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01 Payments and Lending industry shifts **from cash to non-cash**

Like every other industry, the payments and the lending industry has been no stranger to various disruptions. And now, a surge in technology, sector dynamics, and regulatory initiatives coupled with the pressures of the pandemic has compelled the players to shift towards the new normal or a new landscape.

The industry, at the same time, is witnessing a change in customer expectations. With the rise in millennials and the GenZ population, the keenness towards using a physical card is significantly dropping. As a case in point being, credit card usage declined to 36% in 2020 from 64% in 2002.

This presents an opportunity for the payments firms to swiftly meet the ***rising customer's digital expectations as customers migrate from cash towards digital options.***

A similar trend is witnessed on the other side, i.e. Business to Business (B2B) customers. Small and medium businesses (SMBs)/merchants are gradually inclining towards digital lending as it is proving to be a potent force to drive inclusion, especially with the sub-prime demographics. **The global digital lending platform is slated to grow at a CAGR of 24% through 2028. Innovative products are becoming an antidote for the persisting challenges around geography, costs, and transparency.**

The aforementioned pent-up demand from the two faces of the same coin (Retail customers and businesses) forces the industry to move towards digital and contactless. Moreover, the adoption of digital and contactless is further catalysed by the rise of new-age players and BigTechs making inroads within the industry.

"While the pandemic has been a major catalyst, the primary factors that have driven the digital adoption in the payments and lending landscape are evolution of technology and the rise in purchasing power of the customers"

– Philip Belamant,
CEO and Co-founder, Zilch

Strong demand leads to the rise in various alternate payments method

The unprecedented surge in contactless/alternate payments has made the payments industry view the new models from being a **"nice-to-have" capability to a "must-have" service, thus resulting in the rise of various options to choose from.**

With technology enabling the alternate methods, consumers today can use radio frequency identification (RFID)-enabled cards, e-wallets installed on their mobile devices to make payments or use the Buy Now Pay Later option for deferred payments.

While all the methods have a transaction limit set by the banks or the issuer, it empowers customers to make an easy transaction while avoiding physical touchpoints

Contactless cards – Uses near-field communication (NFC), a type of technology that falls within RFID and works when there is a limited distance between objects — in this case, the card or device and the point of sale (POS) terminal.

Pass-through digital wallets – The wallet acts as a proxy for a real card (or cards), and it does not have its own balance. Users can download apps such as Apple Pay or Google Pay and link their cards to make contactless payments through their smartphone, smartwatch, or other wearable devices.

Staged Digital Wallet - This is where the funding and payment stages are decoupled. The user has to "load up" their wallet before making a payment. Examples of this are: PayPal and most cryptocurrency wallets

Buy Now Pay Later (BNPL) – It has become an emerging trend globally as cost-effectiveness, and growing demand for convenient payment has led to the phenomenal rise. Though prevalent in the past, the new payment option has witnessed a surge in the adoption rate as it has empowered customers to buy things they previously could not. A case in point is, Klarna, a Swedish FinTech, offering BNPL services, recorded over 8 million app downloads in Europe in 2020.

While the options remain plenty, BNPL, off lately, has witnessed a meteoric rise. But the pertinent question is – what is it about BNPL that has attracted such strong adoption from both consumers and merchants?

