

EMERGING DISRUPTION: Buy Now Pay Later in Canada

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Buy now pay later (BNPL), a fast-growing point-of-sale (POS) financing product, is disrupting the unsecured lending market segment around the world.

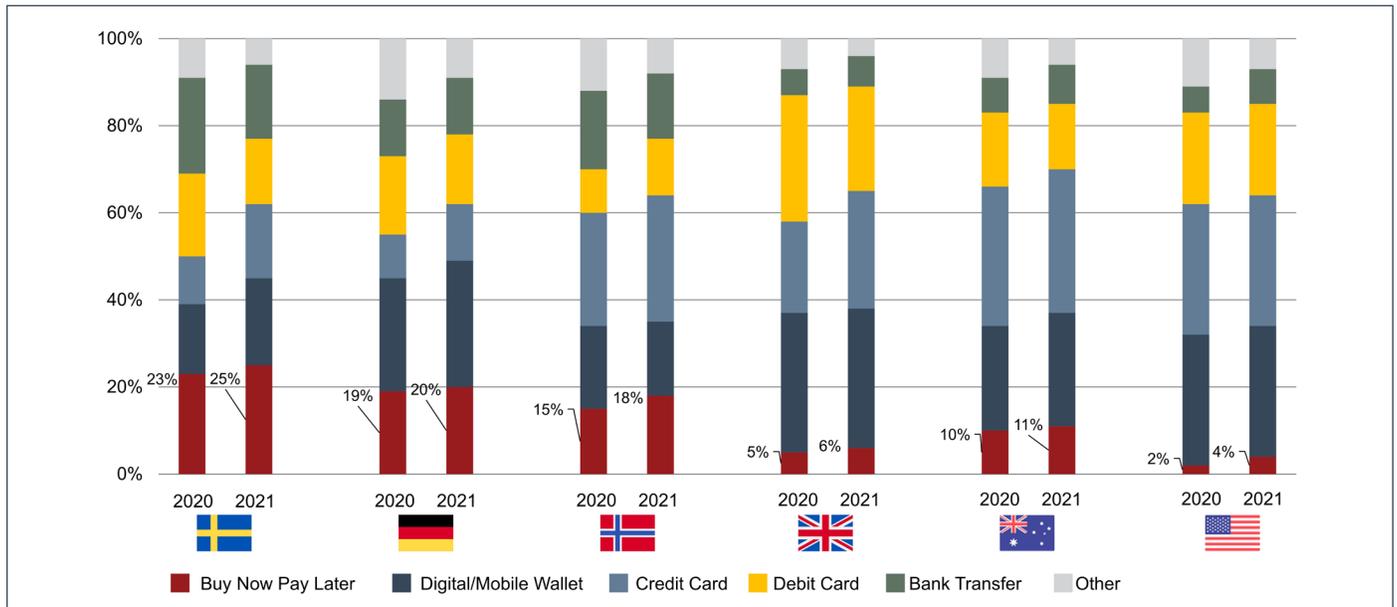
Particularly in the e-commerce payment channel, the BNPL market share in transaction value has grown substantially around the globe^{1,2}. As a result, BNPL has taken significant market share in certain European countries, such as Sweden and Germany (Figure 1). In other parts of Europe, Oceania, and North America, fast year-over-year growth continues (Figure 1).

In the wake of the rapid development in comparable markets, this paper examines the potential of BNPL from a Canadian perspective.

Specifically:

- What is the current state of BNPL in Canada, and how could it evolve?
- Discuss the various risks the BNPL disruption introduces to the Canadian financial system.

Figure 1: Market share of payment types in e-commerce transaction value in comparable markets: 2020 vs 2021.



Source: The Global Payments Report 2022, Worldpay. The Global Payments Report 2021, Worldpay.

How is BNPL different from traditional POS financing?

Retail customers are accustomed to loan offerings at checkout (e.g. installment finance, white label credit cards). BNPL (figure 2) differs from traditional POS financing products in the following ways:

- **No interest** – BNPL products are designed to be interest-free, whereas traditional POS financing products usually bear interest. Instead of profiting from interest, BNPL providers generate revenue from merchants in two possible ways. BNPL providers can charge merchants a service fee for the credit service. Alternatively, BNPL providers can charge merchants a commission for introducing customers to their stores through proprietary apps and websites.
- **No traditional credit check** – BNPL providers typically rely on a soft credit check and their proprietary internal credit system for identity verification and credit approval. (Some providers do a hard credit check on the first purchase.)

