Mindtree
A Larsen & Toubro Group Company

BNPL as a lifestyle solution

How banks can turn the equation towards responsible lending

Welcome to possible

A Mindtree White Paper

Introduction

Buy Now Pay Later (BNPL) is a significant disruption in payments methods and ecommerce financing that has rapidly become popular in the pandemic's aftermath. Amidst restrictions and lockdowns there was an ecommerce surge in the last 24 months. The latest reports revealed a 4x increase in retail purchases using BNPL in the US alone, marking an increase from $24 billion in 2020 to $100 billion in 2021[1]. Globally, the ecommerce market amounts to trillions of dollars with an incredible potential to grow YoY.

BNPL brought unique propositions of convenience to retail customers with the flexibility to get interest-free credit. This was made available to those without credit history as well, with the option to pay at future date in a few weekly or monthly installments. The entire ecommerce checkout experience stands apart with this alternative payment method that provides instant credit facility in just a click. Digital KYC, remote onboarding, and access to an instant credit line are factors driving the soaring acceptance of BNPL across the globe. Customers have grown to relish BNPL with larger basket sizes and no extra pressure on their monthly budget. In parallel, merchants also love BNPL as it drives higher average order value and increased cart conversion.

Fintechs are the early movers who had already launched the BNPL model and started tapping this emerging market demand. Affirm, Klarna, Afterpay, and Zip are some of the names who disrupted traditional financial products with their innovative approach and have acquired customers multifold in a short timeframe. Some of them have already built remarkable BNPL platforms with a strong network of merchants. Banks are facing a threat as these new players are targeting their merchant networks and credit card portfolios. If BNPL is ignored, banks' bottom-line will eventually be cannibalized by these players and they will lose customer trust, loyalty, and market share.

The picture remains incomplete if we ignore how BNPL has disrupted the traditional short-term small ticket lending market which was dominated by the revolving credit card business. Now, the sub-prime or underbanked segment with low or no credit history also has access to credit, using BNPL. But the credit risk is still not fully addressed. Australia's Afterpay reported a loss of $156.3 million and Zip had losses of $652 million in just one financial year due to delinquency; these losses are 700% and 3000%, respectively, higher than the previous year[2]. A large number of young users are impacted for non-payment and often levied with higher late payment charges. This will lead to massive bad debt for BNPL providers if proper checks and balances are not introduced. Moreover, Fintechs lack scale and expertise especially loan servicing and collections.

On the other hand, banks are well-equipped and have ages of experience in handling credit, collections, and loan lifecycles. Banks should play the role of responsible lenders and play a role in the BNPL equation either directly, or by partnering with BNPL enablers. Banks have a wealth of insights from terabytes of transactions, customer, and merchant data. These insights will help banks to personalize the service and make this experience more pleasing for customers. In this white paper, we have discussed the reasons why banks should not shy away from the BNPL revolution and the strategies for banks to penetrate the BNPL market.

Gaps in conventional product

Banks have a long history of providing revolving credit lines in different forms. While the credit card is most popular in the retail market, banks also finance short-term receivables, invoices, and even extend cash advances to small and medium business (SMB). However, there are gaps and these became a huge need during the pandemic:

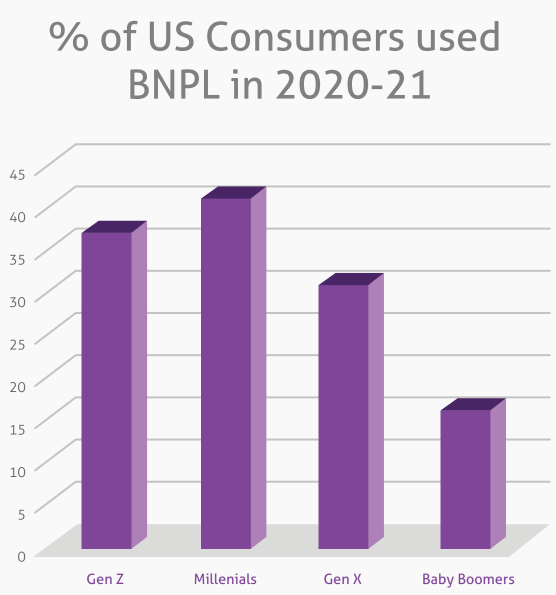

Figure 1: BNPL Users is US[3]

