Buy Now, Pay Later

Revolution Turning Consumer Financing on Its Head

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The figures speak for themselves! Buy Now, Pay Later (BNPL) services are growing at a rate of 39% per year and expected to exceed $260 billion by 2025. Klarna, the BNPL unicorn which has turned the retail experience upside down, is now the most valuable EU fintech with a $45,6 billion valuation. The payment trend surged into prominence in recent years, fueled by pandemic spending by people who wanted to avoid taking on credit card debt while the economy was uncertain. But the hype about BNPL's rise to power is about so much more than pandemic convenience. The retail financing model is completely being restructured. Fintechs, big tech and merchants are forming alliances and their new, attractive offerings are shaking up credit card companies and international payment schemes, who are being forced to completely rethink their strategies. What's happening with consumer financing? Who will win in this new game?

At OpenWay, a global leader in digital payments software, we have long enjoyed developing consumer finance solutions for issuers, acquirers, payment switching companies, and digital wallet companies that increase revenue and meet changing customer expectations. Our article will dispel common misconceptions surrounding BNPL, introduce you to the stars and newcomers in the global BNPL market, how they make money, and what business strategies and technologies can help companies become the next Klarna.

Common misconceptions about BNPL

To understand what BNPL is, let's look at some common myths surrounding it.

1. Isn't Buy Now, Pay Later just another form of POS financing without interest? What's the big deal?

Instalments offered at point-of-sale is not a new phenomenon, and POS lending and BNPL do overlap in features. Generally, BNPL is a primarily *digital financing model* at the point of checkout. It offers highly personalized, flexible instalment plans with no interest fees for smaller-ticket retail purchases such as fashion, usually paid back in a few weeks. Payment is often *linked to the customer's debit card* instead of credit, an important distinction we'll discuss later in this article. Unlike traditional POS loans and instalment purchases of higher-ticket items, BNPL transactions involves minimum credit checks and are frequently made through attractive, easy-to-use apps. This makes them hugely popular among millennials and Gen Z consumers who lack credit history and whose disposable income is smaller. In the UK, *25% of BNPL users are between 18-24 years old* and half are 25-36. Along with the popularity of digital BNPL channels, we are also seeing more BNPL options being embedded into in-store checkout. In a nutshell, BNPL is designed to be most advantageous to people making frequent, small purchases of less than $500 to be paid off in a few weeks or months. These kinds of purchases have been increasing rapidly since the pandemic.

Metrics demonstrate how ‘buy now, pay later’ could become an attractive business model

McKinsey & Company

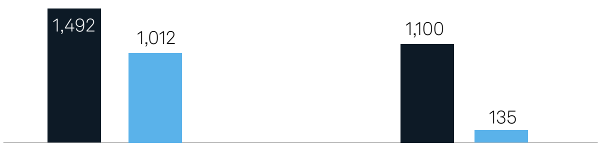
Major performance metrics

■ Private-label credit cards (PLCC) ■ Buy now, pay later (BNPL)

Purchase volume and receivables per active account

Average annual spend per customer, $

Average receivables per customer, $

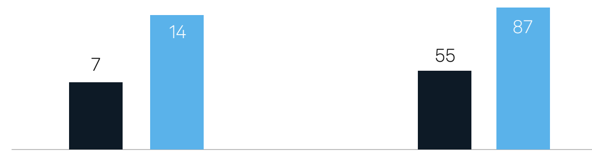


Spending of mature BNPL cohorts (customers>180 days on book) is 70% that of PLCC, but receivables at ~10%

Engagement

Average annual transaction per account

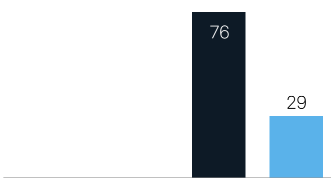
Customer active 12+ month after acquisition, %



BNPL customers are much more active and engaged across transactions volumes, digital app engagement, and length of relationship.

Portfolio performance

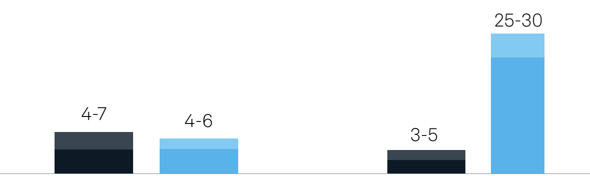
Average annual revenue per customer[1], $



Avenues to grow per-customer profitability of BNPL customers (vs PLCC) include cross-selling DDA and othercredit products

Net credit loss rates[2], %

Return on assets, %



Although BNPL risk-ajusted revenue per account is 1/3 that of PLCC, ROA is much higher, given low average receivables

[1]Risk-adjusted and commission-adjusted revenue (net of losses and net of partner share) per active account.
[2]Loss rate for BNPL calculated on outstanding receivables as reported by BNPL providers.
Source: Analysis of publicly listed BNPL providers (Atterpay, Zip, Sezzle for their US businesses); analyses of Synchrony, ADS, and CRS portfolios.

