CHARGEBACK GURUS

Buy Now, Pay Later:
The Market, the Risks, the Road Ahead

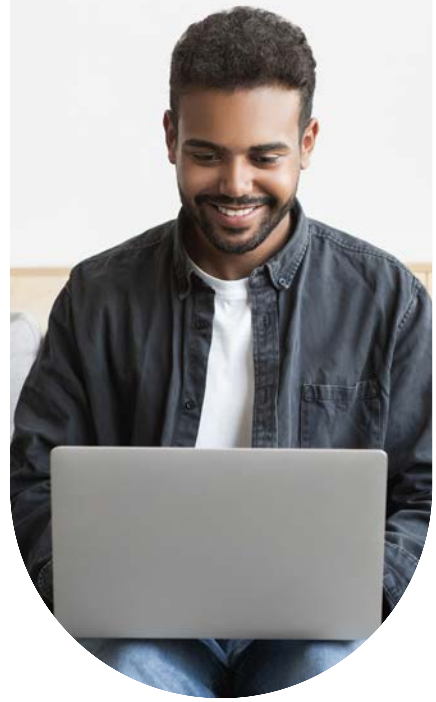
Table of Contents

Summary

Competition among buy now, pay later (BNPL) providers is hotter than ever, with big players like Apple, Goldman Sachs, Visa, and Mastercard getting into the game. It's clear that BNPL is here to stay, but without effective strategies for providers and merchants to mitigate fraud and disputes in the BNPL space, the road ahead could be full of pitfalls.

While the basic concept of paying in installments has been around for centuries, the current digital BNPL industry is still developing. Basic issues like returns and cancellations can sometimes cause difficulties, and fraudsters are still figuring out how best to exploit BNPL for their purposes. Failing to navigate these obstacles correctly could be costly, both for BNPL providers and for the merchants they serve.

In this guide, we'll outline the current state of BNPL, discuss the risks facing providers and merchants and their potential remedies, and take a look at how the BNPL industry might evolve in the future.



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1. The BNPL World

There are a number of important factors that have led to the rapid growth of the BNPL industry. One is that Millennials are less financially stable than previous generations and therefore less likely to be able to make large purchases without some form of credit or loan. At the same time, Millennials are more concerned about debt and are somewhat hesitant to use credit cards for major purchases.

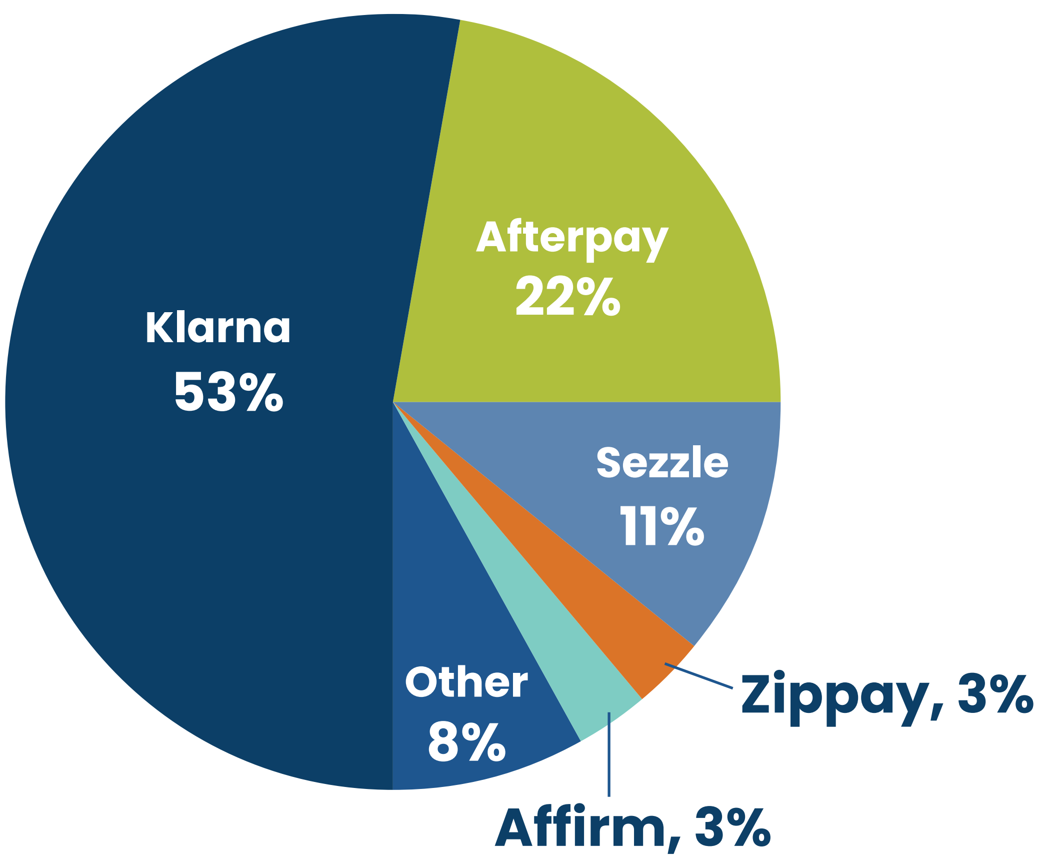
To meet the needs of consumers like these—as well as consumers in regions without much penetration by credit card issuers—companies like Affirm, Afterpay, and Klarna started popping up to offer third-party installment payment services.

