CREDIT WHERE IT'S DUE

AN INSIGHT PAPER FOR BNPL LEADERS

DISCOVERING MODERN CREDIT RISK SCORING IN BUY NOW, PAY LATER

CredoLab

Better Credit Decisions

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INTRODUCTION

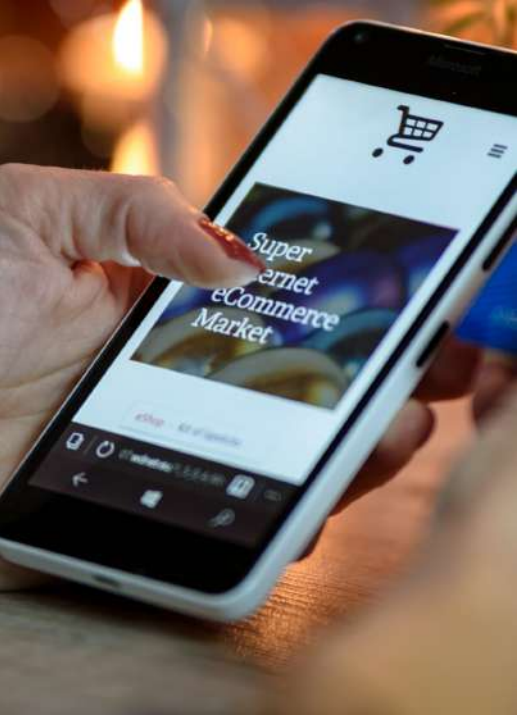
The idea of allowing consumers to pay for goods over a number of instalments is by no means a new invention. Layaway and instalment payments have been part of the financial and consumer landscape for decades.

But now, after a slow process of modernisation, the payment method has been transformed, rebranded, and expanded to reach a much wider global demographic. The buy now, pay later (BNPL) sector is unquestionably booming, driven by its much-publicized popularity with millennial consumers and its timely fit with an explosion in smartphone enabled mobile commerce.

BNPL companies are growing exponentially in several key markets, such as APAC, the United States, European Union, the UK, and Australia. And LATAM has its own players too, who are finding a way to serve markets in the region that have long favoured cash purchases. Companies like PayPal, Afterpay, Affirm, Klarna, Zip or Splitit have amassed millions of consumers and thousands of merchants worldwide.

According to a recent report by the Futurist Group:

- Australian BNPL platform Afterpay added 1.6 million new American customers in the second quarter of 2020, building their active user base to 5.6 million
- In the same period, America's Splitit grew its merchant transactions by 260 percent, year on year
- 21 percent of US consumers stated a preference to use BNPL, versus 17 per cent for credit and debit cards, and just 15 percent for bank-provided payment methods.




ASIDE FROM LARGE MARKET SHARE GAINS FOR DIGITAL/MOBILE WALLETS, WE SEE BUY NOW, PAY LATER SOLUTIONS GAINING ECOMMERCE SHARE. WE EXPECT THESE SERVICES — SUCH AS AFFIRM, AFTERPAY, AND KLARNA — TO GAIN TRACTION AND TRIPLE THEIR CURRENT ONE PERCENT ECOMMERCE MARKET SHARE TO THREE PERCENT BY 2023."

— GLOBAL PAYMENTS REPORT 2020, WORLDPAY

At the same time, BNPL giants are catching the attention of consumer groups, regulators, and media commentators who look at BNPL from a different perspective, while analysing the payment method's potential effects on consumers' financial habits and health.

While the pandemic has accelerated the uptake of BNPL, it has also raised valid questions about consumers' true understanding of the products, their ability to afford what they are purchasing, and the potential impacts on their credit scores.

In this report, we will delve deeper into the buy now, pay later market, weigh up its enormous ongoing potential, and provide you with the latest thinking and research on how the sector can continue to thrive, by taking a leadership role in improving consumers' credit.

MILENNIALS & BNPL

It's impossible to talk about BNPL without speaking about millennials.

This is a generation that has been pored over, analysed, praised, and dismissed – all in equal measure. Perhaps the fairest way to characterise this demographic is this: they matter more and more to businesses' fortunes. Millennials are growing in number in companies, consumer groups, and boardrooms around the globe.

