CHARGEAFTER

The Ultimate Guide to POS Lending for Banks

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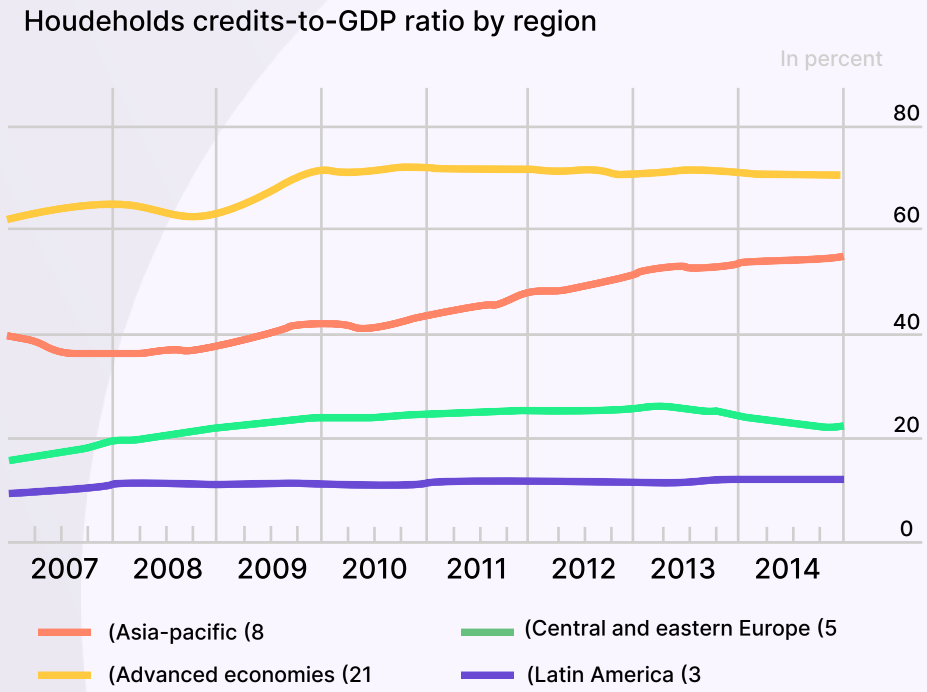
Introduction

The banking sector, a cornerstone of the American economy, is currently navigating the complexities of a shifting financial landscape. With the rise in interest rates, US banks are presented with the opportunity to generate high returns across multiple debt pools. However, this potential boon is not without its challenges.

Consumer lending has long been recognized as the driving force behind societal growth.[1] It facilitates the dreams and aspirations of individuals, from purchasing homes to funding education. But with great power comes great responsibility. Especially in times of economic downturns, banks are faced with the daunting task of narrowing their credit extensions. The focus sharpens, targeting only the most sound and viable use cases. This is where the precision of a finely-tuned risk underwriting model, and an easy-to-launch product framework becomes paramount.

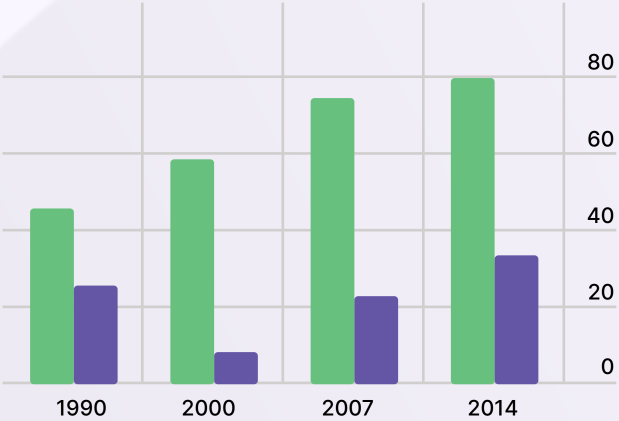


[1] https://www.bis.org/publ/work607.pdf
https://www.nerdwallet.com/article/loans/personal-loans/personal-loan-statistics

