Consumer Finance Monitor (Season 5, Episode 44): The Consumer Financial Protection Bureau's Report on Buy-Now-Pay-Later (BNPL): What are the Takeaways and the CFPB's Expected Next Steps?

Speakers: Alan Kaplinsky, John Culhane, Michael Gordon, Michael Guerrero, and Lisa Lanham

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. I'm your host, Alan Kaplinsky, the former Practice Group Leader for 25 years, and now Senior Counsel of the Consumer Financial Services Group at Ballard Spahr, and I'm very pleased to be moderating today's program.

For those of you who want even more information, don't forget about our blog, Consumerfinancemonitor.com. We've hosted the blog since 2011, so there's a lot of relevant industry content there about the topic we'll be discussing today and a lot of other topics pertaining to consumer finance. We also regularly host webinars on subjects of interest to those in the industry. To subscribe to our blog or to get on the list for our webinars, please visit us at Ballardspahr.com. If you like our podcast, let us know about it. Leave us a review on Apple Podcasts, Google, or wherever you get your podcasts. Also, please let us know if you have any ideas for other topics that we should consider covering or speakers that we should consider inviting as guests on our show.

Let me now describe to you the topic that we're going to be talking about today, and that is the buy now pay later industry, which is an industry that seems to practically sprung up overnight as a very convenient way for consumers to purchase merchandise at retailers either online or in bricks and mortar stores throughout the country. And it's become competition to the credit card industry, principally because most of the buy now pay later products are structured to be interest free to the consumer and it enables the consumer to obtain immediate possession of whatever he or she desires and pay for it over a period of several weeks without paying interest as long as the payments are made on time.

Now, the reason we're doing the podcast show today in this subject is that very recently the Consumer Financial Protection Bureau, our very favorite federal agency, of course, has issued its long awaited report on the buy now pay later industry. As the report indicates, the CFPB's growing interest in and scrutiny of buy now pay later comes at a time when the industry is experiencing massive growth. It's now imperative for both companies that are currently offering buy now pay later products or companies that are considering whether to enter into the buy now pay later market to be aware of the practices that are likely to receive increased CFPB scrutiny, and perhaps scrutiny of other federal and state agencies, and how future CFPB initiatives involving buy now pay later could impact the industry.

Let me now introduce you to our speakers. First of all, I want to introduce you to Michael Gordon. Michael has two decades of experience in consumer financial services law over his career. He served in private practice as a senior federal regulator and as a FinTech general counsel. His practice includes enforcement defense, banking and bank partnerships, blockchain and digital assets, consumer finance and FinTech, corporate governance, payments, regulatory strategy, risk management. Michael was on the startup team that had actually established the CFPB in 2010, 2011, and he served there for five years in a very senior role, a number of senior roles at the agency, including senior counsel to the director, Richard Cordray. He has extensive experience in representing banking and non-banking companies before all kinds of federal government agencies, and he is very familiar with the buy now pay later product.

Let me now introduce you to Michael Guerrero. Mike advises companies across a wide range of industries, consumer protection and consumer finance issues, including clients offering point-of-sale, personal property financing and leasing, rent-to-own products, and installment loans, and most importantly, and pertinent to today's podcast buy now pay later products.

He helps clients navigate compliance with state and federal calling and telemarketing, real estate installment sales, lending and payments laws. He regularly provides advice on structuring and documenting consumer credit programs involving the financing of goods or services. Mike has been named under by Best Lawyers as someone to watch, and also he has served as vice chair and also co-chair of the California Lawyers Association, Business Law Section Consumer Financial Services Committee.

Then let me introduce you to the most senior practitioner on this program today other than me of course, and that is John Culhane. John is a partner at Ballard Spahr and he has been with the Consumer Financial Services Group since we started. John and I and two other people started in 1995, more than 25 years ago. John is a truly an expert, practically every facet of consumer financial services law. I always have said he has encyclopedic knowledge of the law. He remembers not only the laws and the regulations, but he seems like he remembers every case ever decided that's relevant to whatever the issue is that our clients are interested in investigating. He's been named the top Consumer Financial Services lawyer by Chambers USA beginning in 2015 every year up until the present and also he was a charter member of the American College of Consumer Financial Services Lawyers.