2. Aren't merchants shouldering the cost of BNPL's success? Isn't BNPL exploiting them, since they have to pay the provider a hefty percent of each purchase?

Although merchants typically *pay between 1,5-6%* of each BNPL transaction value to the BNPL service provider, they are betting that the increased revenue brought in by their partnership will more than recoup costs. BNPL checkout, both online and in-store, serves up a divided checkout amount to customers that looks more palatable, avoiding "sticker shock" that might make them reconsider the purchase. Customers also repeat purchases more frequently. Affirm has showed *figures* that indicate that adding its BNPL option raises conversions in merchants by 20%. Different reports show that consumers who use BNPL spend more, from 10-40% more than they would with a credit card. One *study* showed that 35% more customers would make a purchase if they were offered interest-free instalments.

BNPL also increases conversions by seamlessly improving the checkout UX. A clumsy checkout process that repeatedly requires filling in data, waiting, and confirming will lead to abandoned carts. BNPL checkout, on the other hand, is often personalized and adaptive, where data is analyzed behind the scenes to whip out the instalment plan most optimal and attractive to the customer for that purchase.

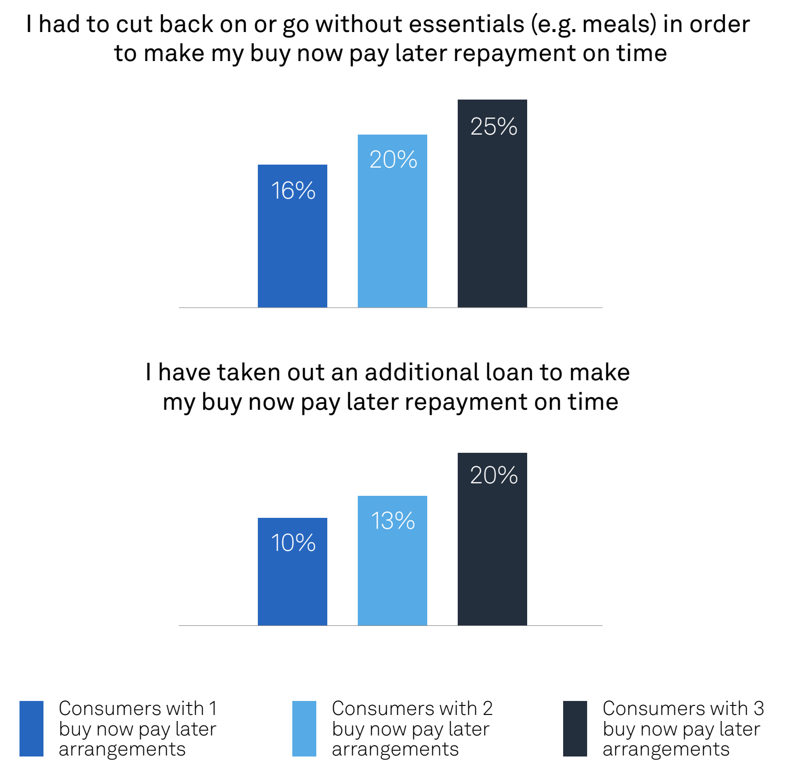
Another merchant advantage that might not be immediately obvious is the huge advertising potential of BNPL apps. Apps like Affirm will grab a profile of a customer's interests as soon as they register, and this gives merchants on the app a way to enhance brand discovery. Instead of investing thousands in generic Facebook and Google ads that aren't necessarily effective, merchants get, in effect, a free marketing advantage through the BNPL app. The app ensures that merchants will be placed in front of selected customers as a known and liked store that matches the customers' interests and preferences. With such immediate access to a large marketing audience, merchants can easily set up targeted promotions, for example, for those who are buying for the first time, or those making repeat purchases.

Source: BNPL statistics provided by Affirm

3. So what about the customers? Isn't BNPL exploiting impulse buyers and making money off of huge fees leveraged against those who can't pay their instalments on time?

It might appear that BNPL providers are making their profit from hapless shopaholics, since the solution can enable those who have the least income to make more purchases than they would otherwise. In fact, fearing consumer exploitation, governments of some countries have been investigating how BNPL has been affecting spending behavior and debt. For example, the Australian Securities and Investments Commission (ASIC) in its *report* found that 1 in 5 of surveyed BNPL users have paid late fees in addition to instalment payments, and that 15% of them had taken out an additional loan to make payments.

