afterpay

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Afterpay submission to the MBIE 'Buy-Now, Pay-Later' discussion document

Afterpay Limited (Afterpay) welcomes the opportunity to provide a submission to the Ministry of Business, Innovation and Employment (MBIE) on its discussion document on the Buy Now Pay Later (BNPL) industry.

In this submission we provide an overview of Afterpay, how we have designed our product, and the importance of good consumer outcomes. We also directly respond to some of the specific questions posed by MBIE's discussion document.

About Afterpay

Afterpay is an Australian financial technology (FinTech) company listed in the S&P/ASX 20 of the Australian Securities Exchange (ASX). Afterpay employs over 1,300 staff across New Zealand, Australia, Asia, the United States, Canada, the United Kingdom, and Europe.

Afterpay has revolutionised the way that consumers pay for goods and services by turning the traditional model of high-cost consumer credit on its head. Afterpay has grown into a leading international player in the BNPL sector, with over 16 million customers globally.

Afterpay offers a simple and highly effective platform for consumers and merchants.

Afterpay is a no cost service to the customer if instalment payments are made on time. Responsible spending rules and consumer protections are built into the service – these rules help ensure customers never revolve in debt, with no exceptions. In circumstances where the customer does not pay their instalment payments on time, their service is immediately suspended, and late payment fees can be applied. Late payment fees are fixed, capped and do not accumulate or compound over time.

Merchants benefit significantly by being part of the Afterpay ecosystem, as it delivers them value, reduced risk, and deeper engagement with customers. Merchants invest in providing the Afterpay service to their customers because Afterpay provides a powerful marketing platform for reaching consumers, as well as reducing their operational costs. As a result, the cost of Afterpay is not borne by the consumer which in turn drives positive merchant outcomes.

The BNPL industry in New Zealand

The BNPL industry is experiencing significant growth in New Zealand, and MBIE suggests 'such growth, coupled with new entrants and innovative and emerging business models, has the potential to significantly disrupt the credit and payment systems industries.'[1]

This disruption is leading to more choice, and ultimately better outcomes, for consumers.

Diversity of the industry

Not only has Afterpay's product been purposefully designed to be different from traditional credit providers, it is also different to the products of other BNPL players.

Importantly, companies in the BNPL industry can earn their revenue in different ways. In Afterpay's case, we make the vast majority of our revenue from the fees we charge merchants. This is a fundamental part of our business model. Other BNPL companies may charge monthly or other fees directly to consumers.

Afterpay's business model and profitability rely on consumers paying on time and therefore not incurring any charges. Consumers that do not pay on time are suspended from the Afterpay service, which means that non-paying consumers cannot drive new sales for Afterpay. And although Afterpay charges late fees, these are capped both in dollar terms ($68) and as a percentage (25%) of the transaction amount - with the cap being the lower of the dollar amount or percentage.

[redacted]

As new business models are created through innovation, regulation needs to be attuned to the different economic drivers of heterogeneous business models.

[1] MBIE 'Buy-Now, Pay-Later' Discussion Document, November 2021, p.10 [29].

Importance of self-regulation

Effective self-regulation can and should play an important role in raising industry standards in the interests of consumers in New Zealand.

Effective self-regulation has many benefits, including:

- It is more flexible and adaptable than formal regulation, and allows industry participants to quickly respond to emerging risks in a market sector. The process of implementing legislative change can be time consuming and backwards-looking rather than focused on emerging issues.
- It can address potential consumer harms in a tailored and more effective way than regulation: because self-regulatory codes are often created within sub-sectors of the financial services industry (such as retail banking, mutual banking, insurance, insurance broking, life insurance, insurance in superannuation, etc) the provisions within such codes can directly address the conduct of businesses and impact on consumers within the relevant sub-sector.
- It can promote confidence by consumers and other stakeholders in the conduct and reputation of an industry sector, particularly where self-regulatory initiatives go above and beyond what is required under the law.
- It can complement and enhance the existing regulatory framework, including by giving concrete and practical meaning to principles-based legal provisions. For example, codes of conduct can elaborate on what it means to treat consumers fairly, or identify the practical steps that businesses can take to ensure they are distributing their products to an appropriate target market.