- **Independent brand** – Whereas traditional POS financing products are typically retailer-branded (e.g., Home Depot Project Loan), BNPL providers go to market with their own brand (e.g., Klarna, PayBright, and Afterpay). A strong BNPL brand gives smaller merchants the credibility needed for customers to use the POS financing option.

Figure 2: Customer experience of buy now pay later.

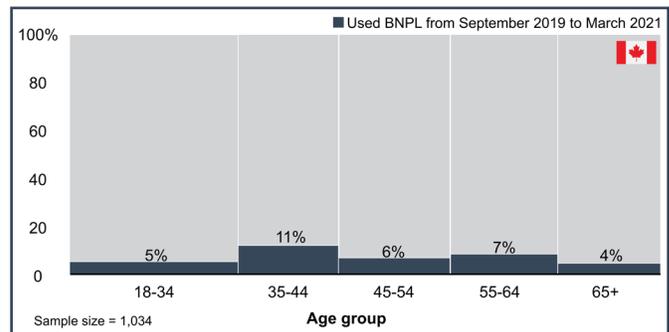


CURRENT STATE AND HOW THE MARKET MAY EVOLVE IN CANADA

BNPL adoption in Canada is currently behind comparable markets of the UK and Australia.

The Financial Consumer Agency of Canada (FCAC)³ conducted a pilot study in 2021 to monitor the proliferation of BNPL in Canada (Figure 3). Approximately 6% of surveyed Canadian shoppers claimed that they had used BNPL services in the reference period from September 2019 to March 2021, compared to 27% in the UK reported in a more recent 2021 survey by Bain and Company⁴ (Figure 4), and 46% in Australia, reported in a 2021 survey by Marqeta⁵. As more consumers start to use BNPL, the North American market presents a significant growth opportunity (Figure 5).

Figure 3: BNPL adoption by age group in Canada.



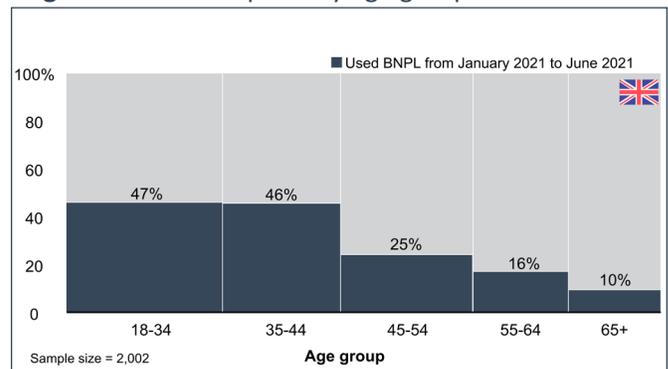
Source: Pilot Study: Buy Now, Pay Later Services in Canada, Financial Consumer Agency of Canada.

Younger age groups lead the adoption. The 35-44 age group now has the highest adoption rate in Canada (Figure 3). This can be attributed to the high purchasing power of this age group⁶, and this group tends to be more tech-savvy than other high-income age group of 45-54⁷. In the next stage of BNPL adoption in Canada, providers will likely target the under-served 18-34 age group based on the adoption patterns in comparable markets. In the UK, both the 18-34 and 35-44 age groups report over 46% have used BNPL services. In the youngest 18-24 cohort, the number of reported BNPL users is higher than that of credit card users (Figure 6).

Both consumers and many merchants welcome BNPL.