Finally, and certainly last but not least, Lisa Lanham. Lisa co-leads our firm's FinTech and payment solutions team. Her practice focuses on financial services matters related to state licenses and federal approvals that are necessary to conduct business for a variety of asset classes and market participants. Lisa joined us along with a team of three other people earlier this year, came to us from another major law firm, and she is really expanded our already very robust state licensing practice. Let me tell you how things are going to proceed today on our podcast show. I'm going to turn the program in just a minute over to John Culhane, who's going to give you important background on what the CFPB did in the report that they just issued. Then we're going to have Mike Guerrero, Mike Gordon alternate in talking about the three areas that the CFPB focused on, what they consider to be problems with the industry, the consumer harm that they identified, the data harvesting that they also identified as something that was not good for consumers.

Finally, the over extension of debt, that is people who were getting in over their heads according to the CFPB by entering into too many buy now pay later extensions of credit at the same time. Then finally, we're going to end up with Lisa Lanham talking about state law issues, what the CFPB had to say about it, and most importantly, the really important state law licensing in consumer protection issues that cannot be ignored, that are on top of whatever the CFPB is ultimately going to do here. Without further ado, let me turn the program over to John.

John Culhane:

Thanks, Alan. The CFPB just put out its report on the buy now pay later industry, and I'm going to provide a quick background as to what they did, what they looked at, and then at a very high level what their conclusions were. And I want to start out just by saying that the CFPB was very clear to say that the product it's looking at is not the point of sale installment loan. It's not the post purchase credit card, installment payment plan, it's the pay in for product. And that's a specific product, a consumer loan with four installments, no interest, typically a 25% down payment and then three installments due in two week intervals. This is an extension of credit that's paid off very quickly. If all goes well, it only lasts about six weeks, and that's the product that they drilled down on.

They looked at two models here that are prevalent in the industry. Basically, the only models that are in the industry, the merchant partner acquisition model. And here, the process starts on the retailer's checkout page with the offer of a buy now pay later product and then the app driven acquisition model where buy now pay later lenders are offering apps with access to a virtual shopping mall and a much greater selection of goods. That seems to be the model that is taking over in the industry. What did the CFPB look at? To kick this process off, they started out by issuing back in December of 2021, market monitoring orders to some of the biggest players in this space, Affirm, Afterpay, Klarna, PayPal, and Zip. And those market monitoring orders are available on the CFPB's website if you want to take a look at them, they're very extensive. They followed that up with a request for information that was published in the Federal Register back in January, comment period ended in March and they receive roughly 40 discrete comments in response to the request for information.

Comments that I think are particularly worth looking at if you're going to go back and review them, there's a 50 page comment letter from the Center for Responsible Lending, the National Consumer Law Center on the Consumer Federation of America. Probably the most extensive comment letter that was received in this process. There's a comment letter from Consumer

Reports and then Alan mentioned we're going to talk about state law issues. There's also a comment letter from 21 Attorneys General and Hawaii Office of Consumer Protection. They said that they also looked at complaints about buy now pay later loans that they accessed from the consumer complaint database. They don't provide a lot of information about that. Buy now pay later is not a search term. It's a little bit difficult to tell exactly how many complaints there are and what those complaints addressed. Then they looked at publicly available information, SEC filings, earnings calls, research papers, media interviews.

This is where they got a fair amount of their information that they then recited in connection with the discussion of possible over extension risk, which we'll get to later. What did they conclude? Well, at a very high level, obviously they found a market with rapid growth. They noted an increase over a three year period from 2019 to 2021 of 970% in originations, a 1092% increase over the same period in dollar volume, total dollar volume, much greater diversity in usage. The switch to the app model has really moved the industry from just being beauty and apparel or more beauty and apparel specific to a very diverse range of merchants. They noted metrics that I think it's pretty clear they thought were good and some they thought were bad. I think they did conclude that the increase in approvals was a good change, but they were not particularly pleased by the increase in late fees, returned orders and charge offs and we'll talk a little bit about that shortly.

They did note competitive benefits, both financial and operational, ease of access to this product, one of the key operational benefits. But of course, this wouldn't be a CFPB report without a warning about potential consumer risk and in this case potential consumer risk in the form of certain specific discrete consumer harms, which Mike will talk about shortly. Data harvesting risk, which I'll talk about, and then the risk of over extension. I'll turn it back to Mike Guerrero to talk about that. Mike, let me turn it over to you to talk about discrete consumer harm.

