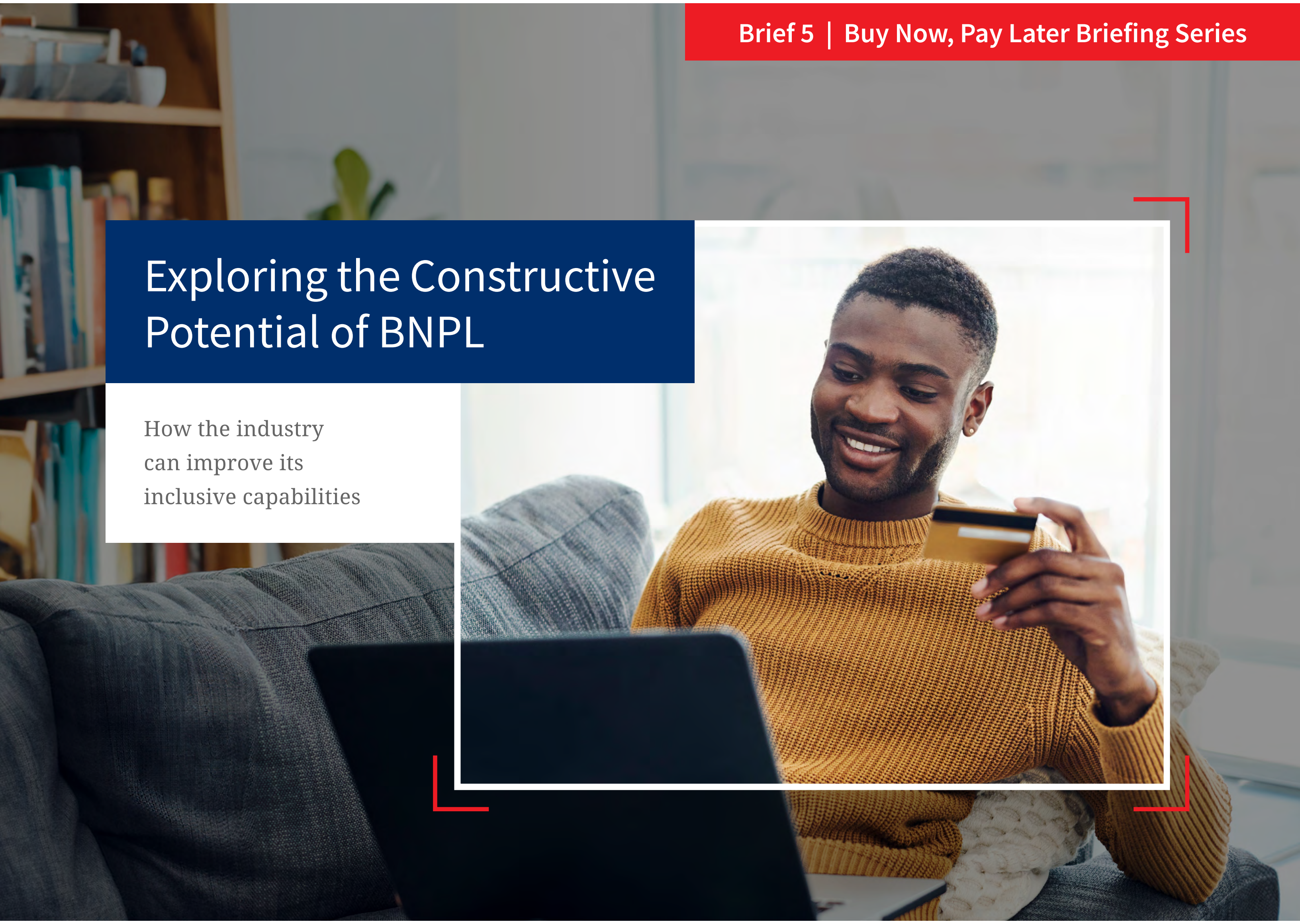
LexisNexis® RISK SOLUTIONS

Brief 5 | Buy Now, Pay Later Briefing Series

Exploring the Constructive Potential of BNPL

How the industry can improve its inclusive capabilities



Are Buy Now, Pay Later products constructive or deconstructive financial instruments? This question has preoccupied industry leaders, consumer advocates, regulators and borrowers as BNPL's popularity has skyrocketed.