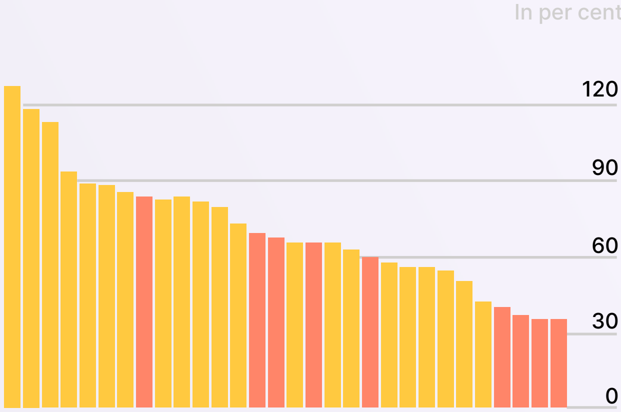
Household debt[1]

As s percentage of GDP

Median within a country group



Top 30 (as of 2014)

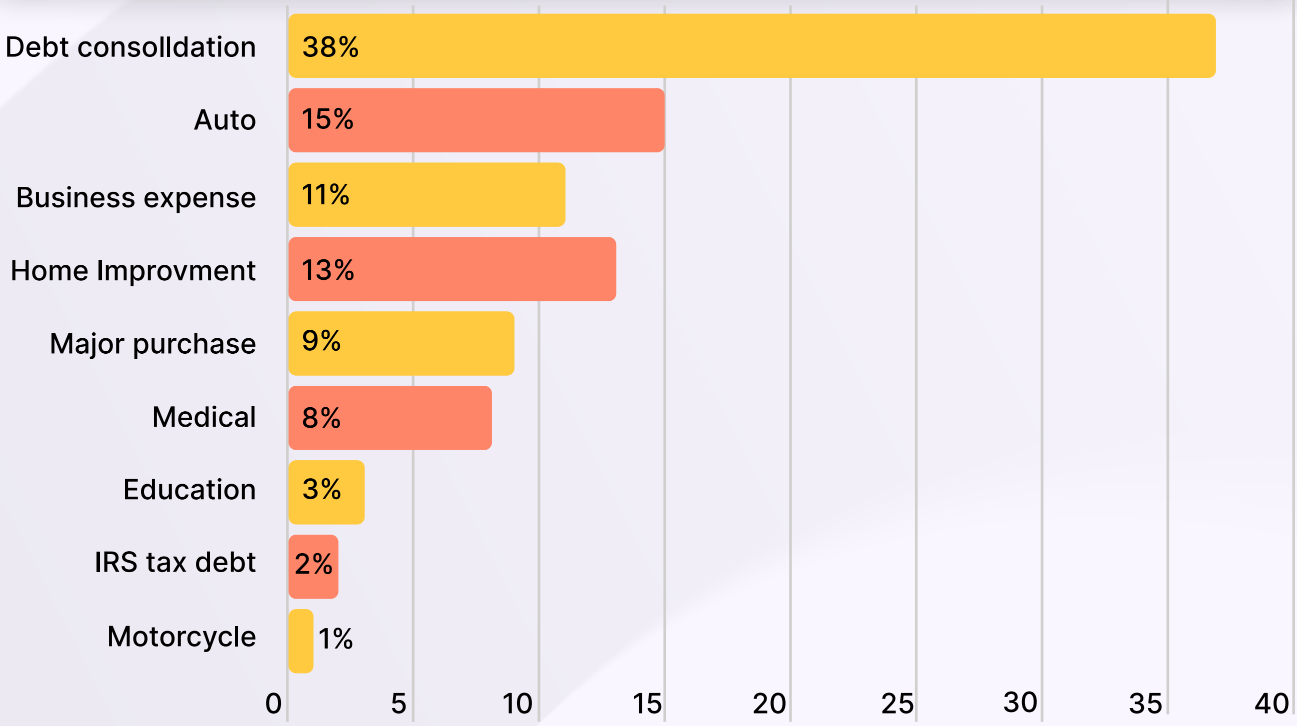


[1] Total credit to households and non-profit institutions serving households (NPISHS). 2 The 21 advanced economies include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, the United Kingdom and the United States; and the 18 emerging market economies include Argentina, Brazil, China, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand and Turkey.
Sources: National Data; BIS.

Within the vast realm of unsecured lending, two use cases stand out in terms of volume: credit card refinance loans and Point-of-Sale (POS) loans. The former allows consumers to consolidate their credit card debt into a single loan with a potentially lower interest rate, while the latter provides financing options at the point of purchase for high-ticket items.