Michael Guerrero:

All right, thank you, John. As John just noted, the bureau categorized the three areas of concern or risk that they identified. The first being discreet consumer harm. This one is interesting. In the market monitoring order, the bureau referred to this a little bit differently. They referred to it as regulatory arbitrage. Basically structuring the product in a way that was designed to navigate around regulations just because we've toned down the rhetoric, at least in my view, to discussing discreet consumer harms. I think the focus of this section really is still on that regulatory arbitrage concept or how do existing regulations deal with these types of situations? Within the discrete consumer harm section, the bureau focuses on four specific types of harms. The first is a lack of standardized disclosures followed by disputes, payments related issues, and then fee related issues.

On the lack of standardized disclosures, the bureau, they have two concerns. On one hand they compare this to Reg Z and one of Reg Z's primary purpose is to give the consumer a tool that they can use to shop around. That's an interesting comparison to a no interest product. The main difference you tend to see is going to be around late fees or potentially other fees, but that's one of the considerations. The other is just clearly informing the consumer of the aspects of the deal. They do reference to you as closed end requirements, the requirement to disclose the APR, finance charge, amount financed, total of payments, look to the open end provisions. The interesting piece there is they look to and hint that they find periodic statements to be helpful. Again, we're talking about a short term product, six weeks, but there is repeat usage. In the report, the bureau talks about consumers on average using a product 2.5 to 2.8 times per quarter with an individual lender.

There is kind of this recurring relationship, but the periodic statement concept it's interesting how much the bureau looks to Reg Z's opened end provisions when addressing this really short term closed end product. One other thing on this front, well, I guess two, there is precedent for there to be a product that doesn't have a standardized disclosure. I think of rent to own, for example, it's not a consumer leasing act product. State laws do mandate how these deals get disclosed, but there is kind of a disparate treatment there and the bureau hasn't come out and said we need standardized disclosures for that too. And this is, in my view, very favorable consumer product, 0%, right? But in any event, the only other thing I would note on the standardized disclosures is in the market monitoring orders, the bureau spent a lot of time asking questions relating to payment reminders.

Are you sending in app payment reminders, texting folks, email? And none of that really made its way to the report. I don't know if there just wasn't enough data provided in that front but was expecting to see something there and we didn't. The next type of harm would relate to disputes. Generally, when we talk about disputes, we're talking about merchant related disputes. So that's where a consumer purchases something, say they're unhappy with it and they try to get a refund. What's interesting about the report is the report once together returns with disputes. When we're talking about percentages and looking at how

many loans have had a return or a dispute, when you add returns, especially when you're talking about the use cases for buy now pay later, it's really going to significantly increase that number. One of the largest uses for buy now pay later is fashion and apparel.

And the report notes this which historically just as a retail concern has a lot of returns. When the bureau compiled the report, they indicated that in 2021, about 14% of all of the loans originated had some sort of a return or dispute associated with it. That amounted to about 4.5% of the total dollar amount in the loans. Because remember, you could dispute an individual item in a multi shopping cart situation, 60% of the disputes or returns were ultimately refunded to the consumer with the remainder of about 40, obviously not. One issue that the CFPB really spent a lot of time focusing on is they don't appear to requiring consumers to make payments during a dispute or during the return processing and they look to Reg Z and specifically Reg Z's open end provisions here, again making a comparison to credit cards.

They acknowledge that Reg Z has robust frameworks for dealing with disputes. On the screen here, I've identified them, but there's protections against unauthorized use, a right to assert claims or defenses, merchant related claims or defenses against the card issuer, prompt crediting of refunds. Then there's the billing error resolution rights, which prohibit a lender from trying to collect an amount that's in dispute. Assessing finance charges on it sets time periods for managing the dispute. There's a robust framework, but again, the credit card product is very, very different. There's grace periods, there's interest, there's the replenishing line, there's not a six week term, but the bureau continues to focus on these credit card comparisons. One thing that jumped out through omission in the report is the CFPB did not make mention of the FTCs holder rule, which does provide some protections to the consumer in that to the extent it applies and the use case for application is more evident in the partner model than the non-partner or app driven model.

But the consumer can assert claims and defenses against the lender. There's not robust framework for how that has to be managed or handled, but there are protections there. With that, we'll move over to the next set of harms. This relates to payments. I would say 90% of the conversation here is in the auto pay compulsory use context, but they do raise other issues. Just for background, there's a prohibition on compulsory use and this comes from the Electronic Fund Transfer Act or Regulation A. And it essentially says that you cannot condition an extension of credit on a preauthorized electronic fund transfer or autopay as long as that autopay payment is an EFT, electronic fund transfer payment. This prohibition is going to apply to EFTs, which typically are debit cards or ACH transactions. That's what we see most often in this use cases.