02 BNPL becomes a global phenomenon and **witnesses a monumental rise in Europe**

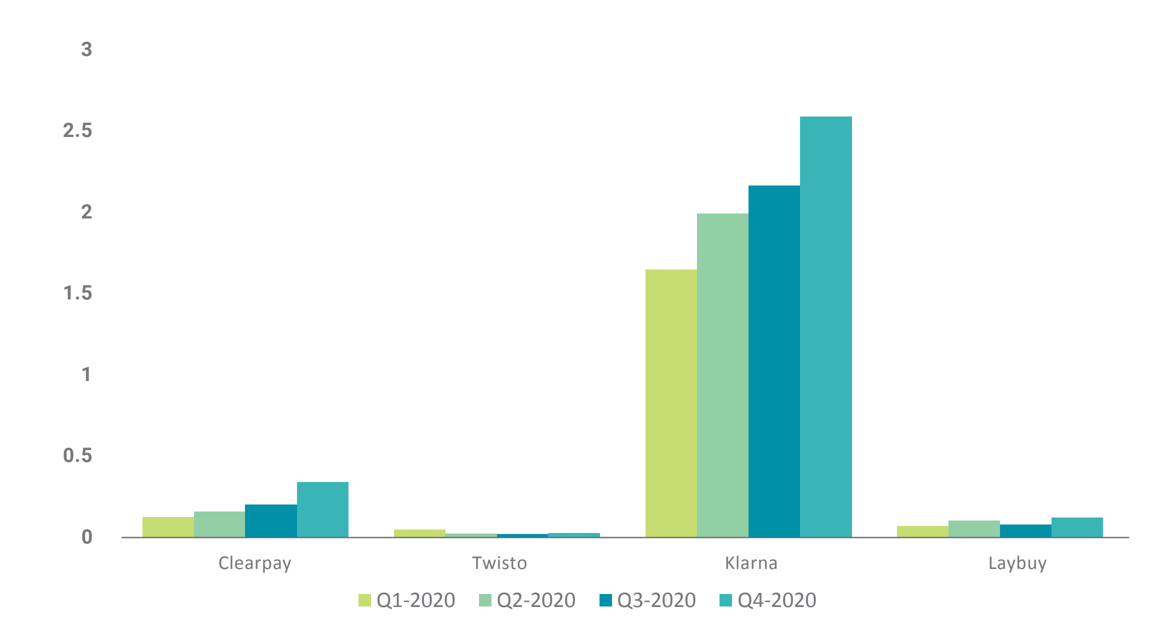
Before going into details regarding the benefits of BNPL across the spectrum, let us deep dive into the history of its origin. While it remains debatable as to when and who pioneered and envisioned the offering, companies such as Klarna in Europe began split pay services back in 2005. In the US, Affirm entered the space in 2012, followed by Australian firms Zip, Openpay and Afterpay in 2013 and 2014, respectively.

Looking at the market penetration, Australia and the UK are further along the adoption curve. They have already seen some regulatory scrutiny of the category, which may provide clues about the product category's future in other markets. While players like Afterpay and Klarna have successfully expanded across multiple geographies, BNPL remains balkanised, with discrete market leaders emerging in different countries/regions.

Figure 1: BNPL providers across the globe (indicative list) | Source: IBSI Research Analysis, Company website

Further deep diving, we witness an exponential surge in BNPL transactions within Europe. Nearly £4 in every £100 in the UK is spent using BNPL. Customers across the region are adopting the services as it allows them to defer payments on goods at no cost. At the same time, BNPL players within the region also witnessed a surge in customer base after experiencing a slight decline in Q2 and Q3 of 2020. (Figure 2)

Number of customers across BNPL firms in Europe (In Million)



The growth and popularity have been propelled by high profile IPO's and increasingly larger investment rounds that provide BNPL companies like Klarna the funding to expand and acquire new customers in the region aggressively. It comes as no surprise that analysts expect the European BNPL market to grow over Eur-300 billion through 2025, with around 9% of eCommerce spending expected to be handled by BNPL.

> *"The penetration of e-commerce offerings within the sub-prime demographic has been one of the major reasons for the meteoric rise of BNPL"*
>
> ***– Mohammed Asif,***
> *Manager, Product Management, Amazon*

03

Explore the options and choose what is the **RIGHT BNPL model for your organisation**

Before jumping on the ship of adopting the right model, the banks and other payments giants must precisely understand the various models within BNPL. Thorough research and analysis on the BNPL ecosystem/model can allow the traditional players to build their base for BNPL adoption and allow them to understand the segment they target, the merchant and consumer needs they address, and the business models they are competing with.