However, BNPL providers point out that their business model is dependent on the



Source: ASIC

VIDEO: Klarna's CEO, Sebastian Siemiatkowski, has to say on #WhyPayInterest and what consumers can do to make sure that the future has a little bit less interest involved.

merchant relationship for profits, so they do not benefit when people cannot pay for their purchases. In other words, when you complete your purchase, the BNPL provider has already made its money from the store, so there is no incentive for it to impose interest rates or late payment fees. Affirm even prides itself on *never changing any fees on its loans*, not even if payments are late.

In most cases, fees do apply for late payments, although most BNPL providers have grace periods and other mechanisms in place to help customers reach payment goals. Afterpay blocks customers from using its services if they miss a payment, and reported in 2021 that 95% of its transactions globally are paid back on time. It also claims that *late fees make up less than 14% of the company's income*. BNPL supporters claim that *their solutions can serve as a budgeting tool and cite a variety of policies that prevent financial misuse*. A Klarna spokesperson noted: "We have safeguards in place to ensure that our products are only offered to those who are able to afford it and who will be able to make repayments in a sustainable way, without impacting their financial well-being". Klarna reports that *fewer than 1% of orders go to debt collection agencies*, and these are only cases where customers could not be reached by the company's representatives. It remains to be seen what regulations and credit laws will appear in the NPL space in the near future.

4. Is BNPL really a threat to credit cards? After all, BNPL doesn't offer rewards, points, miles or cashback, nor does it help you build credit.

BNPL positions itself as a more fair and equal model for credit, an attractive proposition for younger, socially aware consumers. Sebastian Siemiatkowski, Klarna's CEO, has pointed out that the credit card system is *largely subsidized by lower-income users* who pay for the generous rewards given to prime, high-income users. Middle-class, working class and lower-income families are more likely to be penalized for credit card use while receiving little to no benefits. Contrast this with BNPL, which offers to all customers easier and more flexible payment terms and cheaper credit, regardless of whether they have reached prime customer status or have no credit status at all — as is often the case with millennials and Gen Z.

Credit card profitability has shown an interesting decline in the last decade. In the US, the average ROA dropped from 5,4 in 2011 in 2011 to 3,7 percent in 2018. The same *survey* found that millennial and Gen Z consumers tend to avoid credit in favor of debit, especially when making digital payments. According to a new study, *67% of millennials don't have credit cards at all*. And if you think that BNPL is only for those who don't qualify for credit cards, McKinsey reports that among the consumers who choose an off-card financing solution to fund their purchase, about *80%* already have a credit card with credit available for the amount — they just aren't choosing to spend it.

As we will see later, credit card providers are waking up to the fact they have to change their value proposition to keep up with the latest payment trend, which is proving not so much a trend as a revolution. Their customers are turning away from a penalizing model that only lets them redeem reward points for big purchases like air tickets and hotels. Having tasted flexible and personalized payment offers for small, everyday purchases, customers are flocking to the BNPL model, which makes the lending space a win-win-win situation — a win for banks, merchants, and the customer.