The report notes that the buy now pay later providers, in addition to offering these EFT payment options, also offer credit card as a repayment method. And that offering a credit card as a repayment method may be enough to not trigger a compulsory use violation because you're offering a non EFT payment option. The bureau as it relates to the autopay, once the consumer's enrolled, they are concerned about the consumer user experience. How can a consumer or can a consumer even revoke an autopay authorization? They looked at some of the lenders on the more consumer friendly easy side, the consumer can log into a web portal and change that payment authorization. Then if you move a little further towards kind of, they're not risk rating anything but maybe more in the moderate, the consumer would have to call in to cancel that and then there's a couple where the consumer was not permitted to revoke an authorization. On that front, just not the card networks things to consider.

Aside from that, the bureau focused on representments. That's happens when the consumer makes a payment. You attempt to process the payment and the payment fails for insufficient funds. How frequently are buy now pay later companies re-presenting failed payments or resubmitting that failed payment? About 4% of loans had a representment and the bureau was focused on how frequently are representments occurring. They found a range from one to eight representment and the concern is that consumers could be getting charged fees from their bank, probably less of a concern on the debit card side, but there are overdraft protection programs that consumers could be using that would cause a fee to be incurred, also on the ACH side as well. Last thing on payments, the bureau is concerned with what they've called hidden interest and that's when a consumer utilizes a credit card to enroll in a buy now pay later plan, and then accrues interest on the credit card even though it's a 0% interest plan for the buy now pay later program.

Last consumer harm before I kick it over to Mike Gordon to discuss where we think the CFPB is going. The bureau focuses on fees and they spend a lot of time focusing on late fees. It appears and they've painted a picture of a trend where lenders are either trimming or removing late fees. That trend is happening at a very interesting timeline because the bureau also speaks to the economic landscape for buy now pay later lenders. They've indicated that the funds that they get from the merchants, the

merchant discount rate, which is a significant source of revenue that is decreasing through competition, more entrance into the marketplace causing competition on pricing.

Then the other issue that's going to impact pricing is the increased rates or increased cost of funding. On one hand, the bureau is noting and there's a quick preference to reduce these types of fees, but on the other hand they're acknowledging that buy now pay later service providers are going to have to make some changes because the economic environment has changed in quite a bit as of late. You'll see 12% of the borrowers were charged at least one late fee and then about 57% of those late fees are actually collected. That was a surprising to have. I expected a little bit higher. The bureau and the report draws another Reg Z comparison specifically to the Card Act. They say that late fees should be proportional and reasonable, but they don't mention the Card Act safe hardware for late fees, which as of now is $30 for the first delinquency and $41 for subsequent.

Of course, that's going to be a really high amount in the buy now pay later space where the average installment is $35. But again, there's just a little bit of cherry picking from the regulations. At least, that's my take when going through and seeing which ones the CFPB is focused on. The report focuses a little bit on other types of fees, like a per payment fee. It doesn't get into a lot of detail there. It doesn't speak to whether it might be those as finance charges or not. It's really just being objective there and identifying fees that are in the marketplace. But with that, I think, let me pass it over to Mike Gordon to discuss where we think the CFPB might be going.

Michael Gordon:

Thanks Mike. You took the words out of my mouth on a couple things about how the bureau's approaching this regulatory rubric and cherry picking is something that comes to mind and I thought it might be helpful to step back very briefly and talk about why the bureau might be taking the approach and saying the things that it's saying. First off, it's perfectly appropriate and expected that a regulator would pay more attention to a new product that comes on the scene and has explosive growth the way that buy now pay later has. That makes perfect sense. In that, it would almost be responsible for the bureau not to pay attention to changes in the marketplace like that and there may be a need for regulators to respond.

However, regulators are prone to putting things in boxes. One concern that I had as I read the report and as I hear Director Chopra talk about the product is trying to fit a square peg in a round hole that the box, there's not a clear box that Congress has created for this kind of product. And yet, the bureau seems to want to impose the kinds of protections and solutions and regulatory responses that were designed for other products like credit card to buy now pay later. And that just may not make sense in many cases, and Mike gave us a few examples already.

