Four Ways to Mitigate Current Legal Risks in Point-of-Sale Financing So That "Buy Now, Pay Later" Doesn't Lead to "Get Sued"

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"Buy now, pay later" (BNPL) consumer financing has been booming. As the BNPL nomenclature implies, these services allow consumers to purchase products right away but pay at a later date, and they have grown dramatically in popularity over recent years due to their ease of use, low-cost financing, and near-ubiquitous availability.[1] In fact, the volume of debt originated by five major BNPL lenders has increased by 1,092 percent from 2019 to 2021,[2] and McKinsey & Company expects BNPL to comprise 14 percent of all unsecured lending balances by 2023.[3]

Point-of-sale financing is not new; for example, many retailers have had "layaway" and similar programs for several decades. But BNPL is the newest form of this financing in the fin-tech realm. And although similar in concept, BNPL differs from traditional layaway in three key ways: (1) third parties generally finance BNPL services instead of the merchant; (2) consumers gain immediate access to products under BNPL, whereas layaway requires full payment before possession; and (3) many statutes that currently govern layaway do not clearly apply to BNPL.[4]

As always, with increased popularity comes increased scrutiny. The most active regulator in this space is the Consumer Financial Protection Bureau (CFPB). The plaintiffs' bar has also taken aim at BNPL lenders in recent years. As prospective plaintiffs and regulators alike direct greater attention to these increasingly prevalent loans,[5] BNPL servicers and partners should consider four primary ways to mitigate the risk of public and private litigation.

1. Selectively conduct credit inquiries and survey consumers about outstanding debt.

Championed as one of this service's primary advantages, the simplicity of BNPL financing enables consumers to easily purchase products, including those they might not otherwise afford, without traditional financial safeguards. Currently, most BNPL providers require only that debtors be at least 18 years old, with a valid mobile phone number and debit or credit card—notably excluding any credit check typical among traditional forms of consumer debt.[6] Layaway plans also generally forego credit inquiries, but such financing does not usually transfer ownership to the consumer until they have fully paid for the product.[7]

BNPL's general lack of a credit check provides better access to financing for those with poor or light credit profiles, but it could remove the credit check's role as an independent control on expenditures.[8] And, although most BNPL-financed purchases are small, BNPL financing enables consumers to incur multiple loans with different schedules and lenders, creating debts that might be administratively unmanageable or too burdensome when combined.[9] For example, it has been reported that 42 percent of BNPL users have made late payments, and nearly 70 percent admit to spending more through the service than they would have had they paid for their products upfront.[10] Since other lenders generally do not receive information on these loans, BNPL financing has also received criticism for allegedly hindering the ability of all financial institutions, including more traditional lenders, to assess credit risk.[11] Studies have repeatedly found that consumers prioritize personal

loan payments—including BNPL obligations—over satisfying other debt (e.g., mortgages and student loans),[12] so long-standing lenders have justified concerns about the negative externalities that BNPL services impose on all sources of financing. And although all three major credit bureaus intend to report BNPL debt, such plans have yet to be fully implemented.[13]

Accordingly, BNPL lenders should consider opportunities to address consumer protection concerns without sacrificing the accessibility of their services. One example of how to address these concerns would be to perform a credit check for first-time customers. Given the relatively high frequency with which many BNPL consumers incur such loans,[14] "hard" inquiries for each transaction would likely be impractical and cause credit scores to decrease with every "pull"—particularly when numerous "pulls" occur in quick succession.[15] BNPL lenders could perform "hard" checks once for first-time customers and subsequently rely on only "soft" inquiries, which do not impact credit scores, for additional purchases.[16] Drawing inspiration from American Express's reported practice of conducting only soft inquiries when issuing new credit cards to some existing customers, this system informs servicers of consumers' creditworthiness without inundating their profiles with numerous hard checks. And since recurring borrowers often incur these loans in close temporal proximity to each other, their credit histories would generally lack sufficient changes across such brief spans of time to warrant successive inquiries.

That said, even a single credit check might dissuade would-be BNPL customers; for example, lenders risk losing the business of some consumers who are hesitant to apply for loans due to the chance of denial. Following a model akin to the Apple Card,[17] servicers could respond by beginning their applications with a soft check to initially share the approval status and total credit line for new borrowers, only conducting a hard inquiry should the consumer accept their offer. Through this system, lenders would only deter borrowers who lack sufficient creditworthiness—the exact group largely fueling concerns that BNPL services facilitate unaffordable spending.