By nature, BNPL provides consumers with easy, affordable access to financing outside of the credit underwriting process used by traditional lenders. In this research series, we have discovered that a diverse set of consumers are driving the demand for BNPL (see Brief 1) indicating its ability to meet many financial circumstances (see Brief 2). Some manage BNPL responsibilities well while others might take advantage of the product, which we highlighted through various data insights in Briefs 3 & 4.

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There are ways to promote responsible BNPL borrowing and prevent the over-extension that some consumers face when the barrier to borrowing is so low within the BNPL ecosystem. Our final research brief in our *Challenging the Perceptions of Buy Now, Pay Later* series will discuss why BNPL may be considered a financially inclusive product and how the industry can further improve its inclusive qualities.

The World Bank defines financial inclusion as when "individuals (...) have access to useful and affordable financial products and services."[1]

The pay-in-four BNPL model certainly fits this definition with low or nonexistent fees and interest. Additionally, there are generally less stringent credit criteria which provides easier access to consumers with no or sub-optimal credit histories. In this sense, BNPL is a very affordable credit option, and it is clearly useful to consumers if we consider demand alone. BNPL passes this test of financial inclusion — however, lenders need to take the right steps to limit irresponsible consumer behaviors and reward responsible behaviors so that BNPL products can live up to their full potential for financial inclusion.

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Two ways BNPL can become a more financially constructive product

1 BNPL providers should look for ways to reduce the risk of consumers getting in over their head.

This is the primary issue cited by BNPL detractors when critiquing them as financially destructive tools. Consumers who lack financial stability or literacy may unintentionally misuse BNPL without strong limitations in place.

It is paramount that BNPL providers check whether borrowers are able to repay and how many existing loans or BNPL products they have concurrently committed to. While most BNPL firms do have controls in-place to limit high numbers of simultaneous loans to consumers within their own walls — the industry lacks strong visibility across the marketplace to see when consumers have taken out simultaneous loans at multiple BNPL providers.[2]

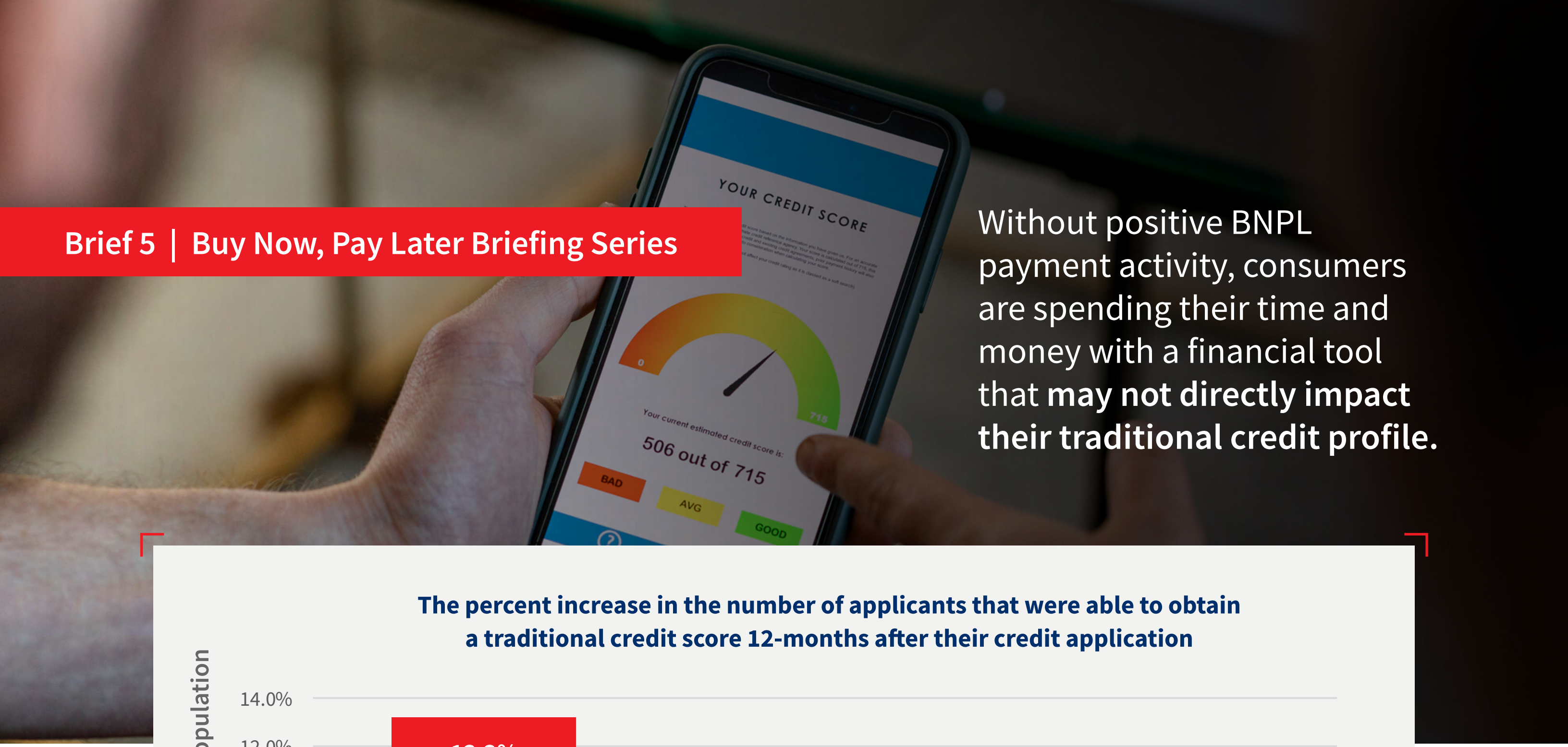
BNPL firms should consider contributing BNPL activity to consumer reporting agencies or consortiums to support sustainable and responsible behavior for lenders and customers alike. Instituting stronger credit checks and monitoring consumer behavior across the industry can help ensure BNPL solutions are financially constructive to consumers.