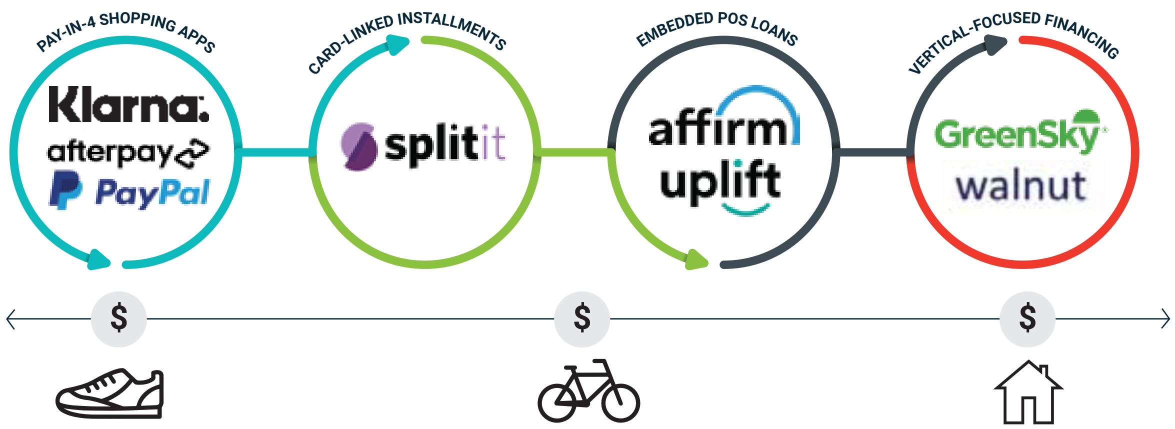


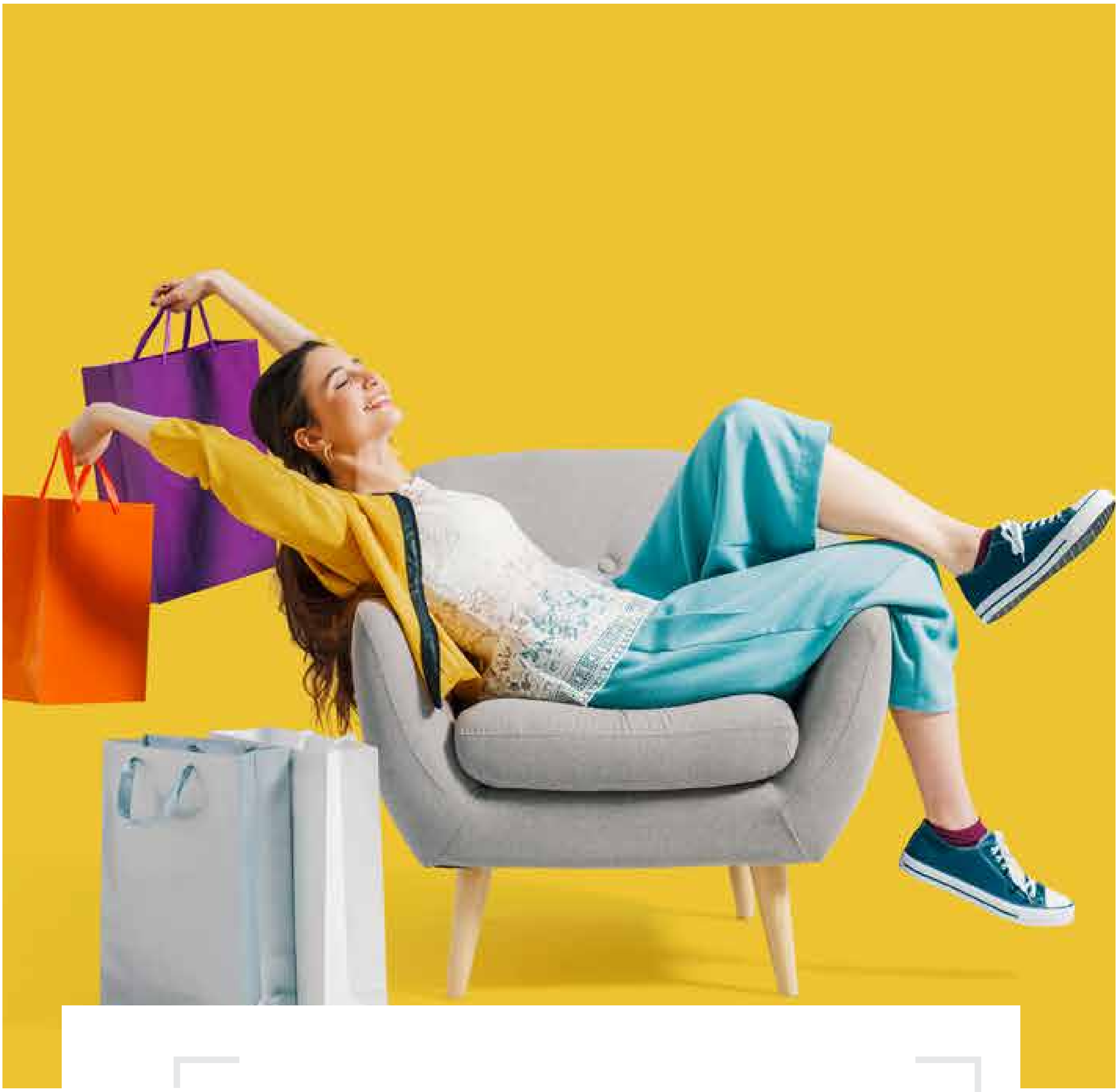
Figure 3: Different BNPL ecosystem/models | Source: IBSI Research Analysis

Integrated shopping apps (Pay-in-4-Shopping apps) are the simplest and most accessible form of BNPL. It allows customers to split small transactions (typically less than Eur-200) into four payments, with the first payment made at the time of transaction and the rest in a two-week interval. A case in point here is PayPal in 2020 launched a modified pay-in-3 model in the United Kingdom that allowed shoppers to finance their purchase over three interest-free monthly instalments. It also rolled out a pay-in-4 model in the United States a month prior.