Then came the COVID-19 pandemic. With brick-and-mortar stores understaffed or under lockdown, consumer attention took a huge swing toward e-commerce. At the same time, many shoppers were experiencing acute economic strain. While 42% of Americans have used BNPL in some form, the percentage increases to 60% among Americans who were laid off or furloughed. Demand for BNPL services skyrocketed, and providers were there to meet it.

BNPL Providers & Market Share

The growing popularity of the BNPL model has attracted several new players, including card networks and big banks. However, a number of companies are already well-established in the market, namely Klarna, Afterpay, Sezze, ZipPay, & Affirm Pay.

BNPL Service Distribution Across All Websites



Source: BuiltWith, 2021

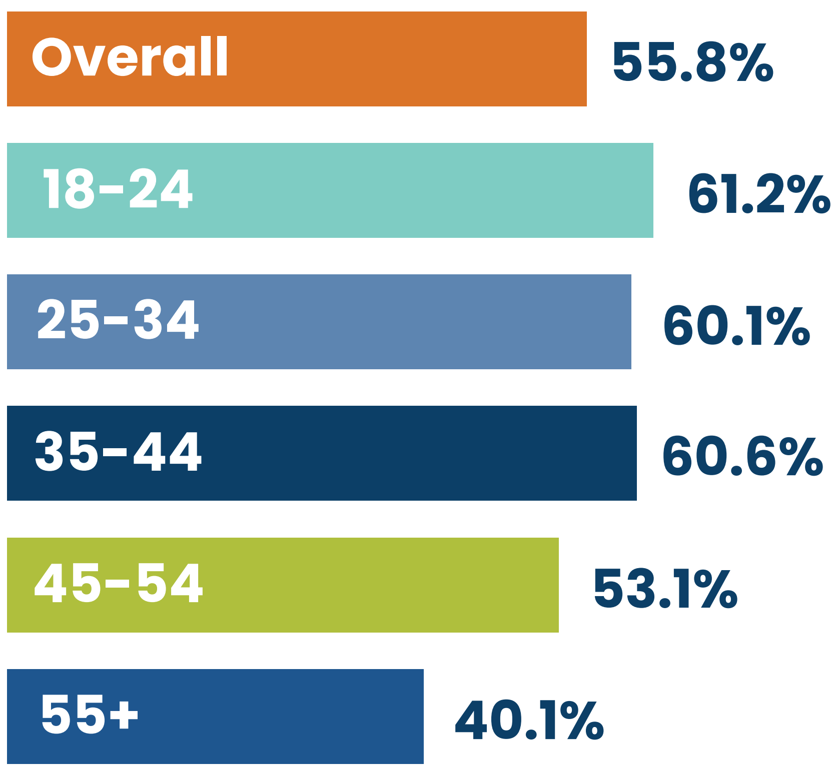
Klarna is currently leading the way in the BNPL space, in part due to its marketing tactics. Klarna has positioned itself as a shopping service rather than a credit provider. As traditional banks have struggled with innovation, Klarna has disrupted the retail banking and credit card industries by providing attractive opportunities for both merchants and customers.

Additionally, Klarna has entered into a partnership with online payments processor Stripe, making it easy for retailers in Europe, the US, and the UK to add Klarna as a payment option at checkout.