Investment bank UBS estimates millennials already own $17 trillion of the globe's private wealth, with trillions more set to be transferred from more established generations in the decades to come.

"FLEXIBLE PAYMENT OPTIONS OFFERED BY A FINANCIAL SERVICES PROVIDER ARE MORE HIGHLY VALUED BY MILLENNIALS (20 PERCENT), COMPARED TO OLDER GENERATIONS (15 PERCENT). THIS IS ESPECIALLY THE CASE IN AUSTRALIA AND THE US, WHERE CLOSE TO 30 PERCENT OF MILLENNIALS PREFER USING PAY LATER SERVICES THAN ANY OTHER PAYMENT TYPE."

— MONEY MANAGEMENT IN A NEW AGE, KLARNA



But why do BNPL platforms seem so popular with millennials? And why have BNPL companies been so successful in reaching millennials in ways that other credit products struggle to?

For many millennials who grew up in the shadow of the global financial crisis (GFC), credit and debt have become negative concepts. In this context, BNPL's popularity among millennials makes perfect sense in a hyper-connected world of commerce.

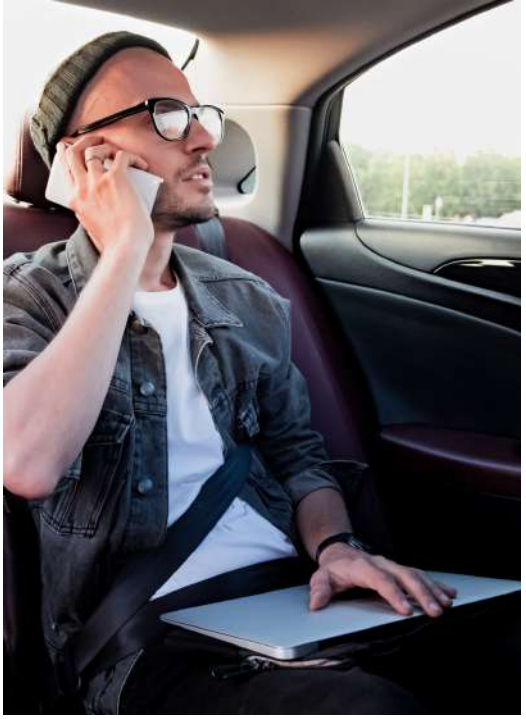
BNPL has provided a middle way for millennials to manage their money, a way to have more 'control' over money, and a way to avoid falling into what some might see as the trap of credit card debt.

Research commissioned by Australian BNPL company Afterpay shows:

- Just 41 percent of Australian millennials own a credit card, while those who do have one are using it less since they have begun using Afterpay
- Millennials are 30 percent more likely to save than their parents
- More than 80 percent of millennials set and track budgets.

However, the popularity of BNPL among millennials isn't all to do with an escape from credit cards. According to a study from the Motley Fool's personal finance service, The Ascent, millennials turn to BNPL to:

- Avoid paying credit card interest
- Make purchases outside their budget
- Borrow money without a credit check.


Deloitte's 2020 Global Millennial Survey offers some further clues into millennial money mindsets. According to Deloitte, on a global level:

- 62 percent of *millennials have set themselves clear financial goals* for the next five years, versus 54 percent of people in Gen Z
- 69 percent feel *confident making decisions about financial products* and services (60 percent for Gen Z)
- 72 percent feel they *have the right level of knowledge about their finance* to make informed decisions (65 percent for Gen Z).

Millennials may get all the attention when it comes to BNPL — but that doesn't mean other generations aren't taking to the payment method too. Increasingly, Gen Z — those born between 1997 and 2015 — are adopting it as well. In fact, YPulse's Retail's New Reality Trend Report found 22 percent of 13-39-year-olds have used BNPL payment installment services already. A further 29 percent would like to.

But looking at the BNPL market purely through the lens of generational finances misses the whole picture, as we will talk about next.

Afterpay: Australian Millennial Favourite

Founded in 2014 by an Australian millennial, Afterpay is now available from more than 55,000 retailers spread across Australia, the USA, Canada, and the UK (where it's known as Clearpay). Afterpay added more than 17,000 new customers to its platform each day during the past financial year, increasing to 20,500 new customers per day in the final quarter of 2020.