However, an economic downturn presents a conundrum. On one hand, allowing consumers to refinance their debt becomes riskier, given the uncertainties surrounding their ability to repay. On the other hand, POS loans, especially for essential high-ticket items, can be seen as a more resilient and sensible use case. The logic is straightforward:in challenging times, banks are more likely to see a soaring default rate in credit card refinancing loans, compared to POS financing programs that merely allow consumers to pay over time for a high ticket item.

Personal loan borrowing purpose, Q1 2023



Objective of this White Paper

Navigating the intricacies of consumer lending, especially in the realm of POS financing, is no small feat. This white paper aims to shed light on the risks, opportunities, and challenges inherent in managing and scaling a point-of-sale financing program. Through a deep dive into the current state of US banks and the pivotal role of consumer lending, we hope to provide insights and strategies for financial institutions to thrive in this ever-evolving landscape.

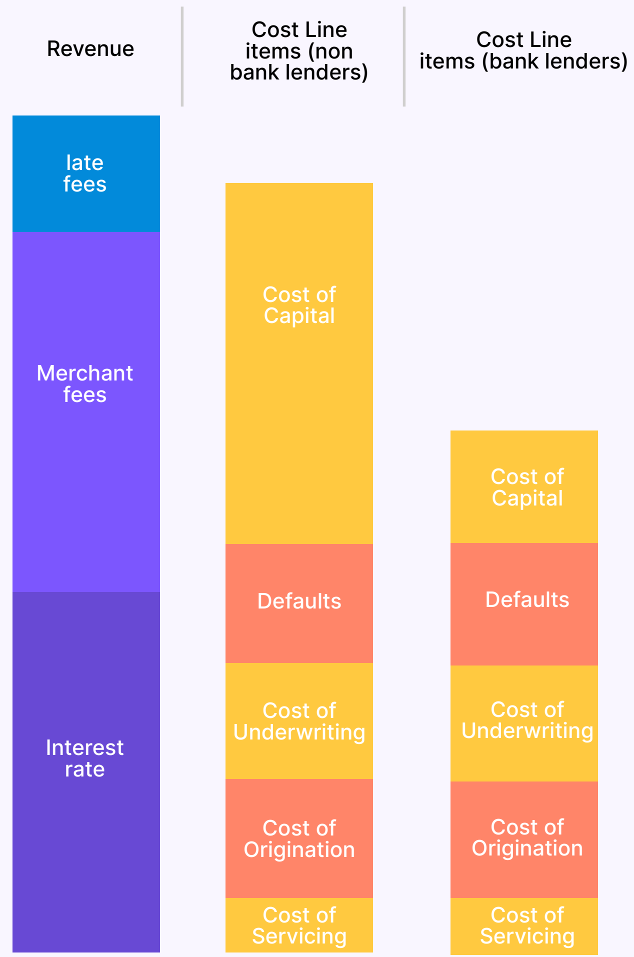
Historical Context and Current State of Consumer Lending

Historically, banks were the primary providers of unsecured personal loans, offering funds for a variety of purposes and remitting directly to borrowers' accounts. Parallel to this, credit cards emerged, allowing consumers to roll over their debt, often at significant interest rates. The 2010s marked a transformative period as non-bank lenders like Affirm entered the scene, emphasizing transparency and fixed monthly payments. Their success prompted traditional banks to innovate, with institutions like Citizens, Ally, and Citi introducing their own point-of-sale (POS) financing solutions or announcing the purchase of POS Financing platform, as was the case when Goldman Sachs acquired GreenSky and similarly Bread was acquired by Alliance Data (owned by Comenity Bank).

However, the landscape began to shift around 2021. With rising interest rates, non-bank lenders faced squeezed margins due to their reliance on borrowed funds. This structural challenge provided an opening for banks, with their low-cost deposits, to potentially lead with their Buy Now, Pay Later (Consumer Finance) offerings.

https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf

https://www.wsj.com/articles/missed-payments-rising-interest-rates-put-buy-now-pay-later-to-the-test-



Priorities of US Banks

The Buy Now, Pay Later (Consumer Finance) model has undeniably disrupted the consumer lending landscape, and US banks are keenly aware of its potential. Those that haven't yet ventured into this space are actively formulating strategies to do so, while banks already offering Consumer Finance are refining their products for scalability and broader market reach.