2. BNPL Customer Base

BNPL's growth has been driven in large part by Millennials and Gen Z. It's not just negative attitudes toward banks and credit cards fueling this—these digitally-savvy consumers are used to subscription services, monthly charges, and the idea of paying for things in bite-size chunks over a period of time.

Share of US Consumers Who Have Used a BNPL Service



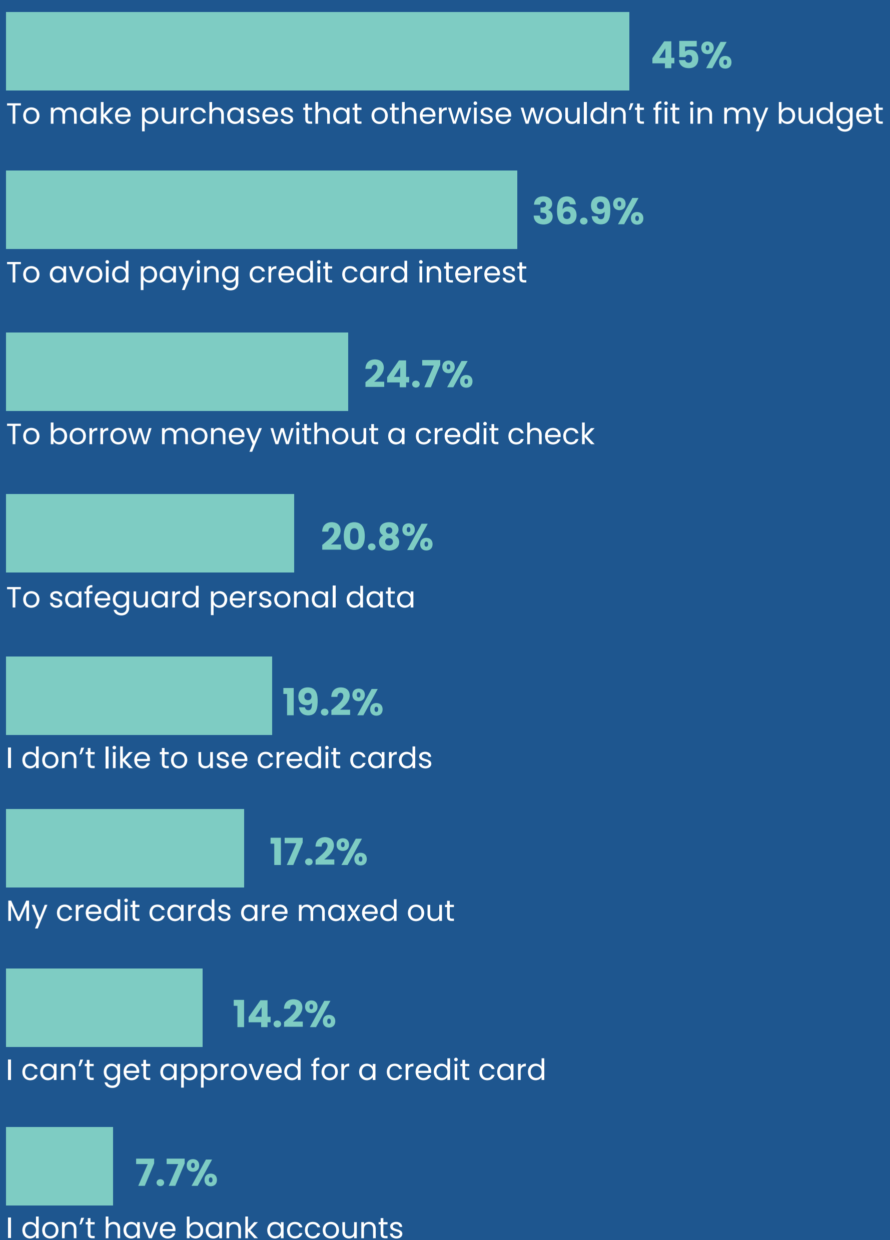
Source: The Ascent, 2021

Reasons for Using BNPL

The typical BNPL customer persona looks something like this:

- Young
- Concerned about interest charges
- Low credit score or no credit history
- Low income

While this profile doesn't describe every customer, a look at the reasons consumers give for using BNPL supports this description.