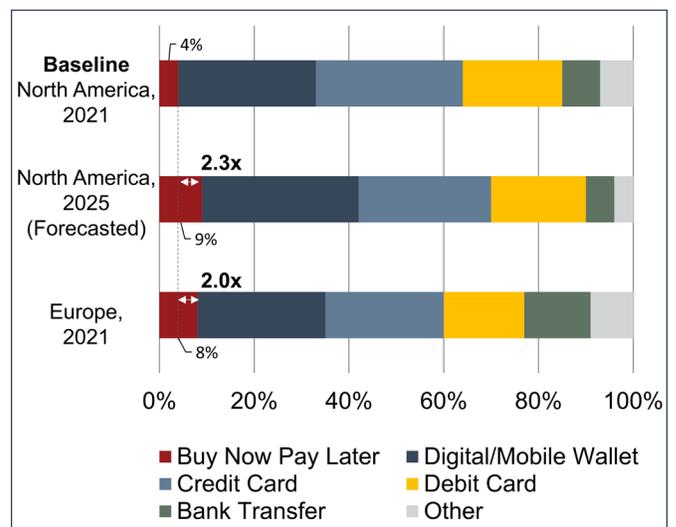
For consumers, BNPL gives them more purchasing power. BNPL is a cheaper alternative to credit cards because of the absence of interest and fees. Additionally, BNPL helps finance a big purchase, alleviating some pressure in budgeting larger purchases. When the surveyed British shoppers were asked how likely they were to recommend the credit products they use to a friend, BNPL users were found to be more likely to promote this consumer credit product than credit card users. (BNPL received a net promoter score (NPS) of 30, whereas credit cards scored 6.) For merchants, BNPL helps to attract customers, improve cart conversion, and boost sales. The most popular categories in Canada (appliances/furniture, electronics, and clothing and fashion) typically have high margins and require high customer acquisition costs. As a result, the merchants show a greater willingness to pay (Figure 7). In addition, over a third of surveyed British merchants noted repeat business and increased customer loyalty. To unlock these benefits, merchants have been willing to pay significantly high fees to BNPL providers.

Figure 4: BNPL adoption by age group in the UK.



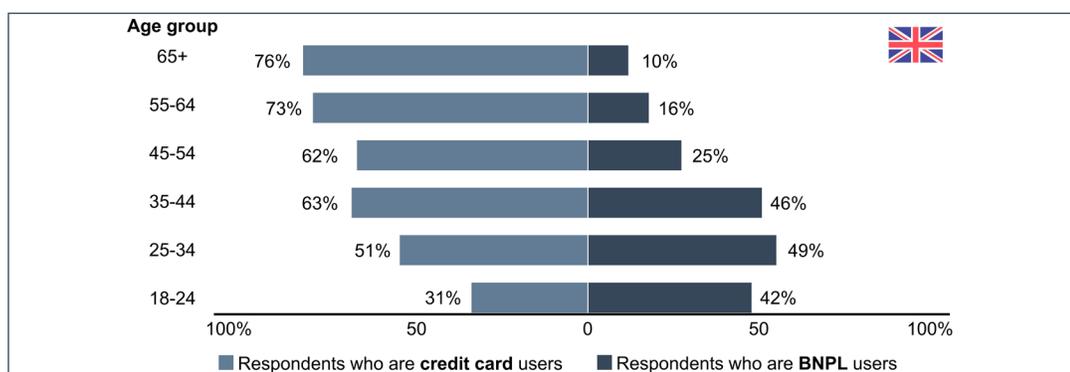
Source: Buy Now, Pay Later in the UK, Bain and Company.

Figure 5: Market share of payment types in e-commerce transaction value in comparable regions: baseline (North America in 2021) compared to North America forecasted for 2025 and Europe in 2021.



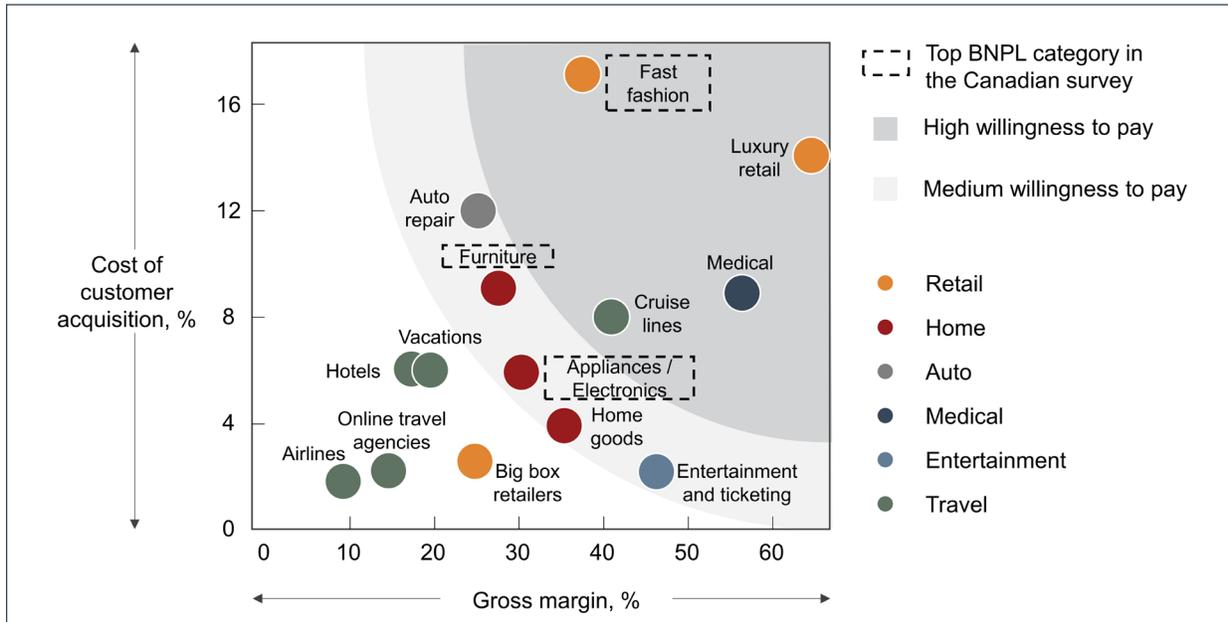
Source: The Global Payments Report 2022, Worldpay.