GIG ECONOMY GROWTH & BNPL

It's no coincidence that the rise of BNPL platforms is happening alongside a boom in ecommerce, the gig economy, marketplace platforms, and increased freelancing. The trends represent a wider shift in developed and developing economies, that involve the disruption of how we all live, work, shop, save, and spend. Some of this was happening before the pandemic began. Some of it has been accelerated throughout it.

According to Moneycorp, the majority of the US workforce will be freelancers by 2027, with an additional four million freelancers entering the workforce between 2014 and 2019. Younger generations are more likely to freelance in the US — and hire independent contractors when they themselves are in management roles.

"BY JULY 2018, HUNDREDS OF THOUSANDS OF UBER DRIVERS HAD ENROLLED IN INSTANT PAY AND RECEIVED $5B+ IN REAL-TIME PAYOUTS. IN ADDITION TO IMPROVING FREELANCERS' LIFESTYLES, ESPECIALLY THOSE LIVING PAY CHEQUE TO PAY CHEQUE, INNOVATIONS SUCH AS INSTANT PAY MOTIVATE DRIVER ENGAGEMENT THROUGH INSTANT GRATIFICATION."

— THE GLOBAL GIG ECONOMY: CAPITALIZING ON A $500B OPPORTUNITY, MASTERCARD AND KAISER ASSOCIATES.



The 'gigification' of the workforce in both the US and other countries has also been given an additional shot in the arm, by the new workplace realities of the pandemic. As companies decentralise tasks from the office, competition for gig workers and freelancers will intensify — creating a new market, where companies with on-demand payment capabilities will win the greater share of freelance talent.

As workers around the globe seek to replace or augment their income, many will avail of contracting opportunities. Food delivery and transportation has been the tip of the spear for this sweeping change. As workforces are reshaped, weekly or monthly wages may shift to daily or on-demand pay.

The move from 'chunks' of income at set intervals to small 'nuggets' of income more often will clearly create opportunities for the BNPL sector, which can help more consumers manage their often limited disposable income across instalments.

Klarna: Sweden's eCommerce Giant

Klarna was established in Stockholm in 2005. Its investors include Visa and Sequoia Capital and the company now claims more than 200,000 merchants and 90 million end customers. Klarna estimates around one million purchases are made each day with its products — and it is reportedly planning to launch a current account.

WEIGHING UP CONSUMER CREDIT RISK

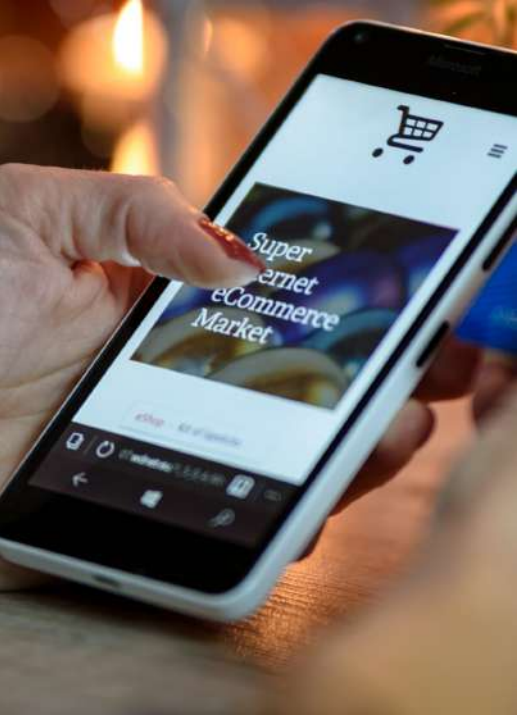
Still, credit is as old as money itself. And experienced financial executives know providing credit always comes with risks.

The question many are asking is this: are convenience and credit a fair pairing? BNPL platforms have earned added scrutiny, owing to the perfect storm of frictionless buying, social selling through the likes of Instagram, and a world where millions are spending more time online due to the pandemic's acceleration of digital commerce and remote working.

"IF YOU'RE LATE PAYING FOR YOUR BNPL PURCHASES, INTEREST AND CHARGES CAN MOUNT UP. IF YOU CAN'T PAY WHAT YOU OWE, BNPL LENDERS CAN USE THE SAME DEBT COLLECTION METHODS AS OTHER LENDERS OF UNSECURED DEBT."