For example, disclosures in a credit card context are much more complicated. It has that more dimensions to that product that would need to be disclosed than what is a relatively simple buyout pay later product. And yet, you could see at the end of the report or in the director's comments on release report, an instruction to his staff to try to find ways to rulemaking or otherwise to get the protections from credit card to apply to buy now pay later, many of which just are not apropo. A second thing that is obvious but unsaid in the bureau's report is that Congress spoke to credit cards and specifically delineated what kind of protections they thought were warranted in that, given the history of that product and Congress hasn't spoken to buy now pay later.

And so the bureau is going to have to take its existing authorities and find a way to reach a product that again, was not that its existing authorities were not designed to reach, and I'll come back to this a little bit later, but we have some ideas about what that may look like for the bureau. But in any event, it's going to be... You can't lose sight of this mismatch between the product and the problems that the bureau sees and its existing authorities. With that, I'm going to pass it back to John Culhane to talk about data harvesting.

John Culhane:

Thanks Mike. Here's another parade of horribles and it's pretty clear that the CFPB has thought that they can take the big tech scares and raise them with the buy now pay later product. What's interesting about the discussion of data harvesting in the report is there's no mention of deficiencies in disclosures or privacy policies and very little discussion of discrete harm that's resulted here. Instead, we have this litany of horrible things that could happen if buy now pay later lenders collect data on customers and they're the kinds of things that we're now used to hearing from the CFPB. The collection of data may threaten

consumer privacy, security and autonomy. Autonomy's kind of an interesting one, not entirely sure what they had in mind there.

Then we have some echoes of the CFPB's recasting itself as a regulator focused on antitrust issues. It may lead to a consolidation of market power at a few large high tech firms, presumably because they'll be better able to exploit the data and profit financially to the point where firms that can't do that are sort of shouldered out the marketplace, may reduce long term innovation, consumer choice and price competition. It's really odd to see that as a comment when this is an innovative product that relies on consumer choice and the main price here is zero interest, although I guess conceivably that the bureau could want to try to encourage competition on the basis of the fees that Mike Guerrero mentioned. Then another potentially horrible thing that might happen is that the harvesting of data may be used to offer targeted discounts presumably on the merchandise, not the financing to some customers but not others.

Interestingly, we don't have an invocation of UDAAP discriminations and unfair practice here, we just have the assertion that this is another horrible thing that could happen. Just like all of the horrible things that we've seen happen with the big tech companies. The CFPB does go on to talk about the risk from current use cases, but it doesn't really have a lot to say about that risk. It notes there's no data sales to third parties yet, although it sort of hints that could be on the horizon or that the buy now pay later lenders might seek to exploit the data that they receive and use that with third parties. Instead, it really focuses on two things and there's sort of different sides of the same coin. The use of demographic, psychographic and behavioral data, I think they pick those words specifically because they sound scary.

But by demographic data, they're obviously referring to things like age, race, gender, country, state of residence, maybe socioeconomic status, although they acknowledge that those pieces of data are not necessarily being used right now by buy now pay later lenders. By psychographic data, they're referring to things like personality traits. I think really what they mean more are interests, lifestyle choices, things about you that can be learned from your shopping patterns. Although then we also have behavioral data and hereby behavioral data, they mean purchase history, but they also mean time on a webpage, your engagement with the webpage, the level of that engagement and that data can be used to select products and brands that will be promoted. Again, this seems to be focused on the app driven model rather than the retailer model where you get the offer at checkout. Oh, I guess it could be adapted for that model.

Then now, there's a dark web concern that's emerging as well that buy now pay later lenders will use this aggregate data to modify the general product experience to drive behavior in subtle ways by which they mean clever use of fonts and color schemes and word choice and flows and screen presentations to drive consumers to purchase more expensive goods, presumably. No use cases cited for that, again, other than sort of a general indication that there is some use of data to promote certain kinds of products. But again, big tech, scary dark web stuff, scary. And of course as scary as it is right now, it can only get worse. The CFPB is very concerned about the movement to the app driven acquisition model, what they call proprietary virtual real estate. I think they're trying to, by using that term, somehow suggest that there's going to be some like the experience, like the mortgage loan experience that led to their creation and they have to preclude the exploitation of the financing of items through virtual real estate.