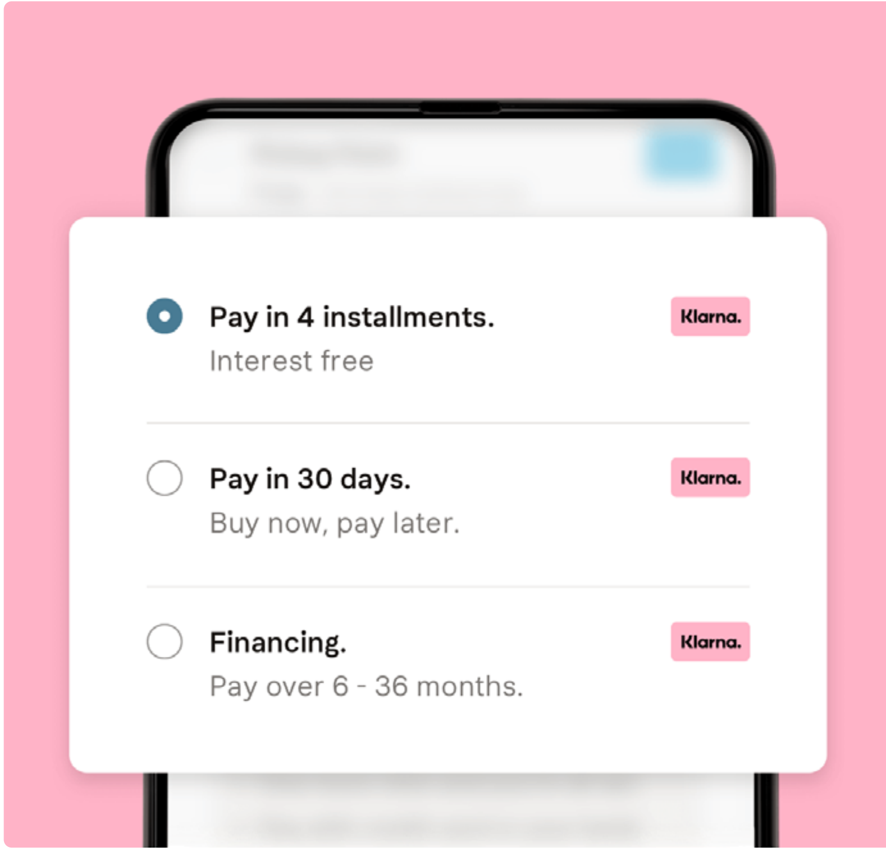
A guide to a BNPL multiverse

Retail banking is fundamentally being restructured from a customer-financed model to a partnering model between a variety of different players. What kind of business models and partnerings are we talking about? Let's take a look.

Standalone stars

Fintechs

Swedish fintech **Klarna** is undoubtedly the North Star of this multiverse. The market leader has heavily invested in their brand image, bringing in celebrities to enhance their visibility and attractiveness to the GenZ and millennial segment. Its *pop-up events* have a cult following, with talks and experiences



Pay in 4, Pay in 30 days and Financing are the Pay Later options offered by Klarna.

▶▶
VIDEO: Christmas advertisement
by Affirm: Get Gifts Not Gotchas

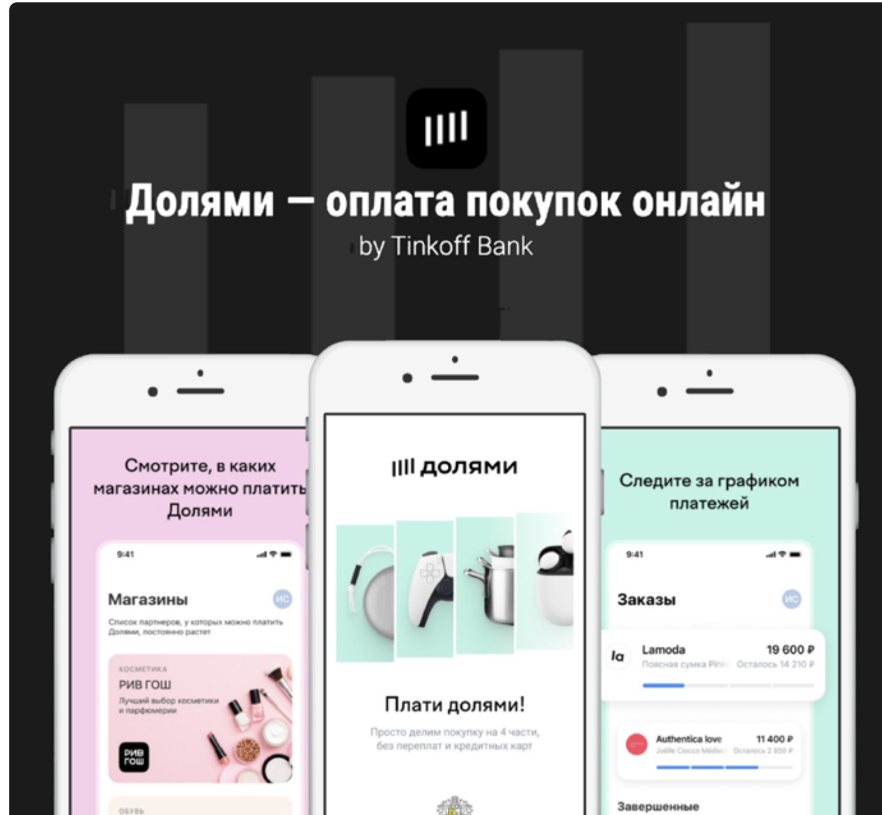
around beauty, lifestyle, design, and personal finance. Their hip image is the perfect juxtaposition for over 250,000 digitally visible retail partners, among them H&M, IKEA, Expedia Group, ASOS, and AliExpress. Having recorded 8 million mobile downloads just in Europe last year, it is set to conquer the US market. In just the last 14 months, it has *doubled the US customer base to 20 million*. But the bottom line is that it's not just a pretty face — merchants are loving that customers using Klarna are spending up to 68% more than the average retail order value. Pricing for merchants varies depending on country, but includes all card processing fees. In Australia, it is 30 cents plus 5,5% of the transaction.

The American BNPL giant **Affirm** provides biweekly and monthly payment option per transaction with its Adaptive Checkout feature. It enjoyed a revenue increase of 71 percent to $262 million this fiscal year, and an *increase in its customer base* by 97% to 7,1 million in the last quarter. Among *rising BNPL players in Asia*, a noteworthy one is **Hoolah**, operating in Singapore, Malaysia and Hong Kong. It reported a 280% increase in partnered merchants within a single year. Its rival **Atome** launched its BNPL solution last year, and just 4 months later was able to report that its over 1000 merchants saw a 20-30% increase in conversions, and a 30% increase in average order size.