- Banks overlooked changing customer behavior in ecommerce and POS lending, especially for millennials to Gen Z segments
- Banks missed reacting quickly to what credit card customers are looking for during the pandemic's uncertainty
- Traditional credit lines are often offered with inflated interest and fees
- Lack of transparency in the credit process & assessment
- Rejection of customers who are underbanked or unbanked or have little or no credit history
- Imposing fees rather than educating or helping customers with late repayment
- Refund and chargeback are time-consuming and cumbersome

The core principles of BNPL

Is BNPL an alternative payments method, a credit instrument, or a budgeting tool? Although some claim BNPL is an alternative payments method, technically it is a unique convergence of instant ecommerce financing with alternative payments methods coupled with the power of digitization in ecommerce.

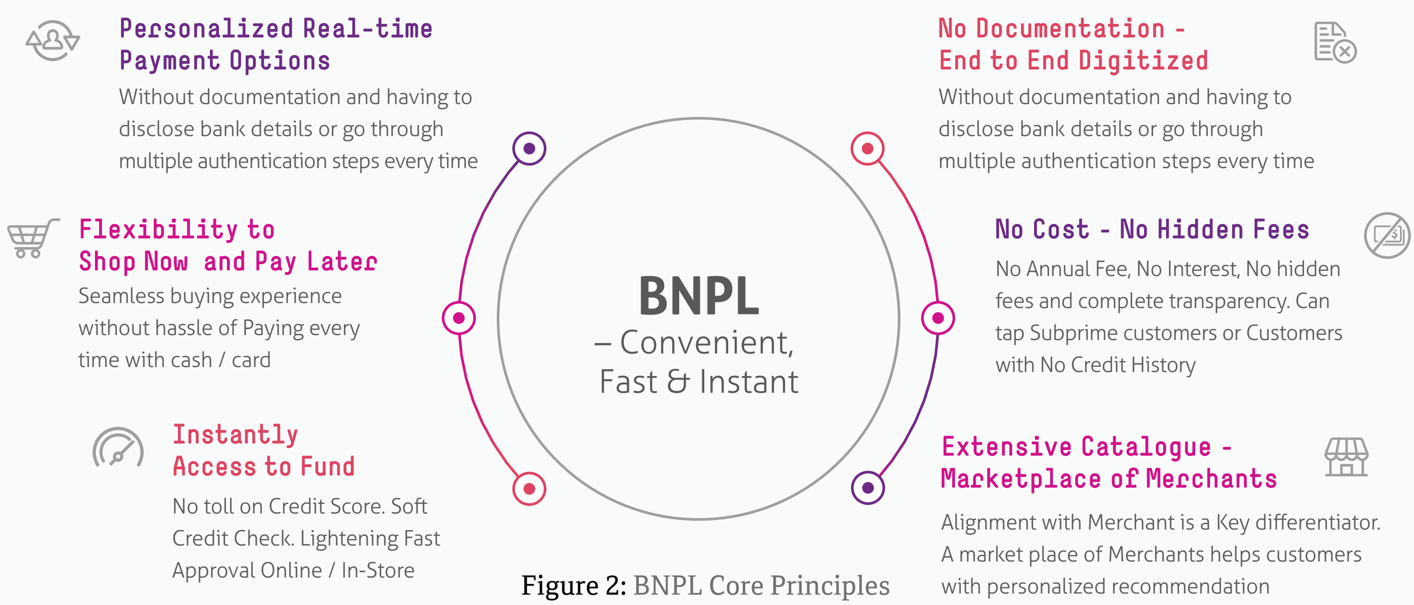

Figure 2: BNPL Core Principles

Key tenets of BNPL:

- **Convenience** is the word that characterizes BNPL
- Seamlessly embedded in the checkout process – **one click checkout experience**
- Traditional short-term revolving credit product is **redefined**
- Customers gain **increased purchasing power.** They can afford the purchases that otherwise wouldn't fit their budget
- Pay in X with **no extra cost**
- Little interest fees for an extended credit period – **no Cost**
- Harness alternative data in instant credit assessment
- Technology and business synergy Advanced AI and cloud-based **tech stack.**
- Sophisticated **mobile-first** experience
- **Flexible** payment terms and pricing in favor of customer credit appetite
- No impact on credit score – **soft credit check.**
- Merchant pays **processing fees** and **merchant discount fees** (MDR)
- Prompt settlement to merchant for the whole purchase results in **enhanced liquidity**
- **Increased revenue** from processing fees as a single transaction is converted to multiple ones