Three primary perspectives dominate the banks' approach to Consumer Finance:

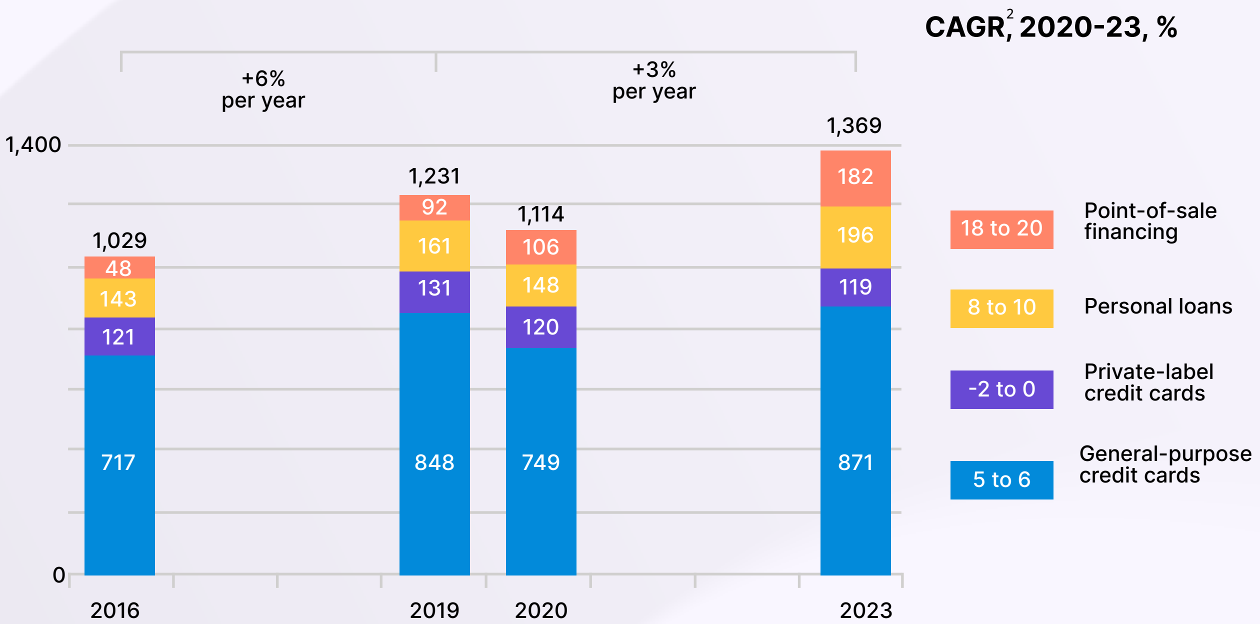
Merchant Services Standpoint: Some banks view Consumer Finance as an extension of their merchant services, aiming to provide businesses with tools to offer flexible payment options to their customers. This not only enhances the merchant's sales potential but also strengthens the bank's relationship with its business clients.

Balance Sheet Standpoint: Other banks are more focused on the potential impact of Consumer Finance on their balance sheets. By offering consumers short-term, interest-free loans, banks can diversify their loan portfolios and potentially attract a younger demographic.

Retail Customers Utilization and Churn: From a broader strategic perspective, banks are increasingly concerned about the competitive threat posed by non-bank Consumer Finance providers. These fintech players are not just competitors in the lending space but are also eroding banks' brand recognition and loyalty. As non-bank Consumer Finance providers divert significant portions of credit card volumes to off-card rails, banks find themselves losing share of wallet and, more critically, a diminishing foothold on their customer base. This shift underscores the urgency for banks to innovate and reclaim their position in the consumer finance ecosystem.

Point-of-sale financing is growing faster than other unsecured lending- a trend likely to continue.

outstanding balances for unsecured lending products[1], $ bilion



[1]Includes all consumer and small-business credit cards, installment-based products offered at point of sale, personal loans, Excludes overdrafts and student loans.Compound annual growth rate.
[2] Source: Federal Reserve; TransUnion; McKinsey Consumer Finance pools

https://www.mckinsey.com/industries/financial-services/our-insights/buy-now-pay-later-five-business-models-to-compete

Strategies for Banks to Enter the Consumer Finance Market

The BNPL sector's rapid growth presents a myriad of opportunities for banks to tap into this lucrative market. As consumer preferences shift towards flexible payment options, banks must adapt and innovate to meet these changing demands. Here are the primary strategies banks can employ:

1. **Bulk Debt Purchase:** One immediate entry point for banks is to purchase debt notes of new or partially paid-off loans in bulk. This approach allows banks to specify their credit risk criteria, ensuring they acquire loans that align with their risk appetite. By doing so, banks can quickly diversify their loan portfolios while maintaining control over the quality of acquired assets.