— UK DEBT CHARITY, STEPCHANGE

It is a double-edged sword. For merchants, the ability to offer and accept payments in a range of different ways is proving critical to their survival. This is especially true for laggards of digital transformation, who are paying the price for an overreliance on brick and mortar portfolios and slow adaptation to online selling, cross-border opportunities, and a boom in mobile commerce.



In the dash to transform, BNPL is a logical leap for retailers — it's one that thousands of stores across the world have already made. Merchants need more customers, and they benefit from a relationship with BNPL platforms, owing to the latter's ability to shoulder the risk of any payment defaults. In the rush to increase conversions and drive more sales, merchants also benefit by avoiding some of the hefty transaction fees of the dominant credit card companies.

"IT APPEARS THE PROMISE OF BEING ABLE TO HOLD OFF ON PAYMENT UNTIL A LATER DATE IS PROVING A STRONGER DRAW FOR YOUNGER PEOPLE IN THE UK. ALTHOUGH JUST 16 PERCENT OF GEN ZERS HAVE USED BNPL SINCE LOCKDOWN, A HUGE 64 PERCENT ADMIT THEY SPENT MORE THAN THEY NORMALLY WOULD WHEN PAYING WITH BNPL."

— COMPARE THE MARKET SURVEY, MAY 2020

But is it now 'too easy' for shoppers to splurge on goods through instalment purchases? Human nature is always a factor, in any kind of sales environment. Academics, for example, have confirmed shoppers can display compulsive shopping habits that are against their own best interests.

When UK price comparison website Compare The Market surveyed British consumers recently, it discovered more than 40 percent were unaware that missed payments for buy-now-pay-later installments could affect their credit histories.

The warning signs are there in the USA too, according to a recent BNPL analysis by Cornerstone Advisors. There consulting and research firm noted that:

- 43% of BNPL users have been late paying in the past two years
- 66% of late payers said they lost track of a bill's due date
- A third said they could not afford to pay the instalment.

Better consumer education may be part of the solution — but will it be enough? Financial regulators seem to think not, as we'll explain shortly.

Affirm: An American Credit Card Alternative

Affirm partners with more than 6000 merchants in the US, including Walmart, Peloton, Audi, and Expedia. Consumers are able to split their repayments over longer periods, sometimes up to as much as 18 months. Affirm is currently preparing a $5B-$10B IPO.

REGULATION IS COMING: IS BNPL READY?

In many countries around the world, BNPL platforms enjoy a special kind of status. They're technically not treated as credit product providers or even lenders, and so, they do not need to take some of the same steps as, say, a mortgage lender, or a trade finance company. This is more of an accident, than it is design.

Because of this, the remarkable recent growth of the BNPL sector is preoccupying regulators in many markets. For example, the Australian Securities & Investments Commission (ASIC) released a review of the sector in the country in late 2018, which found some BNPL arrangements led to price inflation, while others altered the spending habits of their predominantly young consumer base.

The review also found:

- Australian consumers believe BNPL allows them buy more expensive items than they otherwise could afford in one payment (81 percent)
- that they spend more than they normally would (64 percent)
- and that they make more 'spontaneous purchases' (70 percent).

The review also noted that over-commitment can be a risk for some consumers, and that BNPL providers need to do more to 'act fairly' with consumers.



Before the pandemic began, BNPL platforms in Australia created a draft code of conduct to address these concerns about the sector. The code of conduct is still under consideration and it does not include a firm commitment to perform credit checks on customers.

Similar movements are happening in other markets. In the UK, in late 2020, the Financial Conduct Authority (FCA) announced a comprehensive review of the future of the unsecured credit market. The FCA noted:

"There has also been growth in credit agreements to finance the purchase of goods from retailers, which allow consumers to defer payment for short periods through platforms, hosted by firms, not all of whom are FCA-authorised. These agreements are exempt from regulation because they are interest and charge-free, and are repayable in no more than a year through 12 or fewer instalments ... Since creditworthiness checks are not required there is the potential for unaffordable borrowing, with consumers at risk of default and incurring increased levels of indebtedness."

All of this raises the question: should BNPL platforms step up the plate and improve their efforts to check consumers' creditworthiness, before regulations force them to do so?