Card-link instalments or off-card financing solutions is an alternate model to the pay-in-4 model and primarily aimed at customers who still prefer to use their credit cards. This solution allows customers to make midsize purchases vs small-ticket purchases in the pay-in-4 model. **In Europe, Splitit has introduced a debit card-based payment offering, allowing consumers to split their purchase of USD-400 or less into up to three interest-free monthly payments.**

Virtual rent-to-own models or embedded POS loans gives customers an enhanced purchasing power, enabling them to own expensive items (between USD-250 to USD-3000) in categories such as mattresses/furniture and electronics/appliances. Grover, a Berlin-based start-up, uses a subscription-based model, allowing consumers to rent items such as computers, smartphones, games consoles and scooters.

Vertical-focused financing is meant for specific areas such as healthcare and home improvement, where transactions can run anywhere from USD-3000 to USD-50,000. Companies such as Walnut and Greensky partner with the B2C companies that consumers use, which gives them a significant distribution advantage.



"No BNPL firm will restrict itself to a particular style/model when it comes to the business model. They should aim to attract customers and provide them with broader offerings the customers seek"

– Paul Harrald,
Head, Curve Credit

While BNPL may not solve all the payments issues of the customer, it has quickly become an essential tool and is expected to stay. Traditional banks and payment providers must realise the advantages of becoming a first mover and leverage the plethora of benefits that BNPL offers in the current landscape

- Benefits to customers: Consumers get the option of buying items and paying for them with multiple terms ranging from weeks to years, thus improving the customer experience, mending broken customer journeys, and making it frictionless. BNPL enables customers to receive their items before completing a full payment.

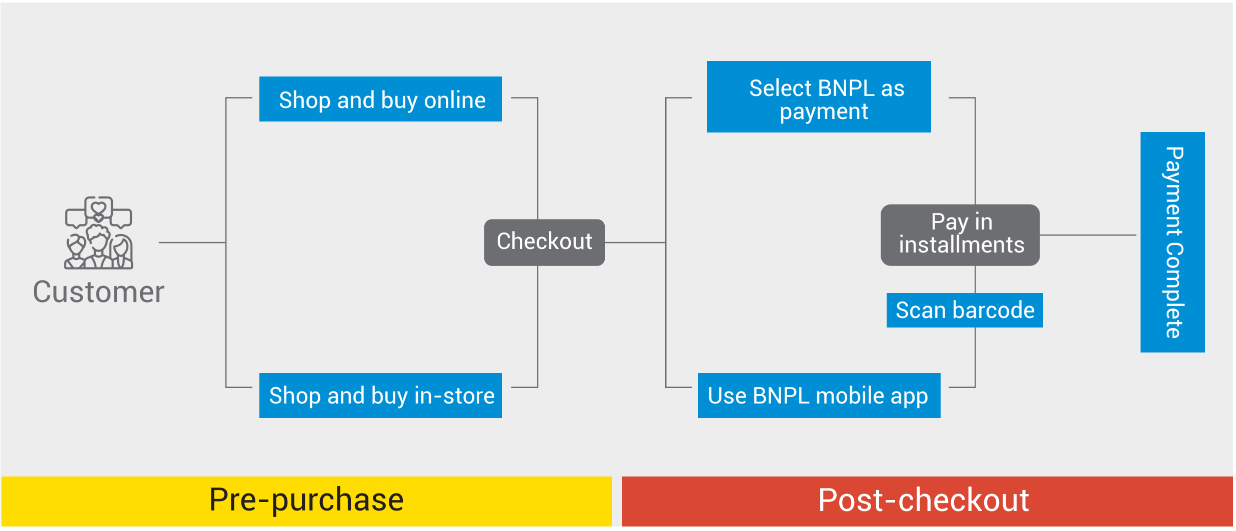


Figure 4: End-to-end customer journey using BNPL | Source: IBSI Research Analysis

- Benefits for businesses: The BNPL model is being used by retailers and other business owners for high-value goods or by those offering low-value goods but want to increase conversions, cart size, reach new customers and keep existing ones. Providers such as Klarna claimed that the addition of BPNL feature led to an increase of 33% in sales value at its client GymShark.