Industry code

In Australia, the Australian Finance Industry Association (AFIA) BNPL Code of Practice (Australian BNPL Code) was developed in response to a formal recommendation of a 2019 Senate inquiry, which found that the BNPL industry should develop self-regulatory arrangements that strengthen consumer protections and create minimum standards.

The Australian BNPL Code has been recognised as an important initiative by an Australian Senate Inquiry and Australian Securities and Investment Commission (ASIC). The Senate Inquiry found that:

> *The development of an industry code of practice in the Buy Now Pay Later (BNPL) sector is an example of where industry is working constructively to respond to stakeholder concerns and seek to achieve appropriate regulation that benefits consumers.*[2]

[2] https://parlinfo.aph.gov.au/parlInfo/download/committees/reportsen/024366/toc_pdf/

ASIC's review of the BNPL sector found that:

> *Industry codes can play an important role in delivering benefits to both consumers and those who are bound by and must comply with the provisions of the code to which they subscribe. An effective code can help to improve consumer confidence in a particular industry.*[3]

Importantly, the Australian BNPL Code incorporates provisions that reflect the principles of the Design and Distribution Obligations (DDO), by requiring providers to identify their target market and ensure their product is suitable for that target market.

Outcome-based regulation

Afterpay strongly supports regulation that is outcomes-focused, and recognises how consumers *actually use a product*, rather than whether a product is capable of being used safely and capable of delivering good value to customers.

Many existing financial services and credit laws are based on disclosure or aim to regulate *processes* rather than *outcomes*. For example, disclosure is about providing consumers with information about a financial product in the expectation that they are able to make an informed decision about whether to use that product. Disclosure comes in many forms - in financial services guides or credit disclosure guides, in product disclosure statements and terms and conditions, and in marketing and advertising.

Similarly, regulation might require that a process be performed - for example, that a point-in-time affordability assessment be conducted when initially providing a loan product to a customer. In this example, the regulation aims to ensure that lending decisions do not result in consumers being provided with unaffordable loans.

However, for both disclosure and process regulation, good consumer outcomes are not guaranteed. Instead, how a product is designed plays a much more significant role in influencing consumer outcomes.

Credit cards provide a useful illustration of this point. It is easy to see how a credit card can deliver value for a customer and how a credit card can be used safely. If a consumer pays off their credit card in full every month, and occasionally benefits from the rewards that are on offer, a credit card is - both objectively and subjectively - a suitable product for that consumer.

SelectCommitteeonFinancialTechnologyandRegulatoryTechnology.pdf;fileType=application%2Fpdf, at page 216.

[3] https://download.asic.gov.au/media/5852803/rep672-published-16-november-2020-2.pdf, at page 22.

But the fundamental problem for credit card companies is that such a consumer is, at best, marginally profitable, and at worst, unprofitable and being cross-subsidised by other - often vulnerable - consumers.

This is because the credit card business model only works if a reasonable proportion of consumers do not pay off their balances in full each month, and instead incur the very high interest rates that apply. That is, credit card companies need revolvers, not transactors for their profitability.

And while a consumer may not obtain a credit card with the intention of becoming a revolver, the ability to make low minimum monthly repayments on a credit card (i.e. the credit card's *inherent product design*) can trap consumers into a cycle of revolving debt only too easily.

But customers that revolve in credit card debt are not benefiting from the use of their credit card, because they are paying a very high price for unsecured credit. And while a credit card company might have complied with its responsible lending obligations when it provided a consumer with a $10,000 credit card limit, these obligations apply at a 'point in time' only and encourage credit providers to provide a consumer with the largest credit limit possible. This is because providing a consumer with a low credit limit reduces the profitability of a credit card account.