2 BNPL products should be reporting both positive and negative payment activity to the consumer reporting agencies.

This could counteract the current negative feedback loop where on-time payments of BNPL products are not reported, while defaulted products are.

BNPL providers are developing plans to address this, but as of September 2023 BNPL only acts as a neutral or negative force on a consumer's primary credit file at the three largest national credit reporting agencies.[3] There is no positive behavior reflected from responsible BNPL usage.

We see this effect in our research when we look at the rate of traditional credit scoreability over time. The figure below shows three populations in our study and the portion of credit invisible consumers that were able to obtain a traditional credit score 12-months after their credit application.[4]



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Without positive BNPL payment activity, consumers are spending their time and money with a financial tool that **may not directly impact their traditional credit profile.**

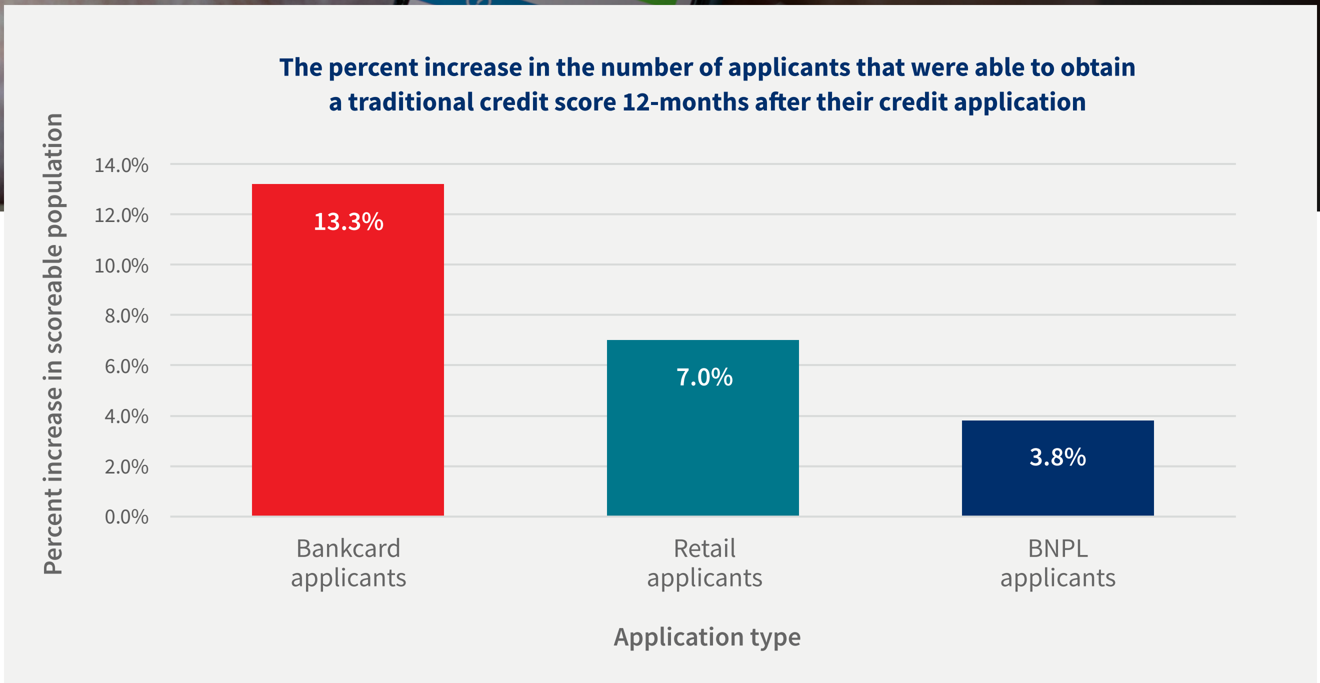

Figure 1: The lack of reporting by consumer reporting agencies on BNPL products suppresses financial inclusion by limiting scoreability.

The takeaway is obvious

BNPL applicants become traditionally scoreable at a much slower rate than their counterparts who utilize more traditional credit tools. Additionally, it is very likely that the BNPL applicants that do become scoreable during that time applied for a traditional form of credit soon after they applied for a BNPL loan.

The current state of positive reporting from BNPL usage to consumer reporting agencies is mostly non-existent.[5] To be a financially constructive instrument in our credit ecosystem, positive BNPL payment activity should be reflected within consumer reporting agency data in a manner which influences their scores.

BNPL is attractive for consumers on shaky credit footing

Our previous research briefs highlighted how BNPL users are more likely to have derogatory events in their past such as evictions, liens, bankruptcies or are highly leveraged and have missed payments. These events translate into worse credit scores and more expensive borrowing.