While the research and statistics paint a favourable picture of BNPL as a payments service, however, before jumping on the BNPL bandwagon, banks must evaluate the barriers that a BNPL landscape presents, as the entire BNPL business model hinges on accurate credit risk assessment and management:

Customer credit risk – BNPL is being used for smaller purchases with minimal credit checks or traditional underwriting, thus appealing to many subprime users. While it offers lucrative deals to customers, spending unwisely or loosely without tracking the financials could lead to major credit risk. However, in these instances, the chances of a default risk become very high. According to a report, 1 in 10 BNPL shoppers has been chased by debt collectors, a figure that rises to 1 in 8 for young people.

Merchant default risk – In the current scenario, some merchants are at greater risk of failure. With declining revenues and rising costs, many merchants are relying on emergency working capital. While some have got the support, many are struggling in deep waters. The critical implication here is that struggling merchants working with buy now, pay later FinTechs can shutter their business without notice, leading to a rise in NPAs for the BNPL FinTechs.

Managing the ever-changing regulations as many vendors have entered the space in Europe and globally, regulators are already closing the cracks. At the European level, various regulatory bodies within Sweden, Germany and others are coming up with stricter rules. In July 2021, the European Commission proposed an update of its rules to protect consumers when they take out a loan. The update demands that information related to credit must be presented clearly so that consumers understand what they are signing up for. Furthermore, the update will flag potentially detrimental products because of the high costs, prohibit the unilateral increase of a consumers' overdraft or credit card limit and tighten the assessment of a consumer's creditworthiness based on the consumer's income and expenses

Effectively managing associated risks is the secret sauce for any BNPL player. Banks and payment providers will need to develop an ability to evaluate credit risk by leveraging upon data intelligence and cutting-edge technology tools to derive deep insights for prudent credit decision-making.

04

Building the right BNPL model requires a **3-Dimensional risk management framework**

As the volume of digital transactions rise exponentially, opportunities arise for traditional players to transform their payment model towards value amplifiers and mitigate the risks by considering an IBSi proposed 3-Dimensional (3-D) Risk Management Framework

Deploy a risk management tech stack + Draw from the ecosystem = Drive the risk-managed experience

To follow this equation, banks and large payment providers will need to wisely select a robust technology that drives a regulated business process, performs optimally online at the point-of-sale between retailers, consumers, and interacts with the ecosystem to ultimately provide the required risk-managed superior experience.

Deploy a risk management tech stack – Build an agile, secured, and cloud-native microservices enabled infrastructure

- The starting point of the transformation journey is to concentrate on areas where risk components reside. Using technologies such as Artificial Intelligence, Predictive Analytics and Machine Learning, banks can slice and dice the data pool to assess credit risk and enable the customer-facing employees to make decisions faster. The aim should be to review and transform the critical areas where technology can carry the load – such as Real-time checks: ID verification, Know Your Client (KYC), Anti-money laundering (AML), credit history and affordability. This way, banks can eliminate human bias with an accurate assessment of the creditworthiness of the end customers and merchants.

Clearpay, a UK based company, also knows as Afterpay outside of UK and Europe, introduced a new merchant analytics platform, Clearpay iQ. The platform provides AI-powered insights, visualisations, and real-time data delivered in one, highly accessible self-service user interface and recommends insightful actions to optimise business performance based on analytics.

> *“It is imperative for the BNPL players to have the right kind of KYC checks and AML in place in order to reduce the various associated risks”*
>
> ***– Felipe Penacoba Martinez,***
> *CIO, Revolut Bank*

Next, after the back-office implementation, is a fast-track plan to migrate mid- and back-offices onto the cloud. While banks in Europe have been using the public cloud for non-critical functions, they need to access their current capabilities and accordingly shift their critical processes into the cloud to make effective risk decisions. For instance, today, data has become the new oil, and at a time when leaders are being asked to process vast data in less amount of time—often amid budget and staff constraints—cloud computing can enable risk teams to react to changes within the external environment and deep-dive into the analytics life cycle to better understand the drivers of risk, all without major expenditures.