A typical customer journey for BNPL:

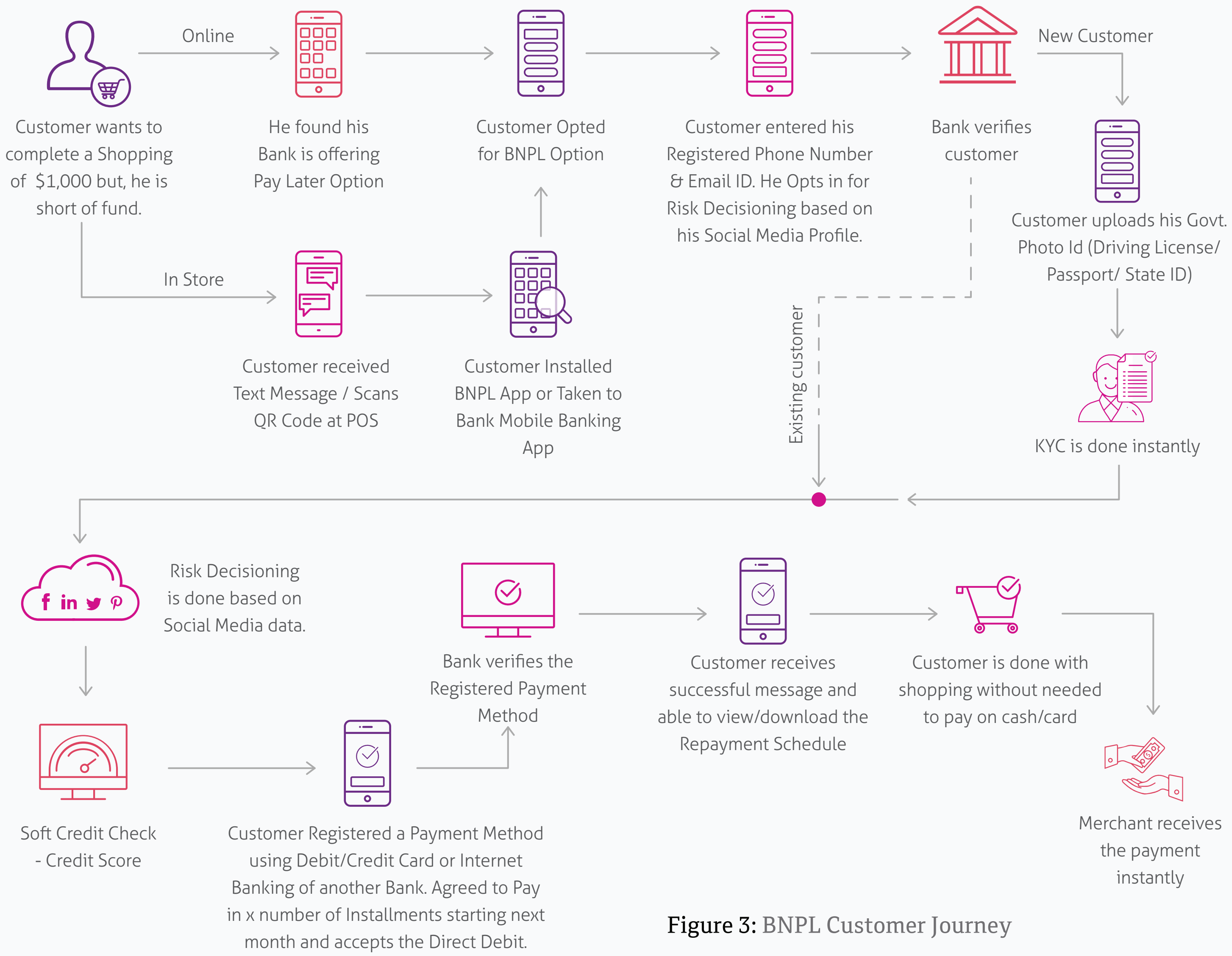

Figure 3: BNPL Customer Journey

Global BNPL adoption

The current market is primarily dominated by Fintechs and card networks like Visa, American Express, and Mastercard have also joined the battle. Of course, there are forward thinkers and banks are also no exception. Citibank, Goldman Sachs, and US Bank have been pioneers in this BNPL adoption journey.