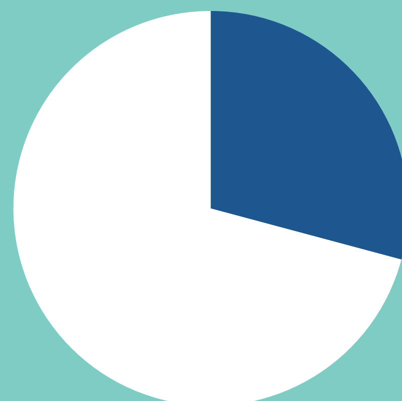


Source: The Ascent, 2021

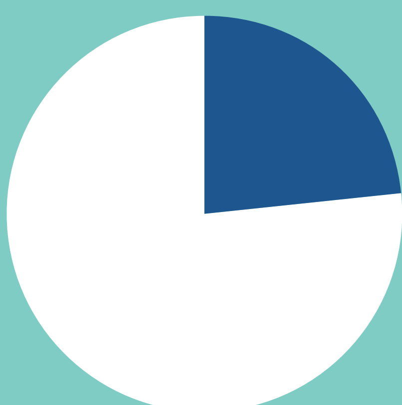
Most Common Purchase Categories Among BNPL Customers

Some industries benefit more than others from the growth of BNPL. Merchants selling high-value products and those with a larger share of young adults in their customer bases will likely see the highest return from offering BNPL options.