Additionally, cloud migration also unlocks various other associated benefits:

Scalability: Public cloud allows banks to pay only for what they use, whenever they need it

Speed: It allows banks to expand into new markets within hours globally

Security: Cloud adoption contributes to better data analytics and robust KYC and anti-money laundering practices, enabling banks to detect fraudulent activities better

Cost savings: Banks can shift their fixed cost into a variable cost, allowing economies of scale

> *"The cloud-native infrastructure provides multiple benefits, such as faster time to market, scalability and security"*
>
> **– *Dylan Tan,***
> *Co-founder and CEO, Split*

31% of global executives claim that cloud enables faster time to market, and 60% + executives say that cloud allows them to reduce cost while allowing them to scale.

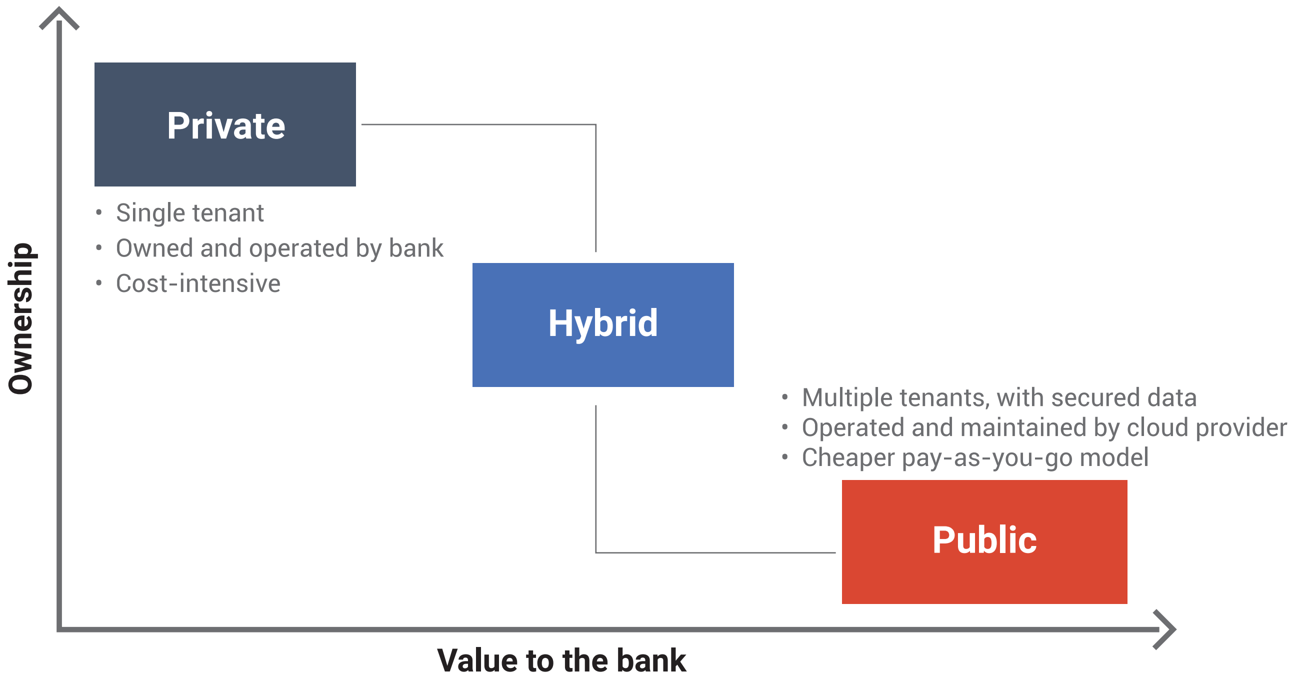


Figure 5: The growing use of public cloud model | Source: IBSI Research Analysis

Once the services are cloud-powered, it is time to scale API networks to accelerate the transformation journey and facilitate open banking. APIs and API management can help banks reduce risk and respond when external volatility arises. Banks can examine the challenges faced by companies that have already entered ecosystems, and mitigate the risks involved in getting their internal leaders, technologies, and legal processes prepared for smooth ecosystem entry. By leveraging pre-existing data routes, financial institutions can capitalize on innovation while optimizing implementation and cost to deliver modern customer experiences.