2. **Acquisition of Consumer Finance Platforms:** Several banks have chosen the acquisition route to gain a foothold in the Consumer Finance market. Notable examples include Goldman Sachs' acquisition of GreenSky, Alliance Data's purchase of Bread, and Square's takeover of Afterpay. These acquisitions are not solely driven by the performance of the acquired platform's debt facility. The influx of new account holders added to the bank's portfolio often justifies such strategic moves, providing banks with a broader customer base to upsell other services.

3. **Strategic Partnerships:** Collaborative partnerships between banks and Consumer Finance platforms can be mutually beneficial. For instance, Ally's partnership with Sezzle (now Zip) allowed the bank to provide long-term loans for higher ticket items, extending beyond the typical comfort zone of Consumer Finance platforms. Such partnerships enable banks to leverage the brand recognition and technological infrastructure of established Consumer

Finance platforms while offering their financial muscle and extensive customer base.

4. **Consumer Finance as a Service:** Outsourcing to a Consumer Finance as a Service provider, like ChargeAfter in the US and Europe, offers banks a turnkey solution. By deploying their branded Consumer Finance solution, banks retain ownership of all customer data, positioning them to upsell other banking services. This approach combines the agility of fintech platforms with the trust and reliability associated with traditional banks.

5. **In-House Development:** Some banks opt for a more organic approach by developing their Consumer Finance programs in-house. Leveraging existing credit card infrastructure, banks like US Bank with ExtendPay and Synchrony with their beta version of Pay Later have introduced their Consumer Finance solutions. While this approach requires significant dollar investment in technology and market research and takes longer than all other options, it ensures that banks have complete control over the product's features, risk management, and customer experience.

	Bulk Debt Purchase	Acquisition of Consumer Finance Platforms	Strategic Parterships	Consumer Finance as a Service	In-House Development
Upfront Cost					
Technical Complexity					
Option to upsell	—				
Ownership of Merchant	—				
Time to market	3-6 mo	6-12 mo	6-9 mo	3-6 mo	18-24 mo

The Consumer Finance Blueprint

Having established the various strategies banks can employ to enter the Consumer Finance market, it's essential to delve deeper into the operational mechanics of these programs. A Consumer Finance initiative is more than just a financial product; it's a complex orchestration of technology, customer experience, risk management, and marketing. To truly thrive in this space, banks need a comprehensive blueprint that outlines every facet of a Consumer Finance program. In the following section, we'll dissect the components of Consumer Finance programs and lay out an operational blueprint that banks can use as a roadmap for success.

Types of Consumer Finance Products

1. Short-Term, Small Ticket Loans

Characteristics: Small loans designed for quick repayment, usually spanning a few weeks to a couple of months. Often, they come with zero interest if settled promptly.

Pros: Swift approval processes and potential to enhance merchant sales.

Cons: Due to the modest loan amounts, the profit margin for banks can be minimal. These loans are predominantly offered by non-bank lenders, sometimes at rates surpassing federal APR caps.

Compatibility with Banks: Highly suitable, with banks capitalizing on their established infrastructure and clientele.

2. High Ticket Loans

Characteristics: Substantial loans meant for extended repayment durations, ranging from several months to a few years.

Pros: For banks, these loans are attractive due to their full compliance with FCRA and TILA regulations, coupled with lucrative returns, especially when interest compounds over extended periods.

Cons: The comprehensive onboarding process can be off-putting for customers at the point of sale, making seamless conversion of borrowers to dedicated bank customers challenging.

Compatibility with Banks: Highly suitable, with many banks either directly offering or collaborating with platforms for this service.

3. Deferred Payment

Characteristics: This model empowers consumers to postpone payments for short durations, typically between 14 to 30 days. While popular in Northern Europe, its US adoption remains limited.

Pros: Offers consumers the flexibility of a "try before you buy" experience.

