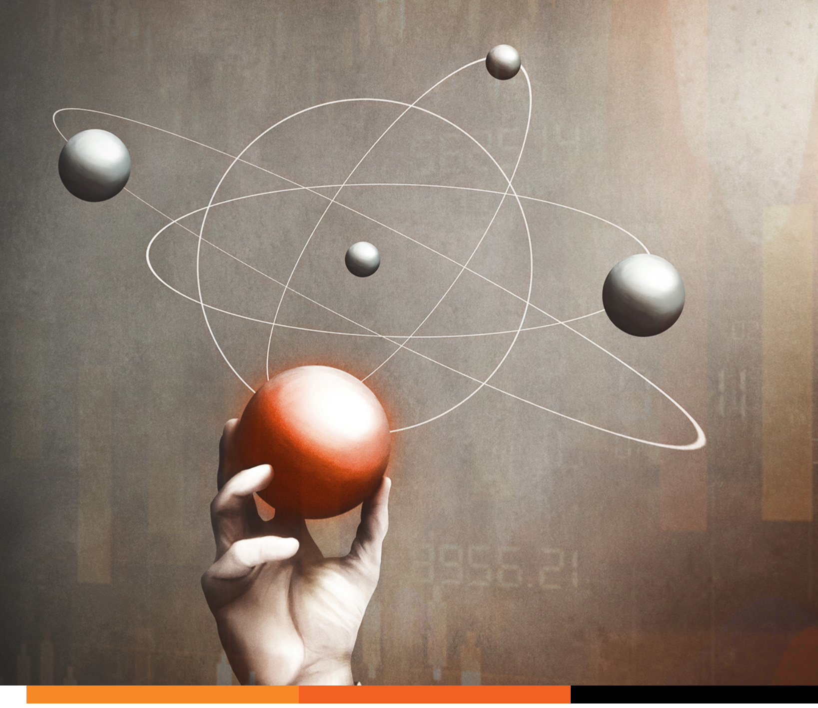
We believe that for BNPL players to be successful and gain customer trust, responsible lending should be more prominent as a central belief. From a practical perspective, we suggest investors address this as part of their broader ESG considerations. For investors making investments through a fund manager, this means a review of the manager's ESG assessment process and ongoing engagement with the fund manager with respect to how potential social risks are being identified, assessed, and managed.

While not meant to be exhaustive, we think the relevant areas for investors considering the suitability of responsible lending practices used by BNPL providers may include the following considerations.

Areas	Examples of issues for consideration
Philosophy	Is it considered a type of credit?
Costs	Is the product charging prohibitive fees and costs?
Credit worthiness	Is the ability to pay considered and assessed? Is an appropriate credit limit established?
Disclosure	Is relevant information provided in clear and easy to understand language?
Dispute resolution	Is there appropriate complaints and dispute resolution?
Collection	What are the collection practices, including behaviours and strategies, used to follow up late payments?
Customer hardship	Is there support for customers in financial hardship?
Regulation compliance	How do they comply with applicable regulatory requirements?
Industry code of conduct	Is there support and adoption of BNPL industry code of conduct?
Collective behaviour	Any efforts to promote industry responsible behaviour and improve welfare of consumers?

Source: Frontier

The final word



BNPL is a new sector that intersects between banking, payment services and technology. BNPL growth and adoption has clearly been dramatic across the world, which is an indication of the appeal of BNPL to consumers versus traditional payment methods. Similar to many other financial products, however, there can be potential harm to consumers if BNPL arrangements are not offered to consumers responsibly and used appropriately, particularly in some cohorts of more vulnerable users.

For investors, the attractive returns earned to date from the publicly available shares and high yielding debt of fast growing BNPL providers are undeniable. However, as the sector matures and more evidence of the negative impact on consumers arising from the lack of formal regulation on responsible lending crystallises, there is reason to believe BNPL providers may face greater headwinds and costs going forward. This could uncover additional ESG-related risks and possibly moderate future investment return expectations. Investors and fund managers should be cognisant of this evolution.

We believe a BNPL arrangement is akin to a form of lending and borrowing and therefore responsible lending should be a core consideration for this sector. Unsurprisingly, we have seen regulators paying closer attention to the BNPL sector with more regulatory scrutiny expected. We think responsible lending practice by BNPL providers is paramount for the sustainable growth of this new sector and recommend investors to closely consider this as part of their overall investment considerations in BNPL.

Want to learn more?

If you would like to find out more about responsible investment considerations for investing in BNPL, Frontier can assist. Please reach out to your consultant to arrange a discussion.

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