API's strategic value appreciated in early 2000 when platform firms Amazon, eBay and Salesforce launched commercial APIs. Today APIs act as a growth engine in two ways:

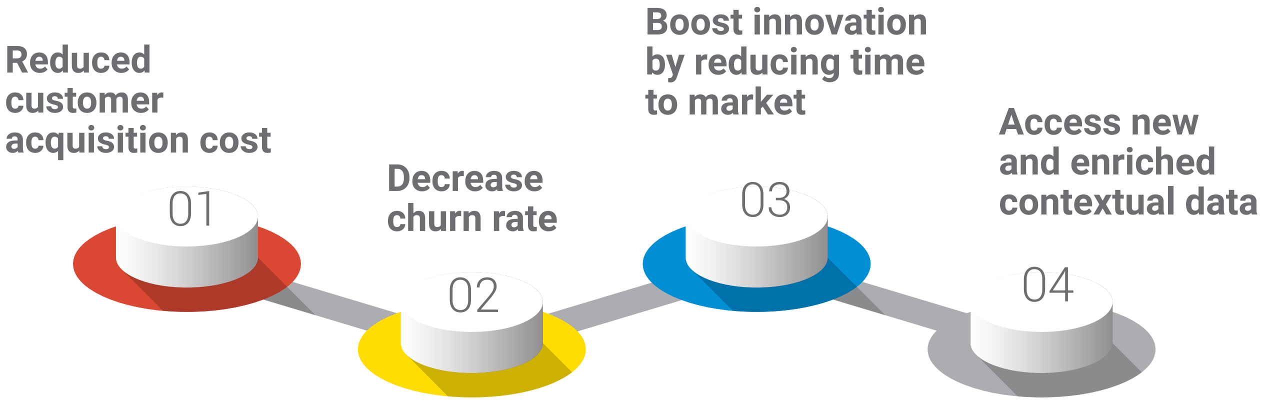
A catalyst to digital transformation: APIs are the central nervous system that synchronise operations by eliminating silos. Banks can leverage APIs to modernise applications and rearchitect monolithic legacy systems into microservices with greater business agility.

Opening new business frontiers: The API enables banks to commoditise banking services and products while developing new monetisation models to diversify the sources of value. This way, banks can become a one-stop shop for all their customers or venture into embedded finance.

> *"Cloud has a special role to play when it comes to the development of a lean infrastructure. While it provides various benefits, it also enables organizations to reduce their cost structure"*
>
> ***– Philip Belamant,***
> *CEO and Co-founder, Zilch*

Draw from the ecosystem – Leverage 3rd party solutions to mitigate risks

The second checkpoint of the transformation journey is to collaborate at scale. It is highly impractical, slower, riskier, and costlier for the banks to develop everything in-house. At the same time, ecosystem banking thrives on creating and cultivating a network effect, thus attracting suppliers and customers. Within an ecosystem, banks can leverage various collaborative synergies and turn competition into co-opetition:



Additionally, to mitigate risk, banks have a great avenue in hand to interact with 3rd-parties with expertise in data analytics, risk score/index modelling and decision automation. They include enabling quick approval/decline decisioning during merchant onboarding and timely responses to changing risk conditions uncovered during ongoing merchant monitoring.

To build a comprehensive BNPL model, banks and payments providers will need to decide the role they play in the ecosystem and shift from the role of integrators towards either ***Supplier (developing products in-house and using third party channels), Aggregators (using its extensive channels for distribution while aligning with the third party for products) or Orchestrators (Connecting with the ecosystem to create maximum value and become a one-stop-shop)***

In UK, Metro Bank used open banking APIs to create its own ecosystem. As one of its partnership, the bank interacts with the UK based FinTech Credit Ladder, to gather information about credit history of tenants within its jurisdiction.

Drive the risk-managed superior experience

Once the infrastructure is in place, and strategic collaboration avenues are shortlisted, banks and lenders must engage with the customers and become their primary point of contact. As a step towards building an ecosystem based on the bedrock of trust, BNPL players should integrate tech-driven data analytics functions as an efficient mechanism and provide a superior user experience.

Today, the BNPL landscape concentrates on consumer financing and merchant servicing. However, adding another layer, i.e. merchant financing, can assist banks in creating a unified experience across the board. While consumer financing and merchant servicing come with benefits ranging from driving the sale processes to increasing the customer lifetime value, adding the third layer of merchant financing will help banks integrate user journeys and make the BNPL process work for all the stakeholders while catering to all the associated risks.