In contrast, Afterpay assigns customers with dynamic spending limits that start low, and only increase with a positive repayment history. Spending limits are also not guaranteed and may go down.

The availability of low initial spending limits through the Afterpay product is an important - and deliberate - product design choice by Afterpay. It means that consumers are exposed to very little risk when they first open an Afterpay account. And because it is relatively straightforward for a consumer to open an Afterpay account, consumers are not incentivised to seek high-cost and predatory alternatives.

Achieving an effective BNPL sector

Afterpay has always believed that high standards and a fit-for-purpose regulatory framework is an important part of ensuring consumers get the best out of the products they wish to use. For this reason, we are supportive of *Option Two* as set out in the discussion document.

Under this option, the government would facilitate an industry code for the BNPL sector. This approach will provide enough flexibility to promote competition and innovation within the sector, whilst having the credibility and oversight of an independently conducted review.

It is important to reinforce that any code must include provisions that go above and beyond what is required by the law, including in having requirements that do not apply to traditional consumer credit providers (for example, capped late fees, and paused accounts when repayments are missed). This will ensure that the BNPL industry is subject to fit-for-purpose regulation that sets high standards.

Conclusion

Thank you for the opportunity to make this submission. We look forward to the outcomes of this review. Please do not hesitate to contact us if you require further input or clarification.

Yours faithfully

Michael Saadat
VP, Global Regulatory Affairs

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Afterpay responses to specific questions in the discussion document

6. Do you agree or disagree with our summary of the types of financial hardship that could occur from BNPL?

A key concern that arose from the discussion document is that BNPL services may create financial hardship for some consumers. MBIE has adopted the consumer-journey mapping approach to understand events that could trigger financial hardship. Below, we explore the interplay between these trigger events and the Afterpay service.

(a) Financial hardship triggered by a missed instalment fee

The first scenario is when a customer has insufficient funds when an instalment is due and the payment is missed. In this situation, Afterpay automatically pauses the customer's account and prevents them from making any further purchases on the platform.

Afterpay's business model inherently needs consumers who can afford the products they purchase. This is the opposite to a credit card model, which relies on a consumer being late and revolving in interest payments for the business to be profitable.

Unlike credit cards, Afterpay's late payment fees are fixed, capped and do not accumulate or compound over time.

(b) Financial hardship when instalments are not missed

The second scenario is when there are sufficient funds in the bank account and the BNPL instalment is processed, financial mentors are concerned that the customer may miss other regular payments.

Afterpay sends SMS and email reminders before each instalment falls due to ensure customers are aware of their upcoming payments. We have also developed a self-service feature that enables customers to move payment dates to better align with other financial commitments. There is no charge for this feature.

We also provide flexible hardship arrangements that are tailored to our customers' individual circumstances. This may involve moving payment dates, waiving late fees or arranging a payment plan. We never decline financial hardship requests, and as soon as a customer reaches out to us we immediately freeze all late fees owing on the account.

Another concern in the discussion document is that customers are not missing payments because they are paying for their BNPL transaction using a credit card, becoming 'part of the on-going credit card debt that accrues interest'.[4] In New Zealand, only 14% of Afterpay

[4] MBIE 'Buy-Now, Pay-Later' Discussion Document, November 2021, p.14 [48].

customers have a credit card linked to their account (much lower than the industry average of 20%).[5]

10. What are the advantages and disadvantages (including costs) from credit checks being used to determine approval for BNPL?

Credit checks do not provide firms with a complete picture of a customer. They were built for lenders to manage their credit risk at a portfolio level. Instead, an outcomes-based approach - reflecting the design of the product - should be adopted to address possible misalignment between the assessment of credit risk ('lender-focused' test) and determining a customer's ability to repay ('borrower-focused' test).

Younger adult consumers typically do not have developed credit histories, and for these consumers, credit checks provide little to no information about the consumer's financial situation.