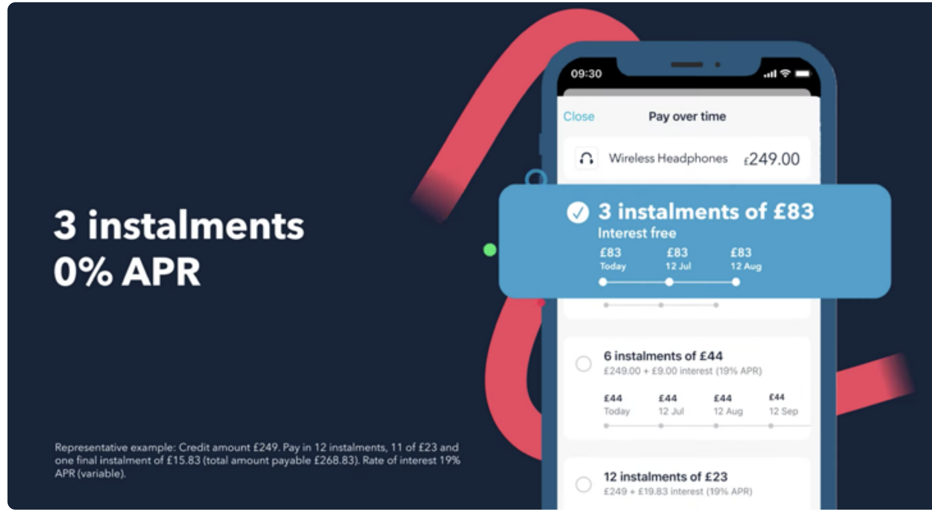
Neobanks

Neobanks like **Monzo** and **Tinkoff**, who already have the young, digital-savvy and mobile customer following, can be expected to take the BNPL plunge early and they have.

Tinkoff Bank is the world's largest digital bank in terms of numbers of customers, and the second-largest credit card provider in Russia. It became the first to launch a digital BNPL service in the country with **Dolyame**, a shrewd e-commerce solution. It offers instalment payments that can be used to purchase products that are usually not sold on credit or instalments, such as clothes, shoes, cosmetics and accessories. The first instalment is 25% of the purchase price, and the rest is debited from the consumer's card biweekly until the full amount is received. An interesting feature is that customers can convert any purchase made with a Tinkoff card and exceeding 1,000 rubles (approximately $13) into instalments in the mobile app. As a lifestyle bank, the new offer is sure to cement bank consumers to Tinkoff's



The name of the Dolyame BNPL service by Tinkoff Bank means "In parts" in Russian.



VIDEO: Ad of Monzo Flex by Monzo

digital financial ecosystem. And since the service is included in the acquiring service for the bank's merchants, there is no need for them to look elsewhere. Merchants pay a set 4% fee per transaction, which may be lowered if the merchant's turnover is greater than 20 million rubles (approximately $275,800) per month.

Monzo's Flex has taken an interesting approach — instead of charging merchants per transaction like Klarna does, they've made their product free. So how do they make any money? Monzo is betting that the BNPL option will act as a *cheap acquisition tool*, signing up new customers eager to use the feature, increasing engagement and boosting deposit volumes. But also, it was reported that Monzo "*applies a fashionable BNPL sheen to an old-fashioned credit line*" by giving the option of a "Pay in 3" without interest or of incurring a 19% interest rate for longer instalment plans.

Whatever their strategy, neobanks can give the Klarnas a run for their money if they solidify their position as lenders while playing up convenience. Next major neobank to launch BNPL? *Revolut* is expected to trial its product across European markets next year.

Large retailers / financers

Some large retailers find it a good business strategy to roll out BNPL under their own brand, even if they are not the ones handling the borrowing process. This is the case with **IKEA**, which has partnered with BNPL provider Jifiti but is *rolling out the service so IKEA appears to be the lender*. Because of IKEA's superb brand recognition and reputation, consumers are more likely to use the BNPL service if they see the whole process as under the furniture conglomerate's brand. Although IKEA has already offered instalments for expensive purchases, this time, it is offering flexible payments for cheaper products not priced in the thousands of euros. As IKEA's company Ingka Group has taken a $20 million stake in Jifiti, IKEA will also have access to insights on how the lending process, consumer payback, and rates affects customers, setting the scene for hosting more financial services sometime in the future.

