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BNPL: The Phantom Debt

Summary

Is “buy now, pay later” a lifeline to those who need non-traditional financing most? Or an unregulated danger zone that could lull consumers into a false security in which many small payments add up to one big problem? Our sense after surveying what limited data *are* available is that BNPL is not a major problem for consumer spending yet. But until there is a definitive measure for it, there is no way to know when this phantom debt could create substantial problems for the consumer and the broader economy. This report looks at the upsides and downsides of one of the fastest growing categories in consumer finance.

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“***I want to live like everybody else.***”

- The Phantom of the Opera, by Gaston Leroux

Manageable Risk for Now, but Fast Growth Warrants Better Monitoring

“Buy now, pay later” (BNPL) is a type of short-term financing that allows consumers to split their purchases into multiple, often interest-free, installments. This payment method has gained popularity in recent years, particularly among younger consumers and those who are averse to credit cards or who may not have ready access to traditional forms of credit. The category has expanded as some merchants may contract with BNPL firms to provide financing that the merchant can offer at the point of sale. But BNPL differs from credit cards in three main ways; it's not a revolving line of credit, each loan is tied to a specific purchase and lending terms are generally easier.[1]

While some individuals may be in over their heads, even by the most robust estimates, the total pile of BNPL loans is not large enough yet to be problematic enough to derail consumer spending on its own. The category is still small relative to more traditional forms of consumer financing.

Still, everything starts out small, and until there is a definitive measure for it, there is no way to know when this phantom debt could create problems for the consumer and the broader economy. In the meantime, it could make life difficult for those who embrace it most enthusiastically. More worryingly, BNPL does this in de-facto stealth mode because it largely flies beneath the radar of both regulators and policymakers.

Overall, BNPL is a relatively new financial product, and there is still much to learn about its long-term impact on consumers and the economy. It is important for consumers to weigh the risks and benefits of BNPL before using it.

Economic Upsides of BNPL

- *More spending*: BNPL means increased consumer spending and another arrow in the quiver of the unstoppable consumer. BNPL can make it easier for consumers to make larger purchases, which can lead to increased spending especially as access to traditional consumer credit has gotten more difficult and become more expensive. This is particularly impactful in terms of making expensive purchases more affordable by breaking them down into smaller payments, which can be helpful for consumers who are on a budget.
- *Increased sales*: The obvious benefit to businesses is that it can boost sales, a dynamic not lost on businesses given the increasingly ubiquitous offers to spread out even the most routine purchases over multiple monthly payments. In a recent example, Adobe reports that BNPL usage hit an all-time high on Cyber Monday this year as consumers increased purchases.[2]
- *Greater financial inclusion*: BNPL can provide access to credit for consumers who may not have a credit card, a good credit history or an established banking relationship. Most BNPL services have easy lending terms, meaning even financially-strapped borrowers can access this form of borrowing.

Economic Downsides of BNPL

- *Potential for overspending*: BNPL can make it easy for consumers to overspend, as they may not fully realize the total cost of their purchases. This can lead to debt problems.
- *Lack of consumer protections*: BNPL products are not regulated in the same way as credit cards, which means that there may be fewer protections in place for consumers. This could lead to consumers being taken advantage of. A September 2022 Consumer Financial Protection Bureau (CFPB) report found inconsistent consumer protections and risk of excessive debt accumulation and over-extension.[3]
- *Hidden fees*: While a staple of most BNPL programs is that the loans are interest-free, some BNPL providers charge hidden fees, which can increase the overall cost of a purchase. Late fees also vary under different providers, and interest-bearing lending is on the rise.[4]

So, how big is the BNPL market and how much does it add to total household debt?

That is like asking how much a rainstorm will increase the flow of the Mississippi River. Obviously it is a factor, though probably not enough to warrant flood warnings yet. That said, we'd have a much better sense of things if there were an accepted standard for measuring it.

Needless to say, the specific size of the BNPL market can be maddeningly difficult to quantify. Or, as researchers at the Philadelphia Fed put it "data on BNPL loans…are scarce. BNPL loans are not currently reported to any of the major credit reporting agencies, and the firms themselves are understandably reluctant to share proprietary data in a competitive environment."[5]

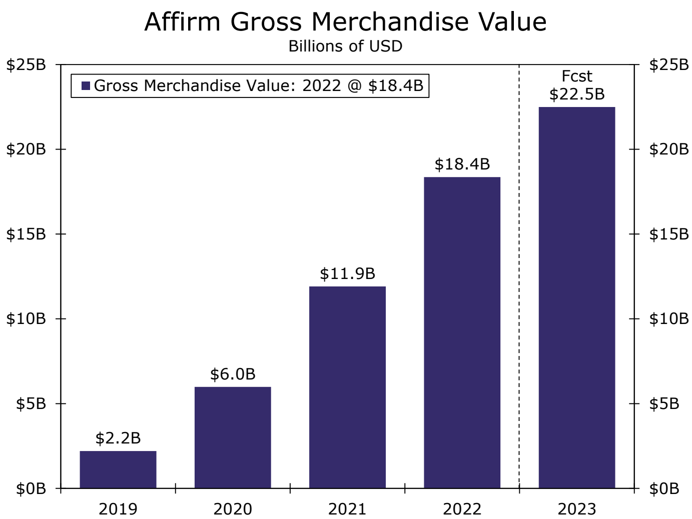
The Phantom Menace?