Figure 6: User adoption comparison between credit card and BNPL in the UK.



Source: Buy Now, Pay Later in the UK, Bain and Company.

Figure 7: Merchant categories by customer acquisition cost, gross margin, and willingness to pay.



Source: McKinsey Merchant POS Financing Survey, McKinsey and Company. Pilot Study: Buy Now, Pay Later Services in Canada, Financial Consumer Agency of Canada.

Credit card issuers will find a more challenging competitive environment, as leading BNPL providers grow their multi-dimensional ecosystem to deepen customer engagement. Unlike the credit card, which only engages customers at the checkout step in the purchase journey, BNPL providers typically engage customers across the entire purchase journey. Large BNPL providers operate on integrated shopping apps (Figure 8). They form a close relationship with merchants and customers by scaling these virtual marketplaces. In addition to income from financing and affiliate marketing, these marketplaces are valuable assets for cross-selling.

A high volume of traffic on the website/in the app and a high level of customer engagement are essential to the efficacy of cross-selling. Leading BNPL players are launching super apps and browser plug-in⁸ as they aspire to Alibaba-like ecosystems (Figure 9), in which the commerce, entertainment, and local service platforms each aggregate users and re-direct them to other product offerings. There is no compelling reason for the user to exit the ecosystem to use a supporting function in another app (e.g., payment) since the ecosystem contains all necessary functions in the customer journey.

Figure 8: Sample website/app homepage for selected BNPL providers in Canada.

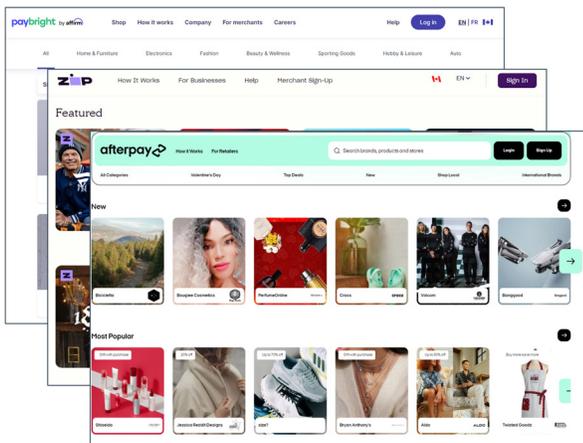


Figure 9: The Alibaba ecosystem.



RISKS FROM THE BNPL BUSINESS DISRUPTION

As the size of the market scales for the BNPL business in Canada, several risk challenges warrant consideration:

Credit risk

The robustness of credit assessment processes requires review and oversight. The credit limit of credit cards is determined based on traditional credit-scoring models, possible ‘hard credit search’, and a time-consuming credit decisioning process. In contrast, BNPL providers make an instant credit assessment at checkout of the customer’s purchase journey. An instant ‘soft credit search’ with a credit bureau is conducted to obtain an overview of the customer’s credit information, and alternative data sources (such as bank transaction data, utility payment, and user-reported education information⁹) are used in credit decisioning for predicting the creditworthiness and likelihood of repaying a loan. The use of alternative data allows BNPL providers to better serve consumers with short credit histories, who present a technical challenge to traditional credit-scoring models. The ‘soft credit search’ process used in BNPL underwriting is neither recorded on the customer’s credit file nor visible to other lenders, which differs from the ‘hard credit search’ process. Thus, as BNPL adoption grows, lenders will lose the accurate view of their consumers’ overall credit situation.