Cons: Can lead to impulsive buying behaviors and potential debt accumulation.

Compatibility with Banks: Best suited for banks with a robust Merchant Services clientele using the bank's acquiring channels.

4. Split Payments

Characteristics: A method that segments the total purchase amount into equal portions, usually settled bi-weekly. This approach utilizes credit card infrastructure, often reserving the unpaid sum on the cardholder's credit line.

Pros: Facilitates the management of heftier purchases without imposing interest.

Cons: Regulated as a Payment Service rather than a loan, it restricts banks from levying borrower interest, limiting revenue to merchant and late fees.

Compatibility with Banks: Ideal for banks with a broad Merchant Services clientele operating on the bank's acquiring channels.

5. Revolving Credit Lines with Fixed Payments

Characteristics: Provides a credit threshold from which consumers can draw and repay over time. While akin to credit cards, it offers a fixed payment plan for specific acquisitions.

Pros: Merges multiple advantages, requiring a singular onboarding process for multiple purchases, and presents a transparent payment structure. It also facilitates the seamless transition of borrowers to bank clientele.

Cons: Potential for high-interest rates and significant debt accumulation.

Compatibility with Banks: Aligns well with traditional banking offerings like credit cards.

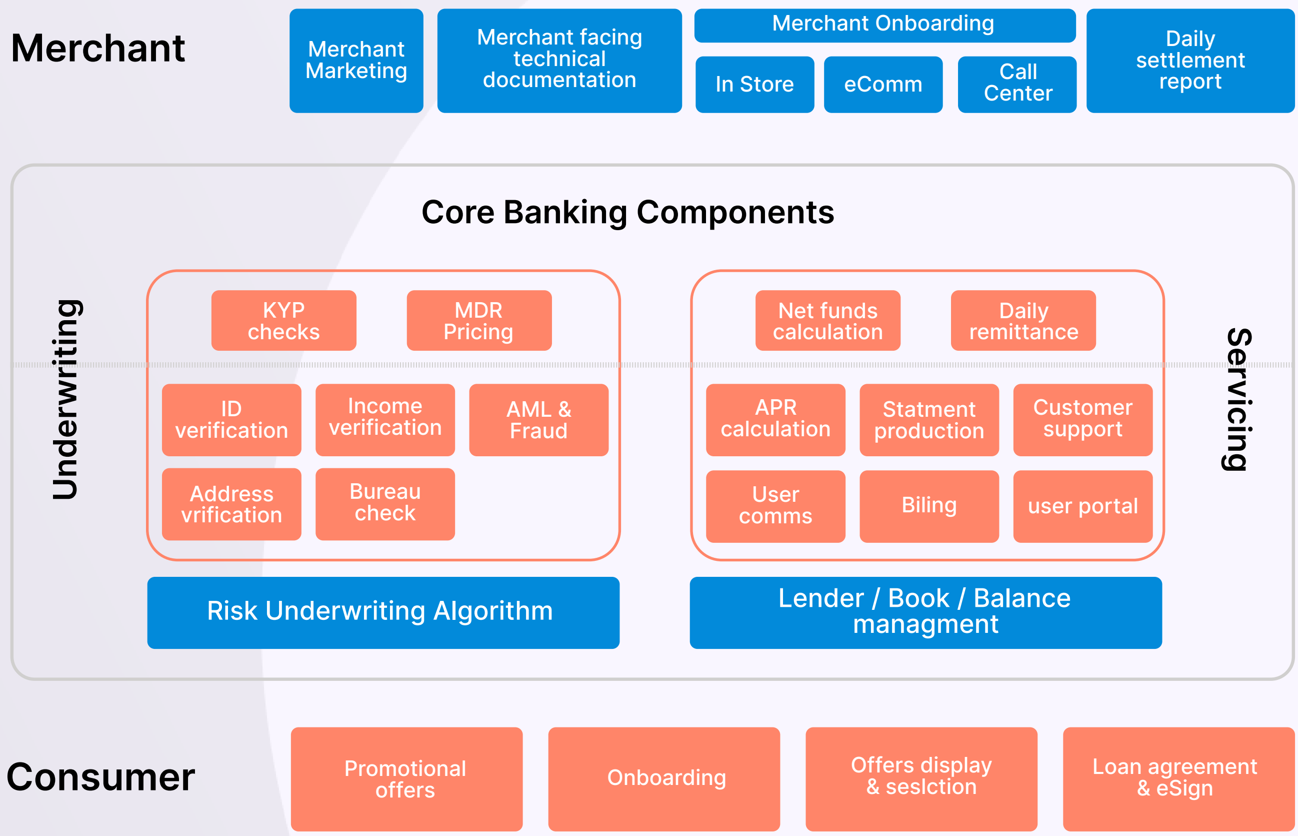
	Revolving Line	Split Payment	Deferred Payment	High Ticket Loans	Small Ticket Loans
Revenue per loan	Medium, supports the full gamut between small amounts and high tickets	Low, from Merchant fee	Low, from Merchant fee	High, from APR, particularly if the loan term is longer than 12 mo	Low, from APR / Merchant Fee
Regulated under FCRA and TILA	Yes	No	No	Yes	Yes
Customer onboarding process	Lengthy	Short	Short	Lengthy	Lengthy
Compatibility with banks' existing activity	Credit Cards	Merchant acquiring / payment processing	Merchant acquiring / payment processing	Personal Loans	Personal Loans