Cognizant of the risk of this rising and unregulated practice, the CFPB in December 2021 issued orders to the five largest BNPL providers to submit customer data to analyze consumer risk and regulatory exposure in the portfolios.[6] It found that there were 180 million BNPL loans originated in 2021 totaling $24.2 billion in value. But what's more astounding is the growth of this segment. Just two years ago in 2019, the number of originations was 'just' 16.8 million totaling $2 billion in dollar volume. That means today's figures represent a nine-fold increase in transactions and a ten-fold jump in dollar volume.

The short duration of BNPL is reason enough for why we should not consider this segment of borrowing in the context of outstanding receivables. For context, the $24.4 billion in 2021 loan value would imply the BNPL market was roughly only 2.5% of the size of the U.S. credit card market at the time. While the CFPB estimate of the U.S. BNPL market feels reasonable to us, the break-neck pace of growth in this segment of borrowing suggests these figures likely understate the true size of this segment today. Any form of consumer financing that can increase by an order of magnitude in two years warrants close monitoring.

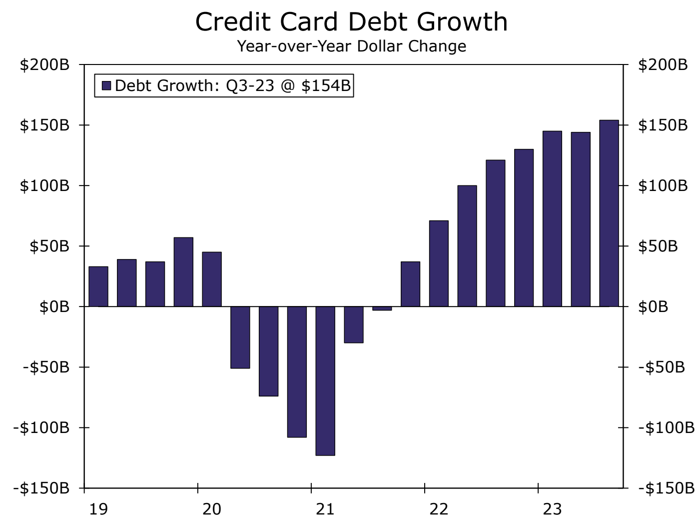
If we look at publicly available data from Affirm, the market leader in the BNPL space, the gross merchandise value rose from $12B in 2021 to what WF equity analysts estimate to reach $23B this year (Figure 1).[7] If Affirms' share of the U.S. BNPL market simply held constant over the period, that would suggest a BNPL total of around $46 billion in loans originated in 2023.

Figure 1



Source: Company reports and Wells Fargo Securities, LLC estimates

Figure 2



Source: Federal Reserve Bank of New York and Wells Fargo Economics

Through Q3, credit card debt totaled roughly $1.079 trillion, which represents a $154 billion increase from what the total had been a year earlier (Figure 2). If BNPL transactions indeed accounted for $46 billion in transactions in the current year, then that implies that BNPL transactions are roughly equivalent to about a third of the annual increase in credit card debt.

The BNPL providers are quick to point out that they provide consumers with increased purchasing power and greater control in managing their personal finances. To a degree, they have a point. When credit card interest rates are north of 21%, it is just common sense for consumers to take reasonable measures to avoid such financing cost. But with no oversight of BNPL providers, it is not immediately clear that savings on financing cost are not offset by fees and penalties.

The watchdogs have their doubts. In a report to Congress in November, the CFPB made it clear that some of the consumers apt to engage in BNPL programs were households that were financially vulnerable.[8] Specifically, the report stated "BNPL borrowers were, on average, much more likely to be highly indebted, revolve on their credit cards, have delinquencies in traditional credit products, and use high-interest financial services such as payday, pawn, and overdraft compared to non-BNPL borrowers." Even if BNPL is a relatively small share of the consumer borrowing market today, increasing vulnerabilities in a small segment can still pose a risk.

My Power Over You Grows Stronger Yet

BNPL could lead to an increase in consumer debt, as consumers may be more likely to take on additional debt if they know they can spread out the payments. Because no central repository exists for monitoring it, growth of this "phantom debt" could imply total household debt levels are actually higher than traditional measures such as the Fed's G.19 or the NY Fed's Center for Microeconomic Data would otherwise capture.

Aside from the clear danger of consumers over-levering, an additional problem is that fast-growing phantom debt would dull the edges of tools long-trusted by policymakers, economists and analysts. The BNPL market may be small now, but if we don't know how fast it's growing, it logically follows that we simply cannot know when it will be a problem.

Endnotes

1 – Di Maggio, M., Katz, J. and Williams, E. “Buy Now, Pay Later Credit: User Characteristics and Effects on Spending Patterns.” (2022). National Bureau of Economic Analysis (NABE). (Return)

2 – “Media Alert: Adobe: Cyber Monday Surges to $12.4 Billion in Online Spending, Breaking E-Commerce Record.” Adobe. November 28, 2023. (Return)

3 – “Buy Now, Pay Later: Market trends and consumer impact.” Consumer Financial Protection Bureau. September 2022. (Return)

4 – Wang, Y. and Mason, T. “Buy-now, pay-later platforms turn to interest-bearing lending via bank partners.” S&P Global Market Intelligence. March 2023. (Return)

5 – Akana, T. “Buy Now, Pay Later: Survey Evidence of Consumer Adoption and Attitudes.” Federal Reserve Bank of Philadelphia. June 2022. (Return)

6 – Consumer Financial Protection Bureau.[3] (Return)

7 – We rely only on publicly available financial data and Wells Fargo Securities Senior Equity Analyst Andrew Bauch’s guidance and estimates regarding Affirm Holdings Inc. financial projections. (Return)

8 – “Semi-Annual Report of the Consumer Financial Bureau.” Consumer Financial Protection Bureau. Spring 2023. (Return)

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