Other retailers, some with their own financing companies, may also be moving in that direction. LOTTE Finance Vietnam, a subsidiary of LOTTE Card, part of the leading conglomerate retail financer in Asia, has launched a BNPL solution, based on OpenWay's Way4 platform. The company hopes to capitalize on its lifestyle-oriented services to enhance the online shopping experience of Vietnamese consumers. They are partnering with the largest e-commerce retailers in their country, including airline and hotel booking providers, to ensure a huge customer base from the very beginning. Customers can choose to pay for their purchases in 3 instalments, completing contact details, KYC and scoring, which takes less than 5 minutes on a smartphone. Since a large segment of the target population is unbanked, this BNPL solution is expected to be an attractive alternative to credit.

Card issuing and merchant acquiring processors

Payment processors can play a key role in the BNPL multiverse by helping smaller banks and fintechs to embed this offering into their retail payment propositions. In 2020, **Nets**, one of Europe's largest processors, introduced a *Universal Digital Lending Platform (UDLP)* developed together with OpenWay. While this solution takes into account consumer concerns and needs, it is designed for financial institutions who need a simple lending-as-a-service solution.

The UDLP allows banks and fintechs for easy connectivity via APIs and the capacity to offer lending products to their customers within just 2-3 months. They can use the UDLP to access a wide range of financing options — not only BNPL, but also pre-approved loans, unsecured loans and even small business loans. The platform enables instalment payments before, during or after checkout. This is a stand-alone solution: any company can use it, regardless of their existing card issuing and payment processing relationships. UDLP won in the "Best Consumer Payment Initiative" category at PayTech Award 2020 for the end-to-end solution for instalment products.

BNPL partnerships

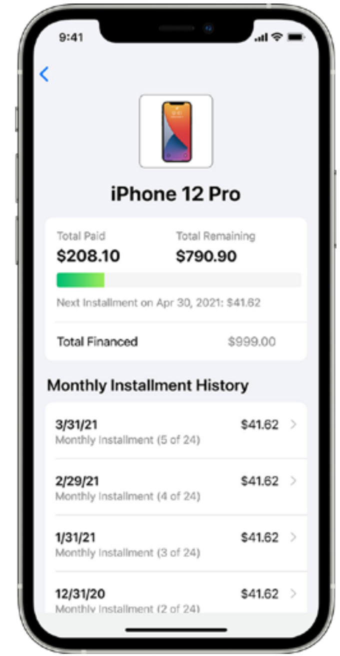
Fintech + fintech — even the best fintechs benefit from expanding their customer base and target verticals

PayPal and **Paidy** aim to conquer the Japanese e-commerce market together. *PayPal acquired Paidy*, a Japanese BNPL service, for $2,7 billion. Paidy has developed a significant two-sided platform of consumers and merchants, and is the leading BNPL service in Japan.

Afterpay and **Square** made headlines recently when Square bought Afterpay in a $29 billion deal. One *fintech analyst commented*: “Afterpay brings this ecosystem of younger consumers who really like this alternative form of credit and they’ve got a really compelling two-sided network of merchants and consumers, a very strong two-sided value proposition which is like the holy grail in payments...the advantage for Square is that they are now able to connect their two ecosystems of merchants and consumers”.

Big tech + big bank — trusted brands team up against agile fintechs

Apple and Goldman Sachs have announced that they are developing a *BNPL feature for Apple Pay* called Apple Pay in 4. Customers can have the option of paying for their Apple Pay purchases in four interest-free payments or across several months with interest. Users can choose any credit card added to Apple Pay to make payments, and the purchases may be made at either



Before, Apple Card users could make instalment payments only for Apple products using the Apple Monthly Installments feature retail or online stores. Goldman Sachs is a good example of an established bank that has taken steps to grow its consumer franchise by investing in the digital payment experience. It first gained Apple as a partner when they launched together the Apple Card in 2019, a new credit card product with no fees, daily cash back and seamless integration into Apple devices. Now by entering the BNPL space with Apple, Goldman Sachs gains agile, digital-savvy and brand-loyal customers, while taking over underwriting, the platform and regulatory compliance matters.

Large retailer + fintech — embedding BNPL into the existing customer experience to make it seamless

Although **Amazon** already offers instalment options on some items, it has firmly entered BNPL territory when it announced its partnership with **Affirm**, news that sent *Affirm shares skyrocketing by 50%*. For the largest online retailer on the planet, it means boosting conversion rates since their customers are able to extend their spending power on smaller items. Affirm wins by getting exposure to Amazon Prime's 200 million members, in addition with its existing 5,4 million customers. Depending on how integrated Affirm will be in Amazon's checkout process, Affirm might even be able to piggy-back on Amazon's success to *become the single largest BNPL player*. Time will tell.