One thing though that I think they've got a valid point here is that the industry is changing here. The ways in which data is available are changing and there will be more value to advertisers if they can get more information about customer usage through the mobile operating system where it now looks like Apple and other providers are going to make it difficult to aggregate that data from a retailer to retailer. Again, concern about what may happen hasn't happened yet, just as scary as a big tech and just as scary as dark web, and of course then there's always over extension. Before we get to over extension, let me turn it back to Mike Gordon for some thoughts about what it is that the CFPB might actually do here with its data harvesting concerns.

Michael Gordon:

Well, we see with the comments around this report more in a consistent theme from Director Chopra, which is his concern about large tech players and the changes that can impact the consumer finance marketplace. It's not surprising in the sense that of his personal experience coming from previous job as an FTC commissioner, but it is a little surprising when you line it up against the authorities that the bureau has. This is one area where I think the bureau would like to make its presence felt and be seen as a primary regulator of large tech companies in lots of different ways, but it will probably be needing to stretch its

existing authorities to do that. What are the more likely things we can see from the bureau? This would apply to not just the data harvesting consumer arm, but the other consumer arms were discussed today.

First and foremost, they explicitly talk about supervision and while BNPL companies are not currently being examined, they forecast that in the report as a possibility. And for one would not be surprised if the bureau were to find a way to begin such examinations. If they do that, they may in fact use this risk based supervision authority that they announced earlier in the year that allows them to pick companies based on a perceived risk to consumers and begin conducting exams of those companies. And this report would provide them more than adequate basis I think in their view for the identification of such risk to launch a supervisory program of companies in this space. I think that's fairly likely. I think enforcement is also fairly likely in some manner or form against either a BNPL company or some service provider too or partner with a BNPL company.

This would be consistent with the bureau's past MO, which is to single out practices that it objects to when sort of the worst... We find the worst offender of say perhaps inadequate disclosures or deception and then use the case to send signals about what it believes affirmative disclosure should look like in the industry. I think something like that could be on the horizon. If they actually want to do rulemaking as Chopra indicated he is instructing his staff to investigate. Recall that rulemaking is an extremely long process for good reason and it's a careful process, but it's one that takes a lot of resources and time and the bureau has generally been not opting for formal rule makings under the Chopra regime and all signals are they won't be doing a lot of that.

This may be an exception in the sense that they have a special authority to authorize standard disclosures for certain types of products and in certain scenarios and perhaps they would invoke that authority to address disclosure issues for this industry. But I still think it's much less likely than more near term action on the supervisory and enforcement fronts. There are other creative arguments I think we may see from the bureau that would show up in the supervisory or enforcement context that would allow them to address some of these practices they're concerned about. The Fair Credit Reporting Act provides a potential hook if they were to try to stretch that act a bit to reach companies that access and use a lot of data in the way that BNPL companies use.

I'm not sure what the strength of that argument would be, but it wouldn't surprise me to see them make arguments like that, but by and large, the bureau will be using its sort of most flexible and favorite tool, which is UDAAP when looking at the conduct in this industry and whether that's through enforcement matters based on disclosures or fee practices remains to be seen. But that's the standard, that's the go-to and that's what we're sort of most likely to see. Anyway, with that, I'll turn it back to Mike Guerrero who's going to expand a little bit on the over extension risk that you're identified.

Michael Guerrero:

Yeah, thanks Mike. Over extension, really getting to, let me advance this slide, really getting to kind of ability to repay considerations. The report focuses on two types of over extension. One is loan stacking and the other is sustained usage. Loan stacking occurs when a consumer goes out and obtains loans from a bunch of different providers, generally without the providers knowing that the consumer is getting loans from others. The consumer is stacking loans and the consumer might not have the ability to repay those loans. The bureau says, this risk and it exists in other contexts, but it's really significant in the buy now pay later space for two reasons. It's a free product and it's a seamless product so it's 0% interest, very appealing to go get it and it's the product appears and virtually every digital shopping cart. There's different lenders offering these products. You go to an e-commerce shop, it's very easy just to get it buy now pay later loan.

With that, the bureau says there's not really a lot of control in place right now to manage this risk. Some buy now pay later providers have what they call a low and grow model. The consumer's first product or loan would be for a lower rate or I'm sorry amount. Then upon having some positive repayment, the amount would increase and the consumer's credit limit would then go up. They say that's helpful, but it doesn't really solve the issue because the consumer can just start going to other lenders as well. That control, it helps on a kind of individual company basis, but it doesn't necessarily solve the issue and the consumer could always at any time go and get other loans.