Ease of spending may contribute to over-extending credit behaviours. Reducing reliance on ‘hard credit searches’ potentially leads to easier credit qualification. New-to-credit young customers may make too many purchases, borrowing from multiple BNPL providers simultaneously. This access to credit by more vulnerable customers may further deteriorate their financial situation due to the less regulated and high late fee structure of BNPL services.

Regulatory risk

Regulators are working with the industry to ascertain the potential impact on the financial system’s stability. The FCAC in Canada commented in the 2021 BNPL pilot study that they continue to monitor how the domestic and international markets evolve. Regulators in comparable markets are closely looking at BNPL:

- The **UK** government may be the first to regulate BNPL systematically. They closed a public consultation on BNPL in January 2022. The

Financial Conduct Authority (FCA) could release new regulations as early as late 2022.

- **Australia’s** central bank, in October 2021, ordered BNPL providers to drop the rule of prohibiting merchants from passing on surcharges for their services to customers. In December 2021, the federal treasurer revealed the government’s plan to regulate BNPL products.

Compliance risk

Consumer complaints (e.g., refund disputes, confusion about the impact on credit score, etc.) are expected to increase with the usage of BNPL. As a result, regulators have taken action to strengthen consumer protection:

- In **Sweden** (home to major global BNPL provider Klarna), merchants that offer a list of payment options are required to display the payment options that do not contribute to consumers’ debt first, according to the newly amended Swedish Payment Services Act.
- In December 2021, the **US** Consumer Financial Protection Bureau (CFPB) ordered five major BNPL providers to file their product information on the risks of their BNPL product offerings. Subsequently, in January 2022, the CFPB engaged with the public by requesting stakeholders’ comments to inform the federal agency’s inquiry on BNPL.

Government agencies should proactively protect the consumers from overspending and over-indebtedness by releasing educational public-service announcement materials to address consumers’ key concerns and confusion around BNPL, such as the impact on credit score, refund policy, and fee structure.

Strategic business risk

As BNPL grows in Canada, traditional lenders will enter and compete in the market. Currently, many banks have already added an installment feature to existing products. This option leverages banks’ existing infrastructure and distribution channels.

While this option allows banks to put up initial defences to fintech disruption, they remain exposed to the following competitive disadvantages compared to the BNPL payment method:

1. **Cost for the customer** – Many banks still charge an installment fee or interest. For example, bank X charges the customer 2% of the purchase amount for a ‘pay in 3’ installment plan, whereas BNPL provider Y does not charge the customer for the same purchase.
2. **Customer engagement** – Bank’s engagement with customers is still limited to the checkout step, not across the entire journey. By comparison, leading BNPL players aim to immerse customers in new experiences (Figure 8, Figure 9). This gap in customer engagement level may lead to lower stickiness and customer loyalty.
3. **Merchant acquisition** – Compared to interest-free BNPL payment options and BNPL platforms, the bank’s installment option does less to cart conversion and offers few additional features for merchant online store capabilities. BNPL has proven to increase customer retention and increase basket value in other markets due to their full purchasing engagement.
4. **Datafication of customers** – SKU-level data generated through BNPL payment is extremely valuable as firms try to better understand customer behaviours. Through big data, customer segmentation, and predictive analytics, firms can generate more valuable insights into the customer base. Accordingly, cross-selling opportunities can be more effectively identified, and marketing campaigns can be personalized to boost marketing efficiency. Missing access to this rich data source is a significant strategic business risk.

Given the above, it is expected all major lenders will build or acquire BNPL or similar capabilities in the near future. Their choice of how to compete introduces a strategic business risk that could impact Canada’s overall competitive landscape of unsecured consumer credit.

CONCLUSION

This paper has introduced the BNPL payment method as a potential disruption to the Canadian market. BNPL has seen material growth as a new means of unsecured consumer lending in other markets in recent years. It is prudent to plan for potential growth in acceptance here in the Canadian market as it has occurred in similar markets around the world and address the risk concerns now.

Risks at a system level means adapting our existing regulatory and consumer protection frameworks for this new way of accessing credit. Financial literacy needs to be a key pillar for this, given the target market is a younger demographic who is likely to be new to credit.

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Endnotes

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