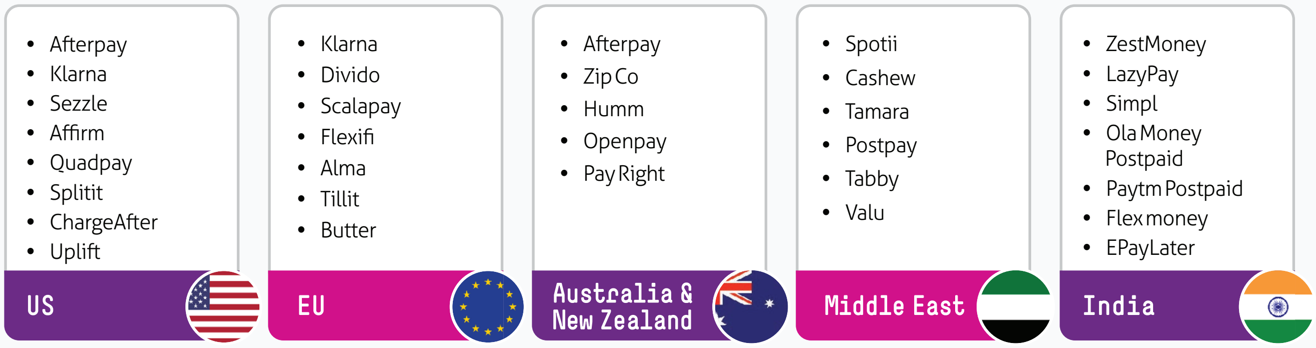

Figure 4: Worldwide BNPL

Recently, many banks and payment players embarked upon the BNPL ride:

- **Citibank Australia** has taken the bold step to have BNPL launch along with new Card[4]
- **Goldman Sachs** acquired Fintech BNPL player GreenSky for 2.2 billion[5]
- Payments giant **PayPal** acquired Japanese Paidy for 2.7 billion to capture the Asian market[6]
- **Synchrony Financials** moved swiftly in the BNPL space with Fiserv Clover in a partnership model[7]
- **Mastercard** enters the US BNPL market as this market frays[8]
- **Goldman** partnered with Apple[9]

Large Fintechs are making strategic and bold moves, engulfing market share and fostering more completion:

- **Square** acquired **Afterpay** for $29 billion[10]
- **Stripe** and **Klarna** partnered for wider reach of customers[11]

‘BNPL as a lifestyle solution:’

Strategies for banks

Banks would need to reimagine their product strategies and redefine them for BNPL adoption. The importance of BNPL is not just as a product; it serves as a bridge between today’s generations and future generations. To build a sustainable business model, banks must ensure they adopt BNPL and join the wind of change. These are the top strategies that will bring differentiated value to banks offering BNPL, giving them an edge.