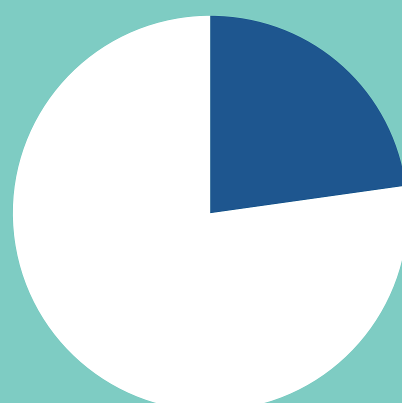
44.3%
Clothing and Accessories



41.7%
Electronics and Appliances

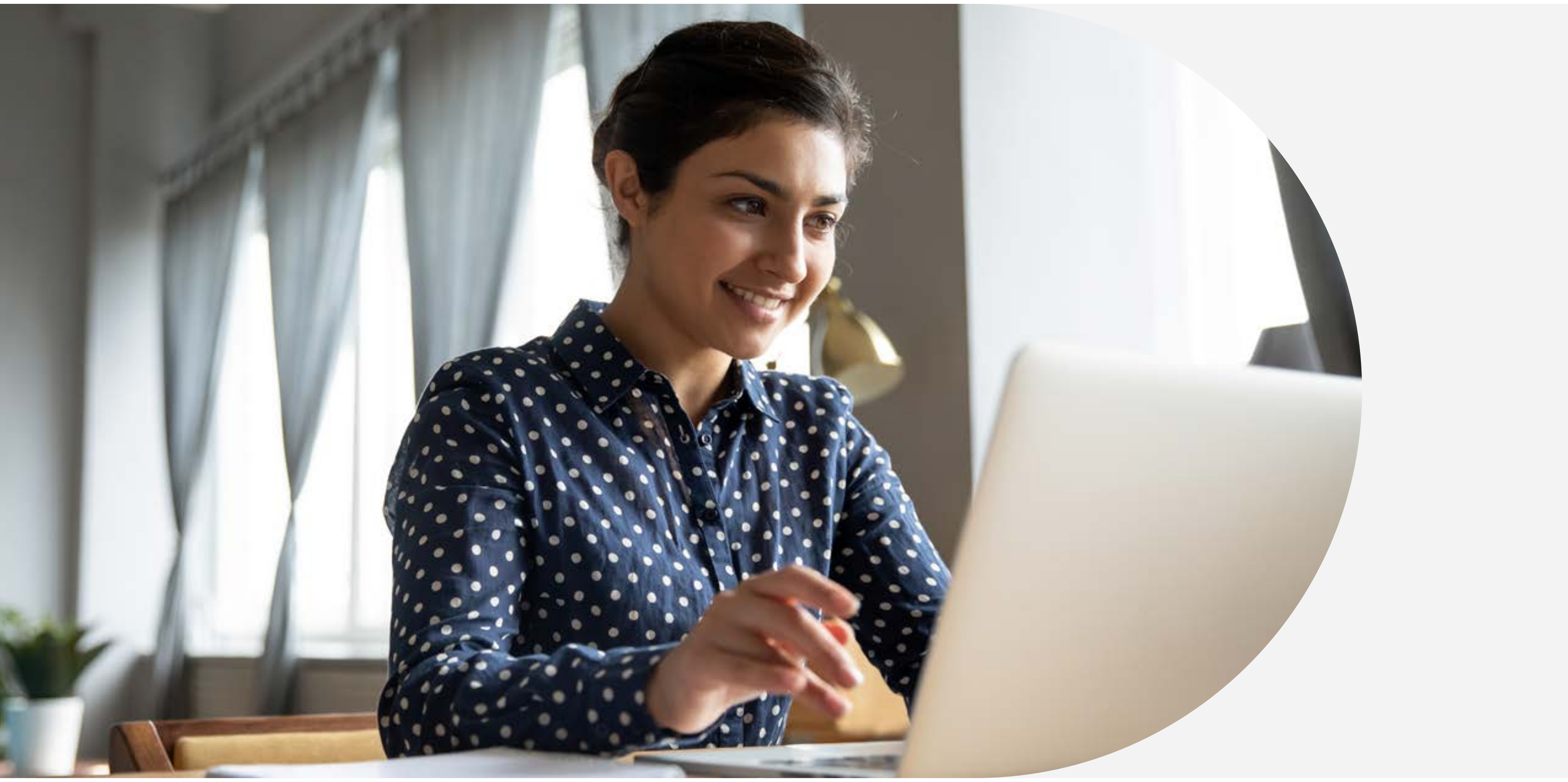


30.9%
Health and Beauty Products



29.5%
Home Furnishings

Source: PYMNTS | Amazon Web Servies, 2021



3. BNPL Payment Options

BNPL plans are typically offered as an option at checkout. If the customer hasn't used the BNPL service before, they'll go through a signup process. Usually, enrollment in a BNPL plan only requires a soft credit pull and does not affect the customer's credit report. When a customer misses a payment, the provider will typically charge a late fee and prevent the user from making additional purchases until the payment is made. Missed payments may or may not be reported to credit reporting agencies, depending on the provider.

Types of BNPL Payment Plans

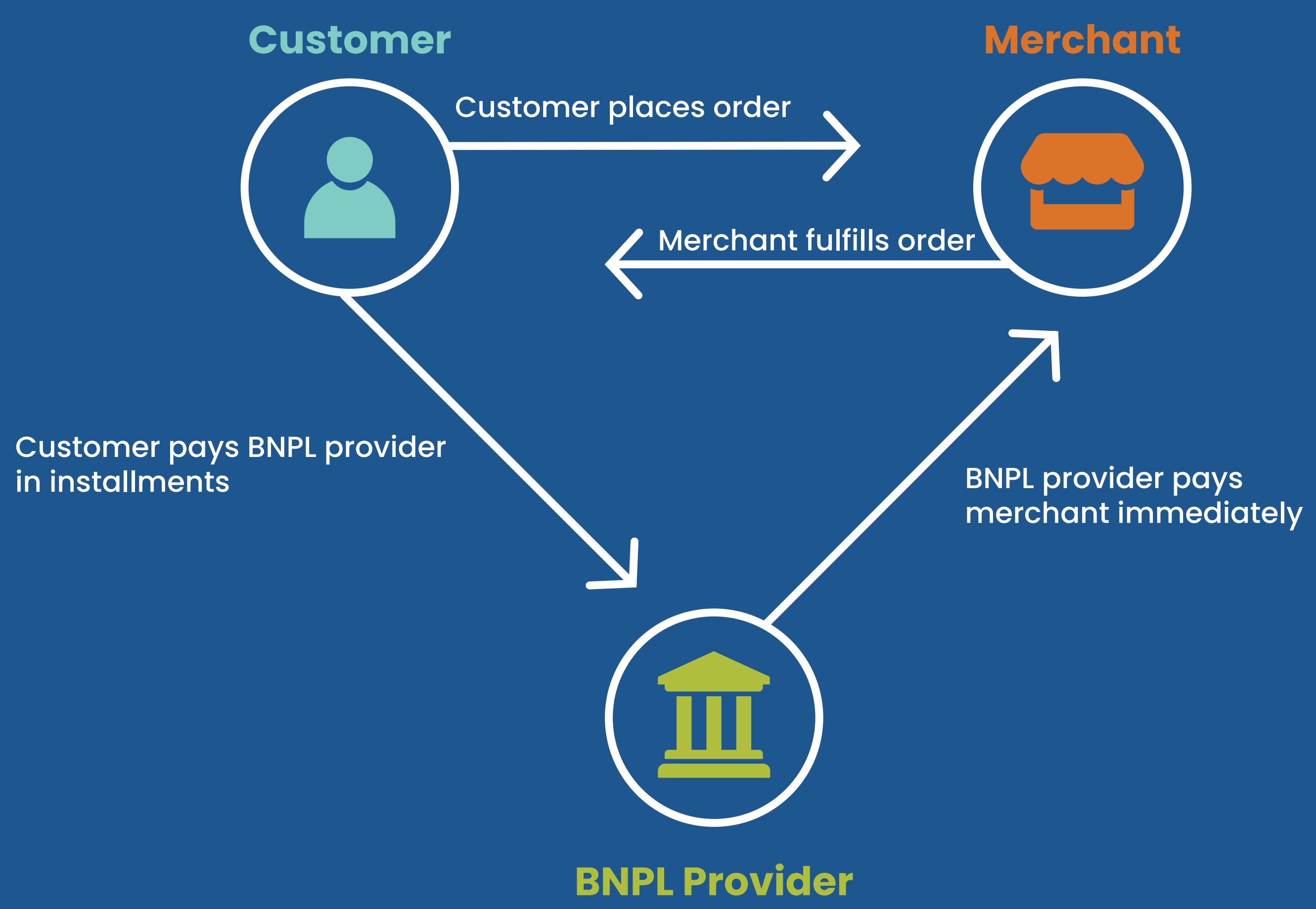
Interest-Free Payment Plan - The customer pays for their purchase in a series of interest-free installments made over the next several weeks. The most common arrangement is splitting the purchase into four payments, with a payment made every two weeks.