One other thing that I thought was helpful is that in this buy now pay later context, you see frequently programs where if the consumers delinquent on a product, they won't be able to get a new one. So pair that with the short term nature of the product and you are mitigating some of that risk because the most time alone can be outstanding. It's for six weeks, but that risk is still there. According to the bureau, the really only way to address this is through some sort of real time reporting, and

that's interesting, right? Because right now, buy now pay later providers generally are not furnishing consumer report information. And even if they did, that information is getting reported on a monthly basis, so you have a delay and that delay is not going to help solve this loan stacking issue.

Also, a lot of the buy now pay later providers are getting a soft pull and they might not see this information in any event. If everyone was getting a hard pull then given that consumers that use this are getting 2.5 to 2.8 loans per lender per quarter, that could be a lot of inquiries on the consumer report. The other thing is that the bureau has indicated that they want consumer reporting agents or buy now pay later providers to report to consumer reporting agencies and they want this information to be part of the core file. They don't want it to be an appendage or some unique buy now pay later report. That again, makes it hard because that core file is set up to be reported on a monthly basis. The comment letters from some of the CRAs in response to the inquiry, generally supportive, indicate all of the bureaus want kind of an appendage setup where this buy now pay later information is not being provided as part of the core system, but it's a separate buy now pay later report.

The bureau, at least in its June blog of this year, their appetite for that seems to be relatively low. They want positive payment history to hit the main report and that to be reflected in the consumers course. What was interesting was the Experian letter, they really touted a kind of real time buy now pay later service and that seems to be something the CFPB is looking for at least as it relates to this risk. Final risk identified in the report would be the risk of or presented by sustained usage. This isn't a risk for folks who are defaulting, this is a risk for folks who find value in the product and keep using the product. It's like the payday cycle of debt argument that the bureau would make. But again, I think it's important to remember that this is a 0% interest loan with an average order value of $135 and a $35 payment. The fees, if a consumer's late, there could be fees, not all buy now pay later providers are charging late fees, but it's a much more consumer friendly product.

The bureau is coming from a place still and supported by a 2017 report by a national consumer reporting agency. And in that report, they found that consumers were actually more likely to repay unsecured installment obligations than mortgages, auto payments or like student loans. They speculate as to why that might be. It might be because it's easier to pay off something that's smaller than a larger mortgage payment. There might be a desire to keep the account open to continue to have access to buy now pay later products. But that is a concern of the bureau. The bureau is also concerned with consumers having the ability to choose where their funds go.

One issue there is with autopay, when a consumer has enrolled in autopay, the consumer, if they don't have the ability to revoke, particularly in that use case, the consumer doesn't have the ability to say, "You know what? I'm falling behind on my car payment, I want to direct funds to my car payment instead of this buy now pay later product that's unsecure." But in any event, the bureau acknowledges that this is very, very difficult to measure. There's not really a tool that can give the bureau insight into this because it's impacting the consumers financials and perhaps the buy now pay later providers financials, but it doesn't become an issue until it's been happening for they indicate months or years. With that, let me turn it over to Mike.

Michael Gordon:

Thanks Mike, and I'm aware that we're getting short on time and I think the state law issues here are really important to cover. I want to in turn hand it off to Lisa Lanham to address some of those issues.

Lisa Lanham:

Thanks. Yeah, it wouldn't be a webinar without an office quote, right? State regulators have been a little stitious of the BNPL market since before the CFPB's inquiry. As you may know, the BNPL market was largely unregulated on the state level until about 2021. Aside from a few cases taken on by the California regulator, the DFPI. California was the first state to begin scrutinizing the industry in about late 2019 when it announced settlements with three BNPL companies. And on the heel of that, the DFPI issued a press release in 2021 that really made it crystal clear that the DFPI requires BNPL companies to be licensed as California finance lenders in order to offer their products to California consumers.

It was after this 2021 press release from the DFPI that we saw the CFPB release its inquiry and state regulators in other states really beginning to express concerns over the surge and consumer usage of BNPL plans and considering whether new laws or regulations should be enacted to further regulate the industry. Just to give a few examples of that, Oregon, Washington and Massachusetts each expressed concern. A representative from Oregon sent in an email to the industry that the department is continuing to monitor these sorts of financing options for consumers and gauge consumer protection concerns. The state also

mentioned that they're part of several state regulatory organizations that are contemplating further action in this space, such as the creation of new statutes to provide regulatory oversight or licensing for these sorts of products.