IPS + major bank — often card-based, customers get reassurance of trusted brand

International payment schemes are targeting the BNPL market space but with their own twist. In some regions, they have been already piloting their instalment API-based services with banks, credit unions and fintechs who use their payment network. For example, OpenWay supported this functionality for a leading bank in Central Asia. In Canada, **Scotiabank** has become the first bank in Canada to offer an instalment payment program using Visa Installments, called the *ScotiaPay instalment payments* option. For card issuers and merchant acquirers this partnership with IPS is very logical, as it leverages the existing relationships and goes through the traditional card rails.

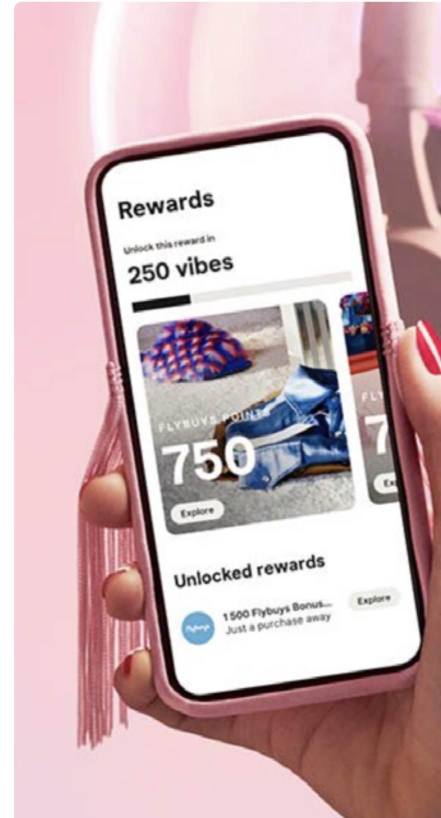
Business strategies and technologies behind a good BNPL solution

So how can you win the BNPL game? Should you go forth on your own or partner with a fintech company, a big tech company, or a large retail chain? What combination will ensure the better ROI?

The short answer is: the company who builds the best customer experience wins! The idea of fintechs integrating into other companies is not new. Neither is international payment schemes teaming up with major banks to produce new products. What's really new is the emphasis on the digital, data-driven customer experience and making the whole ecosystem surrounding it a win for all parties. So let's take a look at the BNPL technologies and strategies that these companies are pursuing, and why they work.

Create a super lifestyle app

Creating a super app that becomes people's go-to lifestyle platform isn't just about advertising and brand recognition. Klarna's biggest asset is data from its 90 million users, the double-barreled holy grail we mentioned — merchant and consumer data. By analyzing consumer payment behavior with machine learning, Klarna is able to understand what an individual's favorite way to pay is in different contexts. This helps them offer the right one-click payment experience to the right person for the right purchase – giving consumers a frictionless, intuitive and reactive checkout experience. Interestingly, Klarna states that their level of personalization based on machine



Users are rewarded with Vibes when shopping in the Klarna app. 1 Vibe = 1 USD.

learning is so sophisticated that *in 75% of cases, consumers choose the payment method that Klarna pre-filled for them* upon checkout.

To build what can be truly called a super app, you need good integration with third parties. Here, Klarna also leads with its *Open Banking by Klarna* strategy, which offers APIs and other platform integration services to merchants. Their services include the Account Information Service, Payment Initiation Service, and Account Insights, which can be used by insurance companies and consumer banking. When companies treat BNPL not as a product, but as a whole digital platform and ecosystem, a variety of strategic partnerships become possible.

Be extremely flexible

Flexible checkout is a term often heard when talking about BNPL solutions. Although most offers are for “Pay in 4” or “Pay in 3”, BNPL provider hopefuls would do well to take a lesson from traditional instalment offers: a variety of personalized instalment plans and schedules available instantly will allow consumers to pick the best, more appealing offer for them and make sure that they won’t be shying away from their purchases before checkout. OpenWay client Nets, one of Europe’s largest processors mentioned earlier, finds that its Universal Digital Lending Platform is being used by all kinds of financial institutions, from banks and e-money institutions and fintech start-ups to create personalized lending solutions that suit a variety of customer payment scenarios and also smoothly handles negative transactions like late payments, purchase returns, or fraudulent transactions.

Keep convenience high in the customer experience

We already said that conversion is the number one concern for merchants, and the main deterrent is long and complex checkouts. In 2021, *1 in 5 digital shoppers abandoned their cart* because of this. Problems with authorization, having to give card details multiple times... all these lead to reduced sales. BNPL can make checkout a seamless, frictionless experience with the payment option strongly integrated in the check-out process. BNPL vendors and merchants being on the same digital platform can *simplify the operational and support model*, where issues can be quickly resolved with item payment, delivery, return and reimbursement. Needless to say, any bumps in the customer journey will quickly sour the BNPL target customer, used to an integrated experience within a single app without the need to figure out which company is responsible for what.