30-Day Payment Plan - Customers are charged a minimal interest rate, typically below 10%, but must pay in full within 30 days.

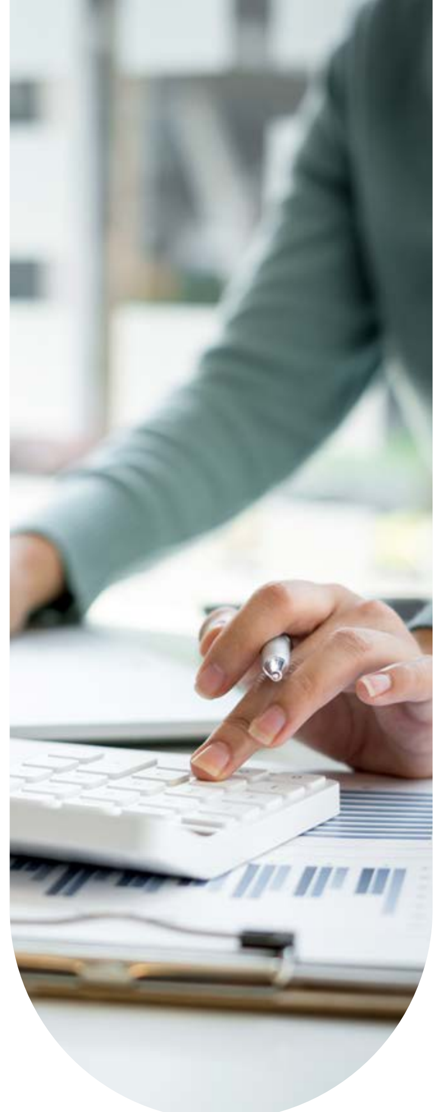
Monthly Payment Plan - Much like a credit card, the customer makes monthly payments toward their purchase while accruing interest, often at a rate between 10% and 25%.

4. The Provider-Merchant Relationship

While merchants can provide and manage their own installment payment plans, third-party BNPL providers allow them to outsource both the approval process and the risk. The merchant gets paid in full up front, minus the fee charged by the provider (usually between 2% and 8%). The provider is then responsible for collecting payments from the borrower.



5. BNPL Threats & Vunerabilities



BNPL is not a risk-free system. The primary danger to providers is that borrowers will stop paying and their loans will have to be written off as a loss. Between 31% and 38% of BNPL customers have missed at least one BNPL payment. While in some cases this is merely a memory lapse, defaulted accounts can quickly run up costs for providers and threaten their already-thin profit margins.