Additionally, since BNPL customers often incur debt across multiple lenders, BNPL lenders could condition financing on the completion of a short questionnaire asking applicants about any outstanding loans with competitors that would otherwise go unnoticed. Some buyers might understate their debt to expand borrowing capacity, but creditors could still point to such surveys as attempted due diligence. Subject to cooperation within the industry, lenders could even establish a joint network disclosing their loans to all participating companies, including those traditional lenders expressing frustration at the current opacity of BNPL debt. Such measures may only be needed until credit bureaus begin to disclose BNPL financing in their reports, however.

Through these efforts, BNPL servicers could more fully address overarching critiques of their business model. Although credit reporting could pose some threats to BNPL's accessibility, lenders have opportunities to tactfully leverage inquiries and questionnaires to limit unaffordable purchases while preserving their service's unique characteristics.

2. Improve the transparency of disclosures and increase compliance with regulations.

Although the United States already has fairly robust oversight of traditional credit arrangements, BNPL providers often are not subject to such governance due to the structure of their loans.[18] For example, the Truth in Lending Act (TILA) mandates the disclosure of certain credit terms to consumers for debts subject to finance charges or repaid over at least five installments.[19] But because BNPL loans generally impose no direct fees and require *four* payments at most, lenders have stated that they do not need to not follow TILA and its rules on, for instance, advertising,[20] opening accounts,[21] and disclosing charges.[22]

Further, since most state laws on credit transactions were not drafted with BNPL in mind, providers are not clearly subject to legacy licensing regimes.[23] Even in cases of broad statutory language, the CFPB has expressed concern that BNPL lenders may be engaged in "regulatory arbitrage" by failing to adequately evaluate the application of consumer protection laws to their business.[24] Seizing on this issue, some states have already demonstrated willingness to proactively regulate BNPL financing: California imposed civil penalties and refunds on several major lenders for lacking proper licensing, Massachusetts classified Affirm as a small-loan company requiring a state license to operate, and Oregon shared that it has been monitoring such services in contemplation of future regulatory oversight.[25] The CFPB also recently announced that it would be invoking a largely unused provision of the Dodd-Frank Act to examine "nonbanks whose activities the CFPB has reasonable cause to determine pose risks to consumers"—likely foreshadowing federal government action given the announcement's timing shortly after the end of the agency's comment period on BNPL financing.[26]

To reduce the risk of future penalties and preemptively address regulatory overcorrection, lenders could adopt disclosure policies more comparable to those of traditional creditors. For example, they could provide a variation of the "Schumer box" outlining basic information about their offerings in clear terms, such as late fees and an explicit reference to the CFPB for credit assistance.[27] And, mimicking recent Australian regulation,[28] BNPL lenders could allow vendors to add surcharges to their transactions explicitly reporting any BNPL-imposed merchant fees that are passed down to consumers—clearly disclosing the full cost of such services. Although these distinct fees might sufficiently constitute "finance charges" and thereby bring BNPL financing within TILA's governance structure, the CFPB's demonstrated interest in regulation suggests that the service's relatively light federal oversight will likely be short-lived.

Additionally, several class-action lawsuits have recently been filed against BNPL lenders, such as Afterpay, Klarna, PayPal, and Sezzle.[29] In their complaints, plaintiffs allege these lenders falsely advertise that their services impose no fees when they can instead lead to overdraft and "non-sufficient fund" (NSF) charges after automatically withdrawing money from consumers' bank accounts.[30] The Sezzle and PayPal lawsuits also distinctly claim that the companies caused multiple overdraft fees on the same transaction by repeatedly reprocessing unsuccessful payments—allegedly creating, for instance, $134 in overdraft fees at unaffiliated banks from a single missed payment.[31] Relatedly the CFPB has reported that all major BNPL lenders allow for at least one "re-presentment" of failed or declined payments.[32]Since such lawsuits are still in their early stages, their prospects and copycat-ability remain unclear. Although BNPL financing apparently can lead to overdraft and NSF charges at customers' separate banking institutions—allegedly in violation of lenders' "no-fee" commitments in advertising—BNPL lenders do not

levy these expenses themselves; rather, consumers' respective banks control the quantity (and the initial disclosure) of overdraft and NSF charges. Nevertheless, BNPL lenders could mitigate such litigation risk through disclaimers clarifying that consumers can still incur overdraft and NSF fees from their respective banks, which would reduce the risk of consumer confusion or misapprehension—not to mention a class-action lawsuit.