OpenWay is your trusted partner in the BNPL multiverse

OpenWay has a long and proven history of helping issuers, acquirers and digital wallet companies increase their revenue via customer-facing credit products and consumer finance solutions, especially mobile instalments. Our Way4 digital payment platform enables flexible financing options at any point in the customer experience — before, during, or after purchase, including:

Pre-approved loans for a purchase (customer activates the pre-approved loan before making a payment)

Buy now/pay later in instalments (customer selects a financing plan at the point of sale in-store or online)

Conversion to instalments after purchase was made

Conversion of a single selected transaction among others

Ability to bundle different transactions together as one instalment (such as a variety of purchases related to a single event, like a wedding or a vacation)

Unsecured loans

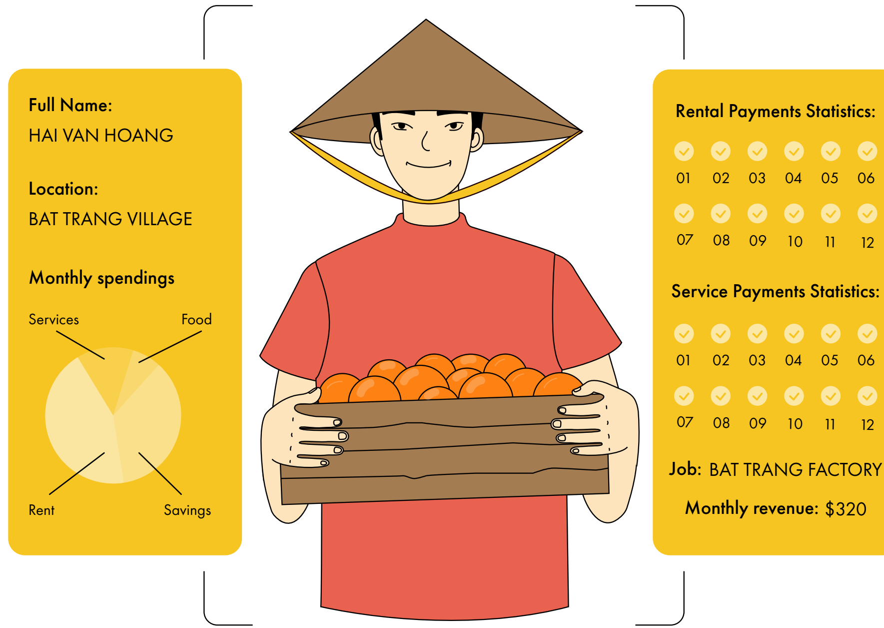
SME financing

Financial institutions can offer any instalment plan or BNPL solution to their brick-and-mortar and e-commerce merchant partners. Way4 can support any kind of interest calculation scheme, including Sharia-compliant schemes. You can personalize tariffs, process instalment applications online and enable your customers to manage their instalment payments via digital channels. Perhaps you are an OpenWay client already on Way4, or your company is relying on another payment solution. But whether you are a fintech, neobank, payment processor, acquirer, issuer, or retail conglomerate, there is a business strategy for you in the BNPL multiverse.

Maybe you are an ambitious processor who wants to try the strategy used by OpenWay client Nets — provide a lending solution for a variety of customer financing schemes that can be used by any kind of financial institution. Or perhaps you want to combine a traditional credit product with instalments on a single card that can be used on any acquirer acceptance network.

Maybe your business idea is to create a whole new retail universe centered around your brand and embracing a galaxy of banks, merchants, customers, and third-party providers. How can you manage the complexity? *OpenWay client SmartPay* in Vietnam has successfully partnered with a consumer finance company to offer digital lending and small loans to micromerchants and consumers who lack anything resembling a traditional credit history. Their platform is exclusively mobile, which is the key customer channel in developing markets and lessens dependence on infrastructure. Consumers are able to purchase goods offered by local merchants on deferred payment terms, and receive a personalized range of in-app discounts, campaign promos and loyalty program invitations. The Way4 platform allows SmartPay to integrate with a variety of partners and service providers via APIs. It also manages wallet accounts and handles configuration of loyalty programs and dynamic pricing. And thanks to the platform's inherent scalability, SmartPay had no problems scaling up its operations efficiently and quickly, having picked up a million users only a year after its launch and over 190,000 merchants.

This is the time to invest in a flexible, reliable and data-driven digital payment solution. As the financial and payment ecosystem shifts dramatically towards BNPL, be ready for the market opportunities and partnerships within your reach. Contact OpenWay to help you roll out the next BNPL success story... your own!



SmartPay offers instalments to micro, small and medium merchants via the wallet platform, which feeds on the data it acquires from merchants' operations.

Learn more: analytic reports, news and case studies

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