To drive the relevant experience, banks can bucket their services across three main points, i.e. back-office processes, integration with ecosystem and transparency, while utilising the first two steps within the 3-D risk management framework:

	Customer Financing	Merchant Servicing	Merchant Financing
Back-Office processes	1. Enable faster on-boarding of customers 2. Utilise the deployed technology for swifter and secured KYC checks	1. Enable faster on-boarding and KYC setup 2. Automate regular/timely payouts to the merchants	1. Eliminate procedural delays by removing silos 2. Shift the risk of payment delays and reduce NPAs by automating merchant payments
Integration with ecosystem	1. Provide multiple payments options to the customer 2. Facilitate interest rate checks and online simulation of repayment plans	1. Bring in new customers and create significant opportunities for additional sales 2. To provide their partners with extensive data and help increase consumer trust during the purchasing process	1. Increase partnership with B2B FinTechs for better working capital management 2. Draw synergies with other partners to assist merchant in the entire financing supply chain
Transparency	1. Provide information regarding return / sale cancellation / reversal transactions	1. Provide options to merchants for enquiries and real-time updates	1. Optimise credit by enabling a consolidated view of merchant exposures

In a nutshell, banks and large payment providers can ensure transparency in the process by creating a holistic view for the associated entities (customers and merchants) while eliminating all the forthcoming risks through back-office integration and partnering with the ecosystem.

Case in Point : BNPL player Affirm collaborates with TeleSign

About: Affirm, a BNPL FinTech, adopted a model which provides shoppers an alternative to traditional credit cards, giving customers the flexibility to buy now and pay overtime at thousands of online stores. The company needed a solution that covered the customer lifecycle to build a complete risk assessment within a matter of seconds by examining a consumer's digital footprint and easily engaging with customers.

Implementation and results: Affirm added TeleSign to its tech stack for its cohesion of solutions comprised of digital identity and programmable communications allowing it to safeguard a purchase using digital identity intelligence.

Using TeleSign as part of Affirm's holistic approach to security, the BNPL player was able increase customer conversion at its PoS by 10% while diminishing merchant risk.

05 Future outlook of the **BNPL landscape**

Today, there is no doubt regarding the prospect that BNPL brings to the table in terms of lending and payments, especially after witnessing the investor's activity in the space. The investment in European BNPL players grew 118% YoY in 2020 to Eur-1.08 billion. And with over Eur- 930 million already raised in Q1 alone, 2021 can be a record-breaking year.

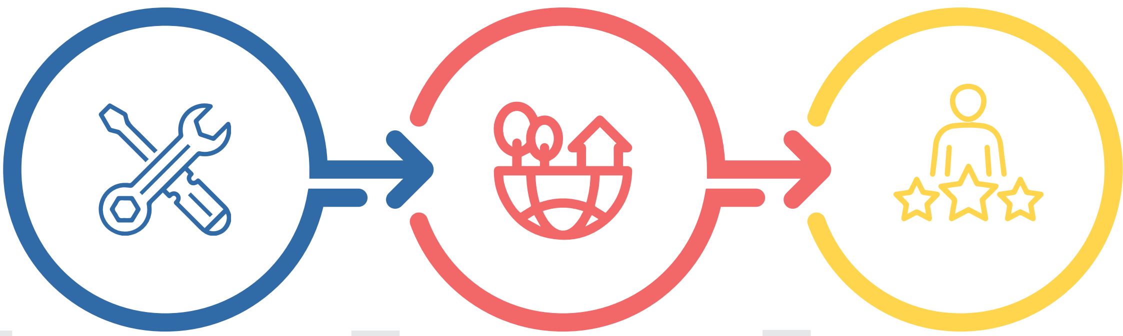
Zilch raised a USD 80M Series B tranche in April 2021, offering a virtual card that allows users to pay in 4 instalments over six weeks at online retail stores and rewards users when they shop responsibly.

In Sweden, Klarna leads in total disclosed funding in the global BNPL space, having raised nearly USD 3.5B since being founded in 2005. It has 250K merchants and 90M active customers.

Moreover, the BNPL market is growing beyond typical e-commerce categories like apparel & beauty into adjacent sectors, including healthcare, travel, entertainment, and home improvement, because of the rising interest, which could eventually lead to consolidation via partnerships or acquisition.

> *"Some industry consolidation can be expected to take place in the near future. While the business model could change from B2B2C to B2C, i.e. a vertical integration, we could also witness white label modelling, where large players with merchant relationships enter into partnerships with niche FinTechs"*
>
> ***– Paul Harrald,***
> *Head, Curve Credit*

Regardless of the shape the BNPL industry takes in the future, banks and other players planning to monetise their services by venturing into this area should and must be cognizant of the risks associated with the industry and use the holistic and robust 3-Dimensional risk management framework prudently to



Build the back-office

- Agile
- Secure
- Cloud-powered
- Microservices enabled

Interact with ecosystem

- One-stop with B2C partnerships
- Mitigate risks with B2B partnerships

Superior user experience

- Increasing customer lifetime value
- Integrate user journey

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