Hoolah: Expanding beyond Singapore

Hoolah is a Singapore-based omnichannel BNPL company that was founded in 2018. It also operates in Malaysia and Hong Kong, and has recently announced plans for further expansion following the closure of its Series A funding round.

THE PROMISE OF BETTER CREDIT-SCORING

The good news for BNPL platforms is that they can play a leadership role in responding to concerns from regulators and media commentators. Ultimately, it all boils down to questions of creditworthiness.

Millions of consumers around the world are now in radically different financial situations than they were a mere year or two ago.

The pandemic has been transformative and much of the burden of being furloughed or made redundant fell on people with loose financial foundations: the young.

A large proportion of retailers are staffed by employees who are also the target market of BNPL platforms. Part-time and casual income has become insecure for this group, after the forced shutdowns of high streets, malls, and department stores across the globe. The sector is still finding its feet — and its future is by no means secure.The very demographic that many BNPL platforms are built on now faces a time of great anxiety and uncertainty.

In this new era, the risks of consumers defaulting and forfeiting are greater now than they were a short time ago.

Regulators were watching before the pandemic, but the severity of recessions in many markets may now force them to take a harder line. Because of this, BNPL platforms now face risks to their brands, bottom lines, and active user numbers.The price of inaction may be costly.

"BECAUSE INSTALMENT PAYMENTS ENGAGE CONSUMERS IN LONGER-TERM COMMITMENTS, THERE IS INEVITABLE DEFAULT AND FORFEIT RISK - WE EXPECT THIS RISK TO INCREASE AS THE MARKET GROWS."

— FINDING THE RIGHT STRATEGY FOR THE NEXT WAVE OF PAYMENTS, OPENWAY

Still, BNPL platforms have understandable concerns about slowing down their products, given how central friction-free buying is to their unique selling point to merchants — their true, and often most lucrative, customer base.

Perhaps these worries are based on outdated perceptions of how credit risk can be accessed. Just as the emergence of the smartphone and ecommerce has revolutionised BNPL, so too has the emergence of artificial intelligence, machine learning, and behavioural intelligence for credit-scoring.

"WE EXPECT CREDIT SCORING TO BECOME A MORE BESPOKE PROCESS, IN WHICH NEW MARKET ENTRANTS FOCUS ON SPECIFIC CONSUMER SEGMENTS AND PROVIDE MORE PRECISE AND RELIABLE SCORES … NEW ENTRANTS ARE LIKELY TO BEGIN WITH RISKIER CUSTOMERS, GAIN SCALE AND START TO COMPETE FOR PRIME CONSUMERS, FORCING INCUMBENTS TO ADAPT THEIR OWN CREDIT-SCORING METHODOLOGIES."

— THE FUTURE OF CREDIT, MONITOR DELOITTE/MASTERCARD

What if BNPL platforms could deliver on their merchant promises of speed, increased checkout conversions, and more customers — all while reducing the volume of missed payments across the board? It's possible.

Artificial intelligence can pull insights from unstructured alternate data sources to rapidly assess a consumers' suitability for BNPL, in a way that does not push genuine shoppers away. With shoppers' consent, advanced credit-scoring could help BNPL platforms and merchants to:

- Instantly analyse creditworthiness
- Selectively provide BNPL to low-risk shoppers
- More accurately predict sales revenue, due to fewer missed payments.

CredoLab, for example, helps BNPL platforms approve customers, even those without credit history. CredoLab makes this possible with customers' consent to analyse smartphone and digital behavioural data to provide a secure, non-intrusive, and transparent way to convert digital footprints into a credit score in real-time, and without adding any friction to the user journey.

ABOUT CREDOLAB

CredoLab develops credit scores based on mobile and web-behavioural data to help lenders make better credit decisions. We strive to make loans accessible to everyone and improve the lives of people who are otherwise left out by traditional banking processes. Our mission is to increase financial inclusivity globally, by transforming the credit decisioning process through our state-of-the-art, data-driven, and cost-effective solution which creates a path for creditworthy individuals to access mainstream financial services

Established in Singapore in 2016, we have partnered with more than 80 lenders to power almost USD 2 Billion in loans issued across 25+ countries.

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