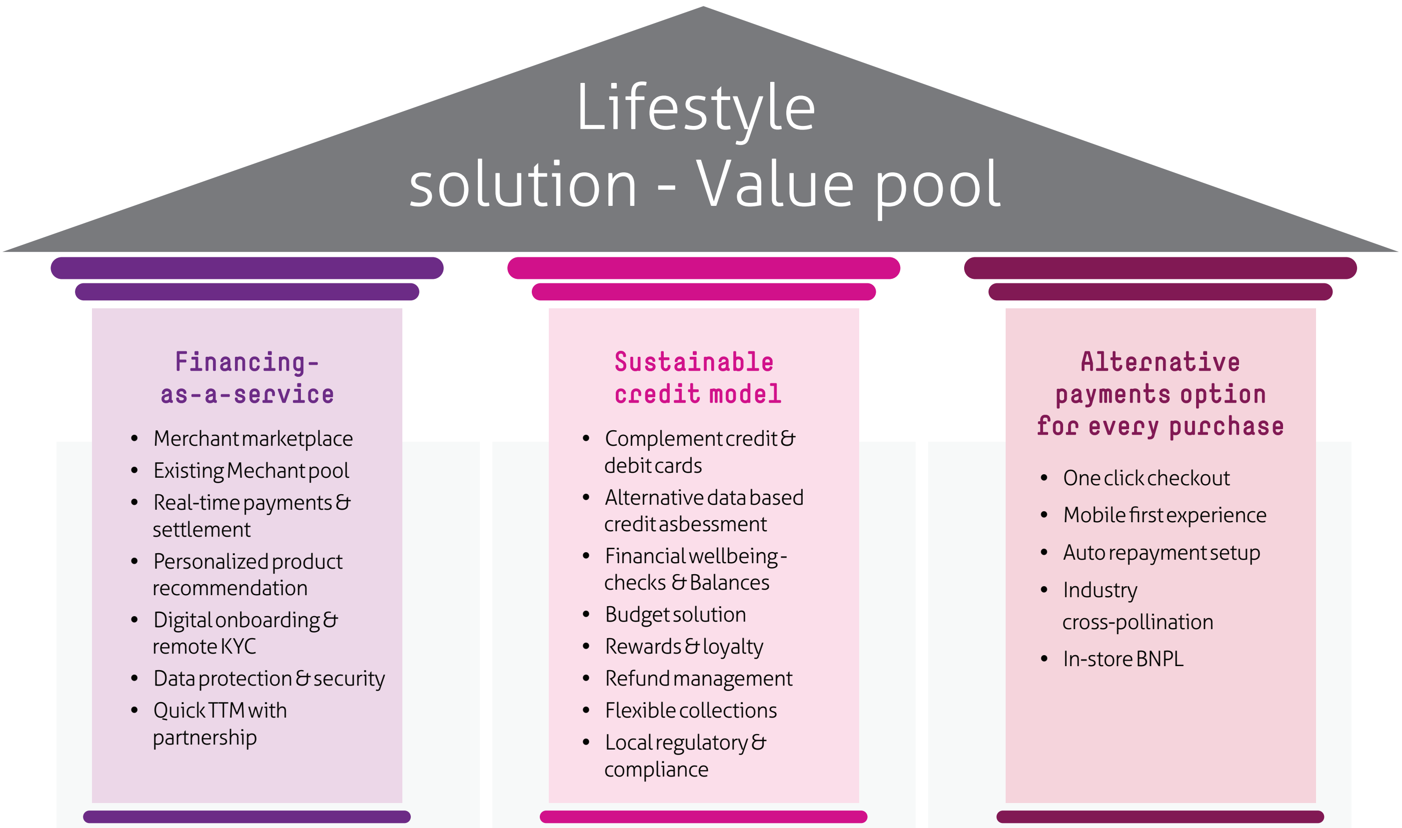

Figure 5: BNPL reimagined as lifestyle solution

Create a one-stop lifestyle solution - A long-term strategy for banks

Customers will depend on banks not just for single ecommerce transaction, but for all future events. They will accept BNPL as a solution to manage all their lifestyle needs. This will help customers to manage and maintain their lifestyle without getting into the death trap of credit or losing track of their financial goals.

a. Financing as a service - A Lifestyle solution

This certainly needs a change in mindset from the traditional product strategy. Volume plays a key role here, as the repeated purchase cycle continues in ecommerce, especially in the retail industry. Transaction volume increases multifold as every transaction is being split into multiple ones. Banks should extend this financing-as-a-service to the **merchant marketplace** and empower customers with value-added services.

Banks should start with **existing merchant pool** which don't need any onboarding effort and straight forward start using BNPL with no additional cost. Commonwealth Bank of Australia launched StepPay a BNPL enabled through Mastercard with their existing merchant base to accept BNPL and receive a 4% back of the total value as an introductory offer[12].

Banks are sitting on an unimaginable wealth of data and can use it for meaningful insight at the customer, merchant, and product level. **Personalized product recommendation** will help customers choose the product best-suited to them from the merchant network. Secured channels for PII data access are another aspect which can differentiate banks from other players. Creating a lean, secure, and composable architecture provides greater flexibility in BNPL.

Partnership with Fintechs for accelerated time-to-market and an advanced technology stack can be a game-changer for banks. Barclays, Fifth Third, and Huntington National Bank have partnered with Mastercard for BNPL[13] while Amazon partnered with Affirm in US[14].

b. Sustainable credit model - Responsible financing

BNPL should be an option for customers to beat financial stress, a tool that assesses **customers' affordability** and recommends BNPL in order to achieve financial wellbeing. Hence, proper **checks and balances** should be in place for credit assessment of customers. **Alternative data-based credit assessment** for customers will enable a whole new world of efficient credit underwriting even for those who are credit challenged or have no credit. It will help such

customers build their credit history within the credit bureau. This will also reduce rejection rates for these customers and support society with financial inclusion like never before. **Responsible reporting to credit bureau** is an important role banks will play in this ecosystem. For a sustainable lending model, banks should focus on credit assessment and also help customers to navigate through their credit management and future repayments, minimizing late payments burden and easing collection pressure.