Against this backdrop, BNPL is an appealing substitute. It goes without saying that credit invisible and non-prime consumers are also more likely to get financing through BNPL than in the traditional credit system. This setup obliges consumers to choose BNPL when that may not be their ideal financial product — at least as currently constructed. Consumers shouldn't be forced into using a product that never contributes positively to their credit scores — the measurements which have historically served as the gatekeepers to most US financial services.

Alternative data can enable more choice for consumers

While this research series has demonstrated that BNPL offerings can be a compelling and positive option for consumers, particularly consumers with limited access to affordable credit tools, alternative data has presented non-BNPL lenders with a useful tool to better serve these same consumer segments. Comprised of data signals which is predictive of consumer credit risk, alternative data can paint a more complete picture of consumers who have established histories and credit scores, while evaluating most credit invisible consumers.

This enables lenders to identify sizeable portions of consumers underestimated by core credit tools — approving more consumers at more attractive rates, and in doing so giving consumers expanded financing options.

New alternative credit tools

Alternative data also presents a path forward for BNPL providers to address some of the issues highlighted in this brief. Most notably, new alternative credit tools are beginning to emerge which offer a more complete and more current understanding of how consumers are seeking BNPL loans across providers. By getting a near-real-time look into how consumers are seeking BNPL loans across the marketplace, lenders can protect both their customers and themselves by avoiding lending to over-extended applicants.

Regardless of the use case — be it BNPL, installment lending, retail financing or other services — we're at an exciting time in the U.S. credit marketplace. Consumers are seeing expanded options for accessing affordable credit. When those offerings are constructed with the right guardrails — and informed by the right data — consumers and lenders will both be in a position to benefit greatly.

References

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3. https://www.protocol.com/fintech/bnpl-credit-scoring
4. For more information on the data and analyses that were mentioned in this research brief, please refer to our previous research briefs 1-4 at this link: https://risk.lexisnexis.com/insights-resources/article/buy-now-pay-later-credit-risk
5. https://advocacy.consumerreports.org/wp-content/uploads/2023/07/BNPL-Policy-White-Paper.pdf

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