Like any other method of payment, BNPL is vulnerable to fraud. The three main types of fraud involved in BNPL are:

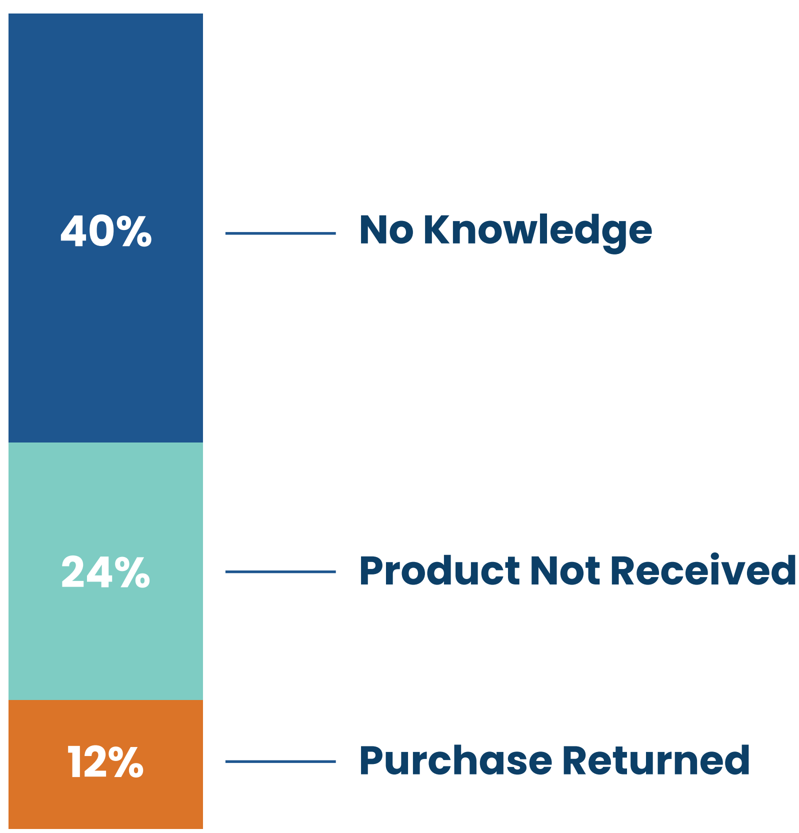
- **Account takeover** — Fraudsters exploit weak or reused passwords to access existing customer accounts and make purchases.
- **Line of credit abuse** — Most BNPL providers allow customers to sign up simply by providing proof of identity. Fraudsters create accounts with fake identities and take advantage of the introductory line of credit.
- **Repayment fraud** — Cardholders dispute a BNPL charge saying they never made the purchase. In some cases, they are the victim of credit card fraud. In others, they're making false claims to try to avoid repayment.

6. BNPL Disputes

Because BNPL installment payments are most commonly made with a debit card, these payments can be disputed by the cardholder, often leading to a chargeback.

As mentioned previously, claims that the cardholder never made the purchase may be cases of true fraud or attempts to get something for nothing. However, all three of the most common reasons for BNPL disputes can be the result of the disconnect between the provider and the merchant.

Top Reasons for BNPL Disputes



Source: Chargeback Gurus, 2022

- **No knowledge** — In most cases, the cardholder's bank statement will only show the name of the BNPL provider when a payment is processed, not the name of the merchant. This may result in the cardholder failing to recognize the charge and disputing it based on a genuine but mistaken belief that it is fraudulent.

- **Product not received** — If there is a delay in shipping, the customer might be charged for multiple installments before the product has even arrived. This might cause them to file a dispute on the grounds that they haven't received what they paid for.

- **Purchase returned** — If the customer decides to return the product to the merchant for a refund, the BNPL provider won't immediately know about the return. When the next installment payment goes through, the customer might be annoyed at being charged for a product they already returned and file a dispute.

When a chargeback occurs, it will be the provider

Chargeback Liability

	BNPL Provider	Merchant
Fraud Disputes	✓	
Product or Service Disputes		✓

7. Combating BNPL Disputes –The Smart Way

that receives it, not the merchant. However, providers will typically pass on to merchants the cost of any chargeback that's caused by a product or service issue rather than fraud. Merchants should carefully examine the terms of any BNPL provider they work with.

Providers can (and should) fight illegitimate disputes through the chargeback representment process. To do this, the provider must gather and submit evidence that proves the charge was legitimate and the cardholder's claim is false. If the issuing bank is persuaded by this evidence, it will reverse the chargeback and return the disputed funds.

