Will Buy Now Pay Later (BNPL) Survive?

BNPL operators (despite a small market share) have shaken up traditional banks and financiers and commanded the attention of investors –as reflected in high stock market valuations. But what are the longer term prospects?

The financial product of BNPL will survive in various guises. It's been around in some form for (almost) ever. The brilliance of the new operators has been in identifying market gaps in existing offerings and using modern payments technology to exploit that.

But the longer term survival of independent BNPL operators is, I think, quite uncertain.

The reason for that view lies in the business models involved, which are not just providing "credit" to retail customers, but are inherently interconnected into the payments system (as the P in BNPL suggests). Their models involve an additional, unnecessary, layer in the plumbing (or electronic pipes) of the financial system, which is not costless.

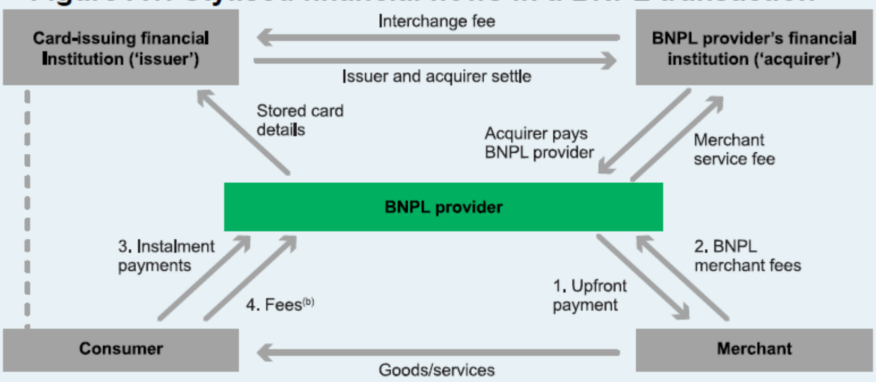
Banks, as fundamental participants in the payments system, are able (and beginning) to offer competitive BNPL style products which avoid that extra layer and its costs.

To understand the inherent payments system weakness in the business model of independent BNPL operators, it will be useful to examine the following figure from a recent [Reserve Bank article](). It's a bit tricky, so its best to first consider what happens in the absence of BNPL.

Normally, when a merchant receives a payment from a customer via a card or other digital method, their account at their bank will be credited with the proceeds. The customer's account at their bank will be debited, either immediately, or later when a credit card transaction is ultimately paid for.

The "plumbing" that enables all that may be either the EFTPOS system, the Visa or MasterCard systems, or the New Payments Platform. While electronic digital "plumbing" has dramatically reduced costs compared to the now antique cheque/paper system, there are still costs associated with the operation and maintenance of this plumbing.

Figure A1: Stylised financial flows in a BNPL transaction[(a)]



(a) When repayments are made from a linked debit or credit card

(b) May be free to consumers for on-time repayments of smaller balances; missed payments usually attract late fees, and establishment and/or periodic fees may apply for larger balances

Source: RBA

As the figure from the RBA illustrates, the BNPL operator interposes itself into the plumbing between the merchant and its bank, and between the customer and their bank. The BNPL operator draws on funds from its bank account to pay the merchant immediately via a transfer into the merchant's bank account. When the customer makes the deferred payments to the BNPL operator, funds are transferred from the customer's bank account to the BNPL operator's bank account.

Since interposing that additional layer involves some additional costs, why has the BNPL model proven successful to date? The simple answer is that BNPL was a new, different, product, attractive to consumers, that banks weren't offering, enabling those additional middleman costs to be offset. (That offset was primarily via the significant merchant charges which merchants acquiesce to in the hope of attracting or retaining customers wanting BNPL facilities).

However, as we have already seen, banks are responding by offering similar products which, essentially cut out the need for the middleman. No-interest credit cards, with monthly fees only if the card is used in, or not paid off at the end of, that month have already appeared.

Do BNPL operators have some other competitive advantage that might see them survive when banks offer virtually equivalent products? Flash marketing and "apps" have given them initial appeal to, particularly younger, customers, but whether there is any customer loyalty that can't be offset by the banks is another matter.

Another possibility is that BNPL operators may be better able to assess and minimise possible losses from customer defaults than are banks. At the moment, they are able to economise on customer credit assessment. The reason is that BNPL is, inappropriately, not legislated as provision of credit. BNPL operators thus escape the responsible lending obligations (RLOs) and other requirements of the National Consumer Credit Protection legislation.

Despite the current government wanting to remove RLOs, it seems unlikely that any such advantage – which consumer advocates argue puts vulnerable consumers at risk – will persist for long.

The most likely scenario for initially successful BNPL operators is eventual acquisition by a bank or other important participants in the payments system to whom acquiring new customers and using product design and technology from the BNPL operator is attractive. The acquisition of Afterpay by Square is one example of such a scenario.

BNPL operators have done the financial sector and its customers a service by incentivising banks to consider and offer different financial products and services. But like in many other cases, the innovators may shine briefly until their reward comes from being "swallowed" by the large incumbents.

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