Credit checks may also cause barriers to financial inclusion. Typically, consumers with higher credit scores access cheaper loans and consumers with low credit scores can only access more expensive loans.

11. What other / additional steps could BNPL providers take to assess affordability for consumers? What are the costs (including disadvantages) of these steps? What are the benefits of these steps?

We note that the New Zealand BNPL industry is developing an indebtedness indicator in partnership with Centrix. More information about this initiative is set out in the BNPL industry's submission to MBIE and further below. Afterpay supports this initiative and believes that it represents a tailored and effective response to the risk of vulnerable consumers obtaining multiple BNPL accounts.

In other countries, open banking is also providing opportunities for firms to access up-to-date financial information, without having to perform credit checks. Real-time insights enable firms to gain a broader understanding of their customer's individual circumstances, and protect vulnerable customers.

Instead of forcing innovative players such as Afterpay to participate in a legacy credit reporting system, our view is that mechanisms such as open banking can provide a more holistic picture of a customer, and ensure that consumers are not unfairly excluded from safe forms of unsecured credit.

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[5] MBIE 'Buy-Now, Pay-Later' Discussion Document, November 2021, p.14 [47].

12. How might affordability assessments be conducted when BNPL credit limits are increased?

Afterpay provides new customers with low spending limits and requires them to make their first instalment payment upfront. Limits are only increased once a customer has demonstrated a positive repayment behaviour over time. Even if a customer demonstrates a good repayment history with Afterpay, we cap the total spending limit.

We believe there are strong public policy reasons to enable Afterpay to provide new customers with low initial spending limits without having to conduct a traditional affordability assessment. Requiring Afterpay to conduct traditional affordability assessments will mean that Afterpay is economically incentivised to provide our new customers with much larger upfront spending limits.

By starting our customers on low spending limits, we are then able to use spending and repayment behaviour to determine whether a customer's limit should be dynamically increased or decreased. Repayment behaviour is widely considered one of the strongest predictors of future repayment capacity, and Afterpay's experience is consistent with this. Our credit losses for more established customers (who generally have higher spending limits) are smaller than for new customers with low spending limits.

Any requirements for BNPL firms to conduct affordability assessments should be scalable and proportionate to the potential risks to consumers.

17. How could information about consumers having multiple BNPL accounts be appropriately shared across the BNPL sector?

As noted above, Afterpay has been working with other BNPL industry members to develop an Indebtedness Indicator, a new reporting initiative supported by Centrix, that is specific to the BNPL sector.

Once live, each BNPL industry participant accessing the Centrix service will be alerted if a new account applicant has an active overdue account with another BNPL participating provider. We believe this industry-based dynamic reporting to be a world first for the BNPL sector.

The service will operate based on a daily feed from each participant denoting every active account that is overdue, and where a customer has consented to this sharing of information for this purpose. Where one or more payments is more than seven days overdue, we will receive a report informing us of the customer's status, and the number of BNPL providers that have provided an overdue status on that customer. This information will be used as part of the upfront affordability assessments being conducted by BNPL providers to ensure we lend responsibly. Each BNPL provider is still responsible for making their own independent decision on whether to provide its services to any such customer.

We anticipate that the BNPL indebtedness indicator could be implemented as soon as the first calendar quarter of 2022 and believe it is an important tool to assist in protecting vulnerable consumers in the New Zealand market. Our intention is to include reference to the indebtedness indicator in our industry code of practice.

The proposed indebtedness indicator has a number of important advantages over the traditional credit reporting system, including:

- Being closer to real-time in providing an indication of someone's indebtedness status with a BNPL provider
- Having comprehensive coverage of consumers using BNPL products, whereas many younger adult consumers have thin or blank traditional credit files with the credit reporting bureaus.
- The indebtedness indicator is also an efficient and effective response in advance of the emergence of a mature open banking ecosystem in New Zealand.