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Buy-Now, Pay-Later Set for Regulatory Onslaught

What's Happening: With the closing tomorrow, March 25th, of a public comment period on the Consumer Financial Protection Bureau's (CFPB) inquiry into buy-now, pay-later (BNPL) companies, we expect that several regulatory actions will be unveiled in the coming months, culminating in mandatory changes to the sector's current business model.

Why It Matters: There currently are no buy-now, pay-later specific federal regulations, although many existing laws and regulations still apply to the burgeoning industry. What the CFPB is likely to do with both its investigative and regulatory authorities is to mandate changes that, in its view, are pro-consumer, while still allowing the industry to exist as an alternative to credit cards. Investors should note that the bureau almost immediately started fact-finding regarding this sector after its director, Rohit Chopra, was appointed and this intense focus is one reason for our certainty that change is coming. Chopra is using BNPL companies as examples of how the government can force a technology-enabled industry to change its practices, and this growing, but not yet large and powerful sector is a perfect guinea pig as he sets his sights on even bigger players in tech, including **Amazon (AMZN), Apple (AAPL), Meta (FB), Google (GOOG), PayPal (PYPL),** and **Block** (formerly known as Square **(SQ)**).

What's Next: The next most likely step in this regulatory process is the bureau publishing a white paper with data it has collected from its order demanding information from the largest BNPL players, including **Affirm (AFRM), Afterpay** (now owned by Block **(SQ)**), **Klarna, PayPal (PYPL),** and **Zip (formerly Quadpay)**. There is also likely to be a portion of the white paper that discusses the range of public comments that were submitted. After that, we expect a notice of proposed rulemaking to be released, with yet another public comment period and potential field hearings, either to discuss the white paper or the rulemaking. Then, sometime towards year end or in early 2023, a final rule will come into effect and BNPL companies will have to comply with new rules regarding how they interact with consumers and with their merchant partners. It is also important for investors to note that at any time in this process, the bureau could also bring an enforcement action against one or more of the companies and as part of a settlement, unilaterally impose terms similar to what will be forthcoming in the rulemaking, as well as extract a financial penalty and compensation for harmed consumers. **While there will be a vigorous debate over the form of new regulations, we have high conviction that they are coming and that the next year will have nothing but headline risk and regulatory pain for the companies involved.**

CFPB Order

The CFPB took its first step in establishing new regulation of BNPL companies when it issued an order on December 16th, 2021 to compel the five largest companies to produce voluminous information about their business practices to help inform future bureau action against those very same companies.

To quote the press release, “The orders to collect information on the risks and benefits of these fast-growing loans went to Affirm, Afterpay, Klarna, PayPal, and Zip. **The CFPB is concerned about accumulating debt, regulatory arbitrage, and data harvesting in a consumer credit market already quickly changing with technology.”**

The release goes on to cite another perennial reason for CFPB Director Rohit Chopra to want to rein in the sector, “More and more Americans are using it, and the most recent Black Friday and Cyber Monday shopping weekend saw massive growth in BNPL. This explosive growth has caught the eye of many investors, including significant venture capital money. Big tech companies are also entering the arena.”

To the CFPB, and Chopra particularly, when venture capital investors and Big Tech firms are involved, it is always a red flag and an example of where consumers may be exploited. Other examples of the bureau citing venture capital investors in a negative light include the settlement with venture capital-backed fintech **LendUp**, where the press release made great note of this financial relationship.

Specifically, the bureau writes that it has concerns over the following: consumers accumulating debts from multiple BNPL companies; BNPL regulatory arbitrage since there is no set of rules pertaining directly to the sector; and data harvesting to inform future marketing by the lender, as well as the shopping patterns of the consumer to inform the merchant.

Debt accumulation is not just a worry about having too many bills to pay which are not affordable, but also the ability for BNPL customers to use the service for “every day discretionary buying” rather than occasional purchases of large big ticket items that typically have some lifespan (an appliance or piece of equipment). The marketing of BNPL from Klarna and Zip at certain Chevron and Texaco gas stations due to the recent increase in gasoline prices is an example of the sector’s nimbleness, but also how consumers could quickly rack up multiple loans and debts with no durable product to show for it.