In order to effectively prevent chargebacks, it's important to know exactly why they're happening. This requires thorough and ongoing analysis of transaction and chargeback data. Once disputes are traced to their root causes, specific measures can be taken to prevent chargebacks caused by fraud or merchant error.

In general, however, we recommend the following dispute prevention practices for BNPL providers:

- Block borrowers who file illegitimate chargebacks to avoid repeat behavior.
- Use advanced identity validation techniques to sniff out synthetic identities.
- Use effective fraud prevention tools to spot payments made with stolen credentials.
- Clearly communicate the lending terms to the borrower at the point of sale and document their acknowledgment and acceptance of these terms.

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8. The Future of BNPL

Regulatory Compliance

The BNPL market is growing at a prodigious rate, with some forecasters expecting the total annual volume to reach $1 trillion by 2025. This growth has led to legislators and regulators in a number of countries discussing possible action.

The scope of government regulation thus far has been limited. The most common change has been to classify BNPL providers under existing regulatory frameworks for lenders or consumer credit companies.

Australia ruled that—like credit card networks—BNPL providers can't prohibit merchants from passing on fees to customers in the form of a surcharge. In the UK, the Financial Conduct Authority asked for changes to BNPL contracts intended to make them easier to understand and to prevent late fees from being charged in certain situations. While more regulations may follow, they're unlikely to be so stringent that they significantly damage the BNPL industry.

Beyond E-commerce

Looking further into the future, BNPL providers have significant room for expansion. Companies could take advantage of their internal data to offer larger loans to select customers. For example, BNPL providers might offer no-interest car loans to customers they evaluate as low-risk, negotiating with dealers for a percentage of these sales. They could even compete with banks in offering mortgages, allowing customers to consolidate all their debt under a single payment rather than having multiple loans and credit cards to manage.

Competitive Offerings

BNPL providers are already competing with credit card networks and issuers in the realm of offering consumer credit for ordinary purchases. Expanding into these new areas would increase their competition with banks more broadly. Some banks and credit networks are responding by creating their own BNPL offerings. Visa and Mastercard have installment programs currently in development, and several banks are partnering with fintech companies to create their own.

Entering into the arena of BNPL is not without risk, however. Many BNPL customers are spending beyond their means, especially younger ones.

Among consumers between the ages of 18 and 24:

- 49% of all purchases are made on impulse.
- 47% of BNPL users have made a late payment or incurred a late fee.
- 44% of BNPL users say they are "somewhat" or "very" likely to make a late payment in the next year.

> **Expanding into these new areas would increase their competition with banks more broadly.**

Even among older consumers, BNPL users are often in precarious financial positions:

- 45% of BNPL users report using BNPL to make purchases that wouldn't otherwise fit in their budget.
- The Australian Securities and Investments Commission found that BNPL was a factor in more than 20% of consumer insolvencies.

- Roughly two-thirds of first-time BNPL users in the US already have a credit card balance that's over 75% of their limit.

Economic Downturn

While the economic downturn caused by COVID-19 helped spur BNPL adoption, future economic downturns could threaten the industry. When consumers are in financial distress, payments on unsecured debt are often the first thing to go.

If rates of default increase, some BNPL providers will fail, while others will respond by increasing the costs they charge merchants. Merchants would then be forced to choose between accepting those increased costs, passing them on to BNPL users directly in the form of a surcharge, or passing them on to all customers by raising prices.

In order to survive increasing competition and future economic turbulence, BNPL providers will need to have the tools and resources in place to carefully evaluate lending decisions, prevent fraud, and contest illegitimate chargebacks.

For any business, developing a comprehensive strategy for dealing with fraud, disputes, and chargebacks requires a deep understanding of the industry, the customers, and the prevailing trends in e-commerce. In order to achieve and maintain maximum efficiency, merchants need to investigate disputes thoroughly and engage in frequent data analytics. It's not an easy undertaking, but it can be achieved with the right approach and knowledgeable support.

About Chargeback Gurus

Chargeback Gurus is a global fintech company that helps merchants prevent, fight, and reverse chargebacks. Merchants often fail to grasp the full extent of the impact chargebacks are having on their revenue and their reputation. With help from the experts at Chargeback Gurus, merchants can recover lost revenue, increase customer retention, and protect their bottom line. Chargeback Gurus can augment in-house staff or manage the entire dispute process end-to-end.

To learn more, visit **www.chargebackgurus.com**

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