Core vs. Enablement Components

In the rapidly evolving landscape of Buy Now, Pay Later (Consumer Finance) financing, it's imperative for banks to discern between the core and enablement components of the Consumer Finance blueprint. This distinction not only streamlines the implementation process but also ensures that banks maintain control over critical aspects while leveraging external expertise for enhanced functionality.

Core Components: These are the foundational elements that form the backbone of any Consumer Finance program. They encompass the bank's proprietary algorithms for risk assessment, customer data management, regulatory compliance mechanisms, and the financial infrastructure to support loan disbursements and repayments. Given their intrinsic link to a bank's operations and the sensitive nature of the data they handle, these components should be developed, managed, and safeguarded directly by the bank.

Enablement Components: These components amplify the reach and efficiency of the core Consumer Finance system. They include merchant onboarding platforms, integration tools for e-commerce systems, customer experience enhancements, and analytics dashboards for merchants. While crucial, these components require a nuanced understanding of merchant needs and preferences. Given that merchants are as much a client of the Consumer Finance program as consumers, it's essential to prioritize their requirements and pain points. Outsourcing these enablement components to technical enablers with a deep understanding of merchant needs ensures that the BNPL program is agile, adaptable, and merchant-centric.



Summary

The strategic emphasis on a merchant-centric approach in Consumer Finance cannot be overstated. Merchants, after all, are the gatekeepers to the vast consumer base that banks aim to tap into with their Consumer Finance offerings. Their experience, satisfaction, and the ease with which they can integrate and manage Consumer Finance solutions directly influence the program's adoption rate and overall success. When merchants find value in a Consumer Finance program, they not only adopt it but also become its advocates, promoting it to their customer base. This ripple effect amplifies the reach and impact of the Consumer Finance solution. Therefore, when banks are in the process of evaluating potential enablers for their Consumer Finance programs, they must prioritize those that demonstrate a deep understanding of merchant needs. The ideal enabler should offer tools that facilitate seamless onboarding of diverse merchants, provide robust integration capabilities for various e-commerce platforms, and offer analytics and insights that empower merchants to optimize their Consumer Finance offerings.

ChargeAfter, with its pioneering stance in the Consumer Finance enablement sector, exemplifies this ideal. By initially immersing itself in the world of merchants, ChargeAfter has been able to intricately understand and address the challenges and aspirations of this critical stakeholder group. This deep-rooted merchant-first philosophy has been the cornerstone of their subsequent developments, especially the lender side of their platform. The Lending Hub for Point-of-Sale financing programs, a proprietary technology by ChargeAfter, is a testament to their commitment to creating solutions that resonate with both banks and merchants. With features tailored to enhance the merchant experience, from easy integration tools to comprehensive analytics dashboards, the Lending Hub ensures that merchants are not just participants but active beneficiaries of the Consumer Finance wave. Furthermore, ChargeAfter's track record of successfully onboarding a diverse range of merchants and scaling their programs underscores their capability and positions them as a trusted partner for banks venturing into the Consumer Finance domain. In essence, ChargeAfter's Lending Hub is not just an enablement tool; it's a bridge that harmoniously connects banks, merchants, and consumers in the dynamic world of Consumer Finance.

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