For regulatory arbitrage, the bureau is concerned that some BNPL products have been deliberately designed to not trigger compliance with certain consumer protection laws and regulations. Examples of this include a lack of disclosures that would be triggered if additional payments were allowed; dispute resolution protections that exist for credit card users do not apply to BNPL transactions, so there is often confusion over how to get a refund and from which party in the transaction; and late fee policies and allowable dollar amounts.

Finally, while data harvesting may not be high on the list of concerns for consumers compared to refunds and late fees, it is at the top of the list for Chopra and the CFPB. The bureau has concerns that lenders will not only try to monetize purchase data further and that merchants will exercise their incentives to increase sales at the expense of consumer indebtedness, but also could use their algorithmic marketing to discriminate against various consumers based on their purchasing history.

CFPB Request for Public Comment

After the December order to the five largest BNPL firms operating in the US, the bureau opted to also ask for public comment on the sector, which is meant to help bolster its case that a new rulemaking is necessary to protect consumers.

On January 24th, the bureau issued a public request to learn more about the "size, scope, and business practices of the BNPL market. The information will help the Bureau better understand how consumers interact with BNPL providers, and how BNPL business models impact the broader e-commerce and consumer credit marketplaces."

As part of the public comment process, the bureau specifically asked for responses from "consumers, small businesses, consumer advocates, financial institutions, trade associations, investors, state and Federal regulators and Attorneys General, and experts in consumer lending, payments, and marketing." Public comments are due tomorrow, March 25th, 2022.

The questions that the bureau asks in the actual order are as follows:

1. What is the consumer experience with BNPL products?
2. What are the benefits and risks to consumers from BNPL products?
3. What is the merchant experience with BNPL products?
4. What perspectives do regulators and Attorneys General have with respect to BNPL products?
5. Are there ways in which the BNPL market can be improved?

US PIRG Report

Earlier this month the US Public Interest Research Group (PIRG) Education Fund issued a report on the industry and its practices, as well as a list of recommendations for the CFPB to consider in its regulatory process.

Having an aggressive non-profit advocacy organization like US PIRG devote attention and resources to a new financial sector is usually a badge of honor for executives at those companies since it shows that they are now large enough and have sufficient penetration into the consumer markets that policymakers and other stakeholders are taking notice. At the same time though, being in the sights of the bureau and aggressive advocacy groups is not going to be helpful to their expansion plans, particularly if future regulation changes their business model as well as the relationship between BNPL firms as lenders and merchants.

US PIRG chose to highlight several aspects of the business model of BNPL firms. These include the relationship between BNPL companies and merchants, the lack of consumer protections compared to credit cards for disputes over the item purchased, and the incentives this relationship creates for consumers to spend more money than they would otherwise.

The report also made clear that US PIRG thought most consumers did not understand the relationship between lenders and merchants and that the alignment of incentives in the business relationship was not clearly explained to consumers and is in fact against consumers' best interests. Both the merchant and lender made more money the more the consumer spent through the BNPL channel. Although not squarely within the jurisdiction of the bureau, this is a widely-held view in progressive circles and it is also linked to the Big Tech companies and their interest in payment systems. US PIRG is quoted saying, "Finally, we maintain our concerns that the vast data collection and monetization engines run by Big Tech firms are designed to fuel an explosion of buying and an increase in consumer debt for stuff we don't need and can't afford and, too often, end up throwing away."

Regarding how consumers interact with lenders, US PIRG raised the following concerns: lenders do not underwrite for a consumer's ability to repay and they do not check for other BNPL debts from other lenders; multiple loans with the same lender can have different repayment dates/schedules creating confusion; lenders often insist on linking to a borrower's checking account as a part of using the service, which can trigger additional fees from financial institutions such as overdraft or non-sufficient funds; late fees are a penalty if a borrower does not pay his or her "free" loan on time; and BNPL products encourage the accumulation of consumer debt for discretionary and often "unnecessary" purchases.