Washington indicated that they're aware that BNPL companies intentionally design their products to skirt state retail installment and sales finance company laws by offering their products at a 0% interest rate. Washington said that it didn't interpret their existing retail installment and sales finance company laws to cover BNPL at the time. But the state did recognize that it finds it difficult to assess whether some of these companies are actually loan companies and a loan company would sensibly be required to be licensed. Massachusetts lastly has not made an official comment as to whether BNPL companies are small loan companies or retail installment finance companies for the purposes of its laws and regulations. But the Commonwealth did actually classify a BNPL company as a small loan company in an enforcement action and required it to be licensed to engage in business.

We expect many more states to follow suit on the heels of the CFPB's inquiry, which is why we're always cautioning our clients to conduct a thorough review of state regulator releases and enforcement actions in order to fully appreciate any regulatory risk exposure for offering these products, especially when seeking to do so without a license. The space is ripe for regulation through enforcement especially, because states can really easily reinterpret their existing license lender laws and regulations to encompass this type of a product. As John previously mentioned, the attorneys general of 21 states wrote a letter to the CFPB in support of its inquiry and the letter is interesting and definitely worth reading with an eye towards what the states are most concerned about.

To preview it for you all, it seems clear that the state AGs are a little stitious too after praising the CFPB for opening up its inquiry and taking the first step towards greater transparency and regulation of the industry, direct quote. They go on to make the following statements in their letter, and I won't read all of it in the interest of time. But you can see they're concerned when products are popular among younger consumers, unfamiliar with navigating credit products and people who are already potentially struggling to make ends meet. They bow to use all resources at their disposal to ensure citizens of their states are protected from the potential harms of these new financial products.

They're concerned with all of this, particularly for younger borrowers and consumers who already struggle to make ends meet or owe other debts, so they're reiterating some of the same concerns over and over. One thing I thought was particularly interesting was they're concerned about the apparent emerging relationships between BNPL providers and for profit schools, including online boot camps and credentialing programs. So they're sort of looking towards what's the future of all of this and how can we really be ensure that our consumers are protected? In the letter, the state AGs expressly urge the CFPB to analyze whether and how the BNPL providers ensure consumer rights and protections, disclosure of fees, charges and other essential terms to consumers, as well as how they comply with general requirements to refrain from unfair, deceptive and abusive acts and practices. They urge them to analyze what steps, if any, the BNPL providers take in considering the ability to repay and the types and sources of information they rely on.

They also want the CFPB to consider specific rulemaking to clarify their obligations to conduct ATR analyses. They urge the CFPB to analyze policies and procedures for these companies for credit reporting and the information that BNPL providers furnish to credit bureaus. They urge the CFPB to monitor the emerging role of credit bureaus in the marketplace. There's a whole litany of things, right? But with two minutes left, I think you tend to, at the point that they're very, very concerned as they're also promising to use all resources at their disposal to protect the citizens of their states. This letter really reads like a shot across the bow to BNPL providers. They're, it appears almost like they're outlining the issues they intend to go after providers for. In short, for us, it seems like providers should really be mindful of inquiries and they often start out as soft inquiries from state regulators and state AGs enhanced licensing requirements, regulatory enforcement actions and litigation.

They're just keeping up with those trends because we expect there to be some enforcement actions and things like that, that are going to be really significant. Just to let you all know, this is something that we are keeping up with every single day. We have a legislation and regulation tracker that we've created with our CVI team and for folks that are interested in a demo, we are able to track all of the evolving actions and regulations and legislation that are coming down the pike for BNPL providers. It's certainly something that we could set up for you all, if you would like.

Alan Kaplinsky:

I want to thank Michael Gordon, Mike Guerrero, John Culhane, Lisa Lanham, for a very interesting, very thought-provoking discussion of the buy now pay later product. You can be sure that in the future we're going to be following this product very closely. We have many clients involved in the industry, so we will be on top of it and we'll be doing future podcasts for sure, and certainly, we'll be dealing with it on our blog. To make sure that you don't miss our future episodes, be sure to subscribe to our show on your favorite podcast platform, whether that be Apple Podcast, Google, Spotify, or wherever you listen to your podcast. Don't forget to check out our blog, Consumerfinancemonitor.com for daily insights on the consumer finance industry. If you have any questions or suggestions for our show, please email us at podcast.singular@ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Thank you very much for listening to our program today, and I hope you all have a good day.