Banks should consider reimagining the BNPL journey by complementing with existing cards. BNPL can be enabled with existing credit and debit cards which in turn increases card-based transaction fees. In fact, leveraging existing cards' data, insights, and loyalty platforms can highlight BNPL as a more attractive option. The US Bank has launched ExtendPay for credit card holders to finance purchases without interest[15].

c. Alternative payments option for every purchase - Industry cross-pollination

BNPL as an alternative payments option for customers can be enabled in every transaction for customers. **Industry cross-pollination** can enhance revenue stream for banks enabling BNPL not just for retail but also for travel tourism, medical, education, and even for utility payments. This embedded financing could be at the back of every type of customer transaction with API-based integration at the service provider side.

BNPL can accelerate small & medium business as well with these alternative payments options, enhancing cash in hand or liquidity for the business while they have shorter cycle time from their distributors. Banks can be **part of the SMB segment's growth story** from mom-and-pop stores to midsize enterprises. In addition, **in-store BNPL** is fairly new and banks must tap this fantastic opportunity without delay. Splitit InStore and Afterpay Card launched in-store BNPL option complementing cards. Afterpay Card is Mastercard Debit card integrated with Apple Pay and Google Pay wallet[16].

What's next – Tighter regulations?

At the moment, BNPL, globally, is mostly in the hands of Fintechs and some technology players. A large number of new, small, and emerging Fintechs as well as micro-finance companies are getting into this space. The BNPL space is largely unregulated as BNPL providers do not charge interest in most cases. Hence, they are not forced to adhere to the code of conduct by the credit authorities in most geographies. This exposes consumers to significant risk. Customers are typically at risk of getting credit even beyond their affordability. The majority of customers do not have a clear understanding of BNPL risk. This increases the risk of credit offering to vulnerable customers.

Regulators of each jurisdiction may impose tighter regulations as increasing numbers of smaller players join the party. This also means there may be an approval process in the near future for onboarding new merchants to BNPL platforms. Another possibility is that approval from a regulatory body may be required for launching a BNPL product. More stringent approvals may come in the picture for the SMB credit segment. In the UK, supervision of the BNPL industry by the supervision of Financial Conduct Authority (FCA) has been proposed[17].

Banks need to adopt responsible lending with the goal of a larger share of quality borrowers over a period of time. They should consider long-term strategies that are sustainable for building trust and comfort among customers.

Conclusion:

BNPL has a future trajectory of tremendous growth and journey of evolution. This is proven by recent rapid adoption among customers, especially the younger generation. It is more than just a checkout experience or means of financing a retail purchase. Today, young customers worldwide are looking for flexible payment options during checkout so they no longer have to stick to the traditional credit card. In fact, this subset of customers is keen to have enhanced liquidity for any potential disaster scenario. Today, this has become a wellness mantra. While they believe that cash is king, the credit card is not a preferred payment method for them. In addition to convenience, speed, and security in credit, banks have a social responsibility to guide customers in managing their credit in an efficient way for their financial wellbeing as well as that of society. In this scenario, lending affordability cannot be ignored and ignoring it should be considered a form of delinquency.

Through BNPL, banks can reduce barriers responsibly for those who are credit challenged or don't have credit history. Through constant monitoring and review during the repayment period, banks can categorize customers based on their credit behavior. Eventually, banks will create a larger pool of credible customers. High time for banks to take proactive steps, adopt groundbreaking innovations to enhance customer stickiness, accelerate their market share and revenue, and at the same time responsibly reduce barriers to those who are credit challenged.

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As Chief Business Officer for Mindtree's Banking, Financial Services and Insurance (BFSI) business, Mukund leads a portfolio of accounts globally and is responsible to formulate strategy and its execution to accelerate growth. He acts as a close advisor to consult and facilitate aligning client needs with Mindtree and its partner capabilities, driving transformation. Mukund has been consulting with Financial Services for 20+ years and has a track record of having shaped and successfully built practices with a strong market positioning, helping clients succeed. He has an MBA from the University of Texas and is based out of New York.

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