The study also analyzed complaint data submitted by consumers to both the CFPB and to the Better Business Bureau (BBB). Complaint data is a key metric that the CFPB uses in deciding where to focus its resources and the steep uptick in the number of complaints that the sector has seen since the holiday season of 2020 is part of the reason for its active focus in this area. It is also worth noting that Affirm had the most volume of complaints by far, although this is likely explained in part by its larger market share in the US, compared to its peer firms.

The BBB data that was found by US PIRG showed that only Affirm was accredited by the BBB and that the main focus of complaints focused around customer service and billing.

This type of complaint is about which party, the merchant or the lender, is responsible for an outcome when the consumer has a dispute about the product and wants to cancel, exchange, or otherwise modify the purchase. As of now, there is no federal mandate that the lender must engage on these issues, which is not the case with a credit card purchase.

An example of this is from a February 2022 BBB complaint that was made public and was included in US PIRG's report: "Thank you for contacting us regarding Ms. ***** ******* order discrepancy with ****. Our customer support team has been in contact with her to properly address her concerns. Our Installment Agreement outlines that merchants are responsible for issuing any refunds owed back to the designated Afterpay account (in accordance with their policies). Merchants take full ownership over their shipment, return and refund policies and the timeframes associated with them." While the consumer paid for the product via a BNPL (in this case Afterpay) loan, she must establish a communication channel with the merchant and attempt to get reimbursed by them, while still owing the debt to Afterpay.

What BNPL Should Expect Next

Although a white paper is almost certainly coming in the near term, investors in both retailers and BNPL companies should begin to prepare for what we expect to be mandatory changes to the current business model. Among the possible range of changes are the following:

1. CFPB large market participant rules to regulate at least the companies listed above;
2. As part of these rules, the **bureau mandates that BNPL firms adopt an ability to repay analysis before offering a loan** and ensure that the Truth In Lending Act applies to their credit products;
3. As part of the ability to repay analysis, **mandate checks for other BNPL loans and ban new loans on that platform and others until old loans are paid off using either a dollar amount or number of loans**;
4. **Limit any late fees to a federally-allowable amount** proportionate to credit card late fees;
5. **Forbid BNPL firms from insisting on access to checking accounts as a prerequisite** for access to credit;
6. Insist that payments are reported to credit reporting agencies;
7. Ensure that racial discrimination is not occurring by conducting disparate impact assessments of existing loans under the Equal Credit Opportunity Act; and
8. **Ensure that consumers have the same dispute protection**s for merchant fraud as they would have with credit cards with clear lines of responsibility for lenders and retailers.

In addition, the CFPB has said that it is working with its "international partners in Australia, Sweden, Germany and the UK, specifically the Financial Conduct Authority." **Although we do not expect that the bureau will change any future regulation of US law based on what is done overseas, investors should note that there is widespread concern**

throughout the developed world in these products and we expect that other nations will adopt similar regulations, although they will be tailored to their particular legal system. What seems clear though is that the status quo will be changing in the coming months.

Why Block and PayPal May Be Larger Targets Than Their Peers

Notably, PayPal and Block received notices for BNPL as well as part of the Big Tech order because they are more integrated into the current consumer finance ecosystem than the other tech companies and offer more products and services. **This deeper integration also creates more risk for them than the other tech firms because they are smaller and more dependent on consumer finance for their revenues than Meta or Amazon.**

For Block in particular, because its platform already combines two obvious aspects of consumer finance -- Cash App and the recently acquired BNPL company Afterpay -- it makes perfect sense for the bureau to focus on the firm. Both of those subsidiaries are already squarely under the CFPB's jurisdiction, but we expect that those two enterprises in combination with Spiral (Block's crypto line of business) make it even more of an attractive target for Chopra who is out to create new rules for both fintech and Big Tech's interactions with consumers.

Block also adds on top of these existing risks its use of music service Tidal, which it uses to heavily market its financial products to racial minority customers, who in turn have become a substantial portion of Cash App's customer base and are also attractive as potential customers for Afterpay's BNPL services from other large firms like Klarna or Affirm.

That means that Block, a company with far fewer resources than the other companies that are subject to CFPB scrutiny, may face inquiries on racial discrimination and disparate impact on top of any concerns about its involvement in payment systems, crypto, and actual consumer lending.

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