Finally, since BNPL lenders typically forego disclosures to credit bureaus, consumers may not build history through timely payments on BNPL-financed purchases.[33] The alternative presents greater concerns, however: given the short-term nature of most BNPL loans, such financing would reduce the average age of a consumer's credit history and increase utilization rates, likely counteracting any benefits derived from the initial disclosure altogether.[34] For example, a $200 BNPL-financed purchase paid off in a timely manner over two months would have the same effect as opening a credit card with a $200 limit, immediately maxing it out, paying off the balance within two months, and then canceling it.[35] Consequently, as the three major credit bureaus look to include BNPL financing in their reports, they all have stated an intention to implement options or mandates for BNPL lenders to exclude such loans from core credit score calculations.[36] Considering the potential for misconceptions among some consumers who believe that they can improve their scores through responsible BNPL borrowing,[37] servicers could correct any such misunderstandings through additional disclaimers explicitly stating otherwise.

3. Adopt post-sale procedures comparable to debit and credit cards.

Most BNPL financing also currently differs from traditional sources of credit on the basis of dispute resolution, return, and automatic repayment procedures. Consumers can often file complaints to their card issuers when encountering problems with the quality of a purchase, but many BNPL lenders do not offer comparable services and can instead hinder this process by obscuring who should be contacted for assistance.[38] In addition, many consumers have expressed difficulty when seeking refunds for returned products financed through these services,[39] as such transactions often require that BNPL lenders communicate with the respective vendors and void future payments, refund past charges, and adjust merchant fees appropriately—steps that currently appear to involve substantial human intervention and thus can lead to both lengthy and error-prone processes.[40] Finally, most BNPL lenders require that borrowers repay their debts in automatic installments, a practice prohibited for traditional credit products.[41] Although such universally mandated "autopay" increases debtors' likelihood of repayment, the CFPB has expressed concern that it adversely limits customer autonomy to, for instance, change payment methods or prioritize other financial obligations above BNPL loans.[42]

Given the CFPB's interest in this topic,[43] lenders could contemplate more robust consumer-protection-oriented post-sale procedures. Chargeback policies akin to those of credit cards could be ideal because many consumers are familiar with such policies[44] (e.g., a three-tiered liability system that provides protections to consumers who give timely notice of fraudulent activity).[45] Servicers could also streamline consumer returns; for instance, they could preemptively negotiate return policies when initially contracting with merchants, alleviating the communication issues that currently afflict some BNPL lenders. This initial discussion and negotiation may also lead to opportunities to improve efficiency through automation. And BNPL lenders could more explicitly provide contact information for customer support for returns or disputed transactions to avoid borrowers, for example, turning first to the servicer when they should have started with the vendor. Lastly, servicers could adopt "autopay" policies akin to those of more traditional creditors; that is, rather than requiring automatic repayments, they could incentivize borrowers to voluntarily opt into such programs through customer loyalty programs[46] for those purchasing with "autopay."

4. Monitor "data harvesting" given the growing need for alternative revenue channels.

Like many web-based technology companies, BNPL lenders can gather significant amounts of data from customer purchases, including information on items bought, prices paid, and most frequent times for shopping.[47] Private businesses often value such payment histories, and some lenders have leveraged their data to promote specific products and create closed-loop shopping applications with partnering merchants, often tailored to younger audiences.[48] Predicting that increased market competition will exert downward pressure on merchant fees paid to BNPL providers, the CFPB anticipates this conduct will only grow in popularity as lenders search for new revenue channels.[49] Increasing bad debt balances among BNPL lenders and the Federal Reserve's recent increases to its benchmark rate also indicate that such companies will soon face higher interest costs, foreshadowing even greater reliance on revenue streams alternative to interest and fees to maintain and grow profit.[50]

The extent of BNPL lenders' current "data harvesting" varies from lender to lender and is not widely known. Therefore, the CFPB inquired into creditors' practices surrounding behavioral targeting and data monetization, citing concerns related to privacy, cybersecurity, and autonomy.[51] These issues implicate numerous legal risks, justifying at the very least controls over information systems to avoid breaches. In addition, even though federal regulations on data privacy remain sparse, the growing number of comprehensive state protections[52] suggests that BNPL lenders should exercise caution when monetizing customer information—potentially enabling consumers to opt out of certain usages or data collection altogether, or requiring opt-in consents similar to those required for checking overdraft programs regulated by the CFPB.

Key Takeaways

BNPL offers a novel, affordable, and straightforward source of accessible financing to some populations that have struggled to acquire loans elsewhere.[53] But such innovation faces risks, both known and likely on the horizon. Among other things, BNPL lenders face both litigation and regulation related to credit checks, disclosures of key lending terms, dispute resolution and post-sale procedures, and data collection practices. No fewer than 21 state attorneys general[54] and six U.S. senators on the Committee on Banking, Housing, and Urban Affairs[55] have recently urged the CFPB for heightened governance over these services. BNPL lenders could adopt additional safeguards and polices to better protect themselves against current and prospective risks in these areas. ⊙

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