Is the next generation of lending dead on arrival?

Six months ago, Klarna was the king of buy now, pay later, valued at USD 45.6 billion. Yet, in July 2022, Klarna had to make a round of redundancies that led to a plummet of 85% in valuation, leaving it at USD 6.7 billion. What happened and what does this mean for the future of embedded lending?

Embedded lending has often been called the "next generation" of financial services, but with Klarna facing disaster, does this means that next generation is dead on arrival? Is embedded lending the future or just a flash in the pan?

Klarna profile

- *Online sales +30-60% in 2021*
- *55% of consumers used BNPL in 2021*
- *Klarna valuation - USD 45.6b -> USD 6.7b (-85%)*

Founded in 2005, Swedish fintech Klarna became the leading embedded lending provider in Europe. In 2021, it was placed as Europe's most-valuable private tech company with a worth of USD 45.6 billion.

The Klarna platform began by offering an embeddable package that allows customers to gain instant credit on purchases at checkout without a credit check. Using the information customers already filled in during checkout, Klarna approves them to purchase the item instantly and pay back the balance in a series of interest-free payments.

Once that had been established, Klarna started offering customers accounts through an app, which directs them to retail outlets that have partnered with Klarna to offer BNPL, meaning their payments can all be managed in one place.

During COVID-19 lockdown, customers often needed items such as remote-working setups like desks and office chairs. Stuck at home, they needed essential home improvements. Not to mention, the standard emergency costs, such as broken boilers and smashed phone screens, continued to need payment.

Locked down at home, the only way to acquire these goods was through ecommerce stores like Amazon. As a result, online sales soared 30-60%, depending on industry, over the course of lockdown, according to Digital Commerce 360.

Customers, however, sought to spread the costs of those purchases, particularly with an uncertain economy and the potential for redundancy looming over them. As a result, 55% of consumers said they'd used BNPL in 2021, according to The Ascent.

In this environment, Klarna thrived. In June 2021, the firm raised USD 639 million in funding and was valued higher than any other private tech company in Europe.

With the cash injection, came a raft of new initiatives. In 2021, Klarna started offering bank accounts and a physical payment card.

Yet, in May 2022, Klarna announced 10% redundancies, before their valuation crashed 85% in the next month. What happened?

Klarna timeline:

- ***2005*** *Founded*

- ***2007*** *Investment from AB Oresund*
- ***2010*** *Increased revenue by over 80% to SEK 400 million*
- ***2011*** *Listed by the Telegraph as one of Europe's Top 100 most-promising tech companies*
- ***2012*** *Entered Austrian market*
- ***2013*** *Merged with SOFORT AG to become Klarna Group and entered the German market*
- ***2015*** *Launched in the USA*
- ***2019*** *Raised USD 460 million and was valued at USD 5.5 billion - biggest fintech startup in Europe*
- ***2020*** *Alibaba invested in Klarna through affiliate Ant Financial*
- ***2021*** *Launched bank accounts in Germany and "Pay Now" service in the USA, as well as a physical payment card*
- ***2022*** *10% redundancies and 85% crash in valuation*

What does the fall of Klarna mean for embedded lending?

Embedded lending providers like Klarna are facing challenges. A combination of three "R"s led to the plummet in Klarna's valuation:

1. **R**eputation
2. **R**egulation
3. **R**ecession

Firstly, there is deep concern that BNPL will lead to a financial crisis in the lower-income brackets, as in-store credit options are considered one of the factors that led to the Great Depression. In 1925, one-in-seven US dollars spent in the USA were on instalment payment plans.

In the modern day, 30% of BNPL customers have made a late payment, so there seems to be evidence that BNPL is helping customers spend beyond their means. As such, various experts and media outlets have expressed their concerns about the sustainability of embedded lending.

This has caught the attention of the regulators. So far, BNPL providers like Klarna have been operating in a "Wild West" without regulation. With the above concerns, however, the UK's Financial Conduct

Authority - long an indication for coming regulation in the rest of the world - has set its sights on BNPL providers.

Of course, regulation is not a bad thing. No-one wants to be operating outside the best interests of customers and the economy. However, tighter regulation could eat into the profitability of the sector.

This becomes more crucial as global firms are tightening their belts. Despite the tragic death toll of the COVID-19 crisis, governments around the world acted to leave infrastructure largely unimpacted. However, the measures taken to protect us from the pandemic now need to be paid for and this will take its toll on the world economy.

With a recession looming on the horizon, disruptive startup fintechs are concerned. Newer firms, of course, don't have the dry powder to outlast a recession.

Embedded services, such as BNPL, have often been thought of as the future of lending, but the future-facing providers may well be looking at a grim future, which could put a sudden stop to embedded lending.

What does this mean for established lenders? Well, it could well be an opportunity.

- *30% of BNPL customers have made a late payment*

The challenges facing embedded lending are an opportunity for established lenders

Fintech startups in the embedded lending space are facing the challenge of three "R"s. New companies lack a strong **reputation**, experience with **regulation**, or the cash reserves to last through a **recession**. Established lenders, however, have all three of these things.

Traditional lenders have existing customers and good reputations in the market. They know and have worked with regulators, and they have the cash resources to last through a recession. As such, they are in an excellent position to pick up the torch that the embedded lending startups may be dropping.

This could well be the best way to keep on the right side of retailers. We recently saw Amazon threaten to stop accepting Visa payments unless they were given their preferred rates. This got all the way to a customer announcement that Amazon would no longer accept Visa after a countdown before an agreement was arrived at. This shows Amazon are willing to turn away partners that don't keep it happy.

If Klarna are no longer able to offer BNPL options to Amazon, an established lender that stepped in and undercut Klarna could build an effective relationship with Amazon that could leave them in a favourable position.

Likewise, there is still intrinsic value in the BNPL market. In a recession, options to spread payments into instalments could be very attractive to customers, and not just at the lower-income end. Censuswide actually found that 58% of higher-income shoppers were net-favourable to using BNPL options.

Not to mention, the possibilities of BNPL have yet to be fully explored. The Censuswide survey found that consumers were also open to using BNPL to purchase hotel accommodation, grocery shopping, restaurant and takeaway food, plumbers and electrician services, and gym memberships.

- *58% of higher-income shoppers were net-favourable to using BNPL options*

Next-generation lending will be driven by traditional lenders

There is life left in the next generation of lending yet, it may just be that few of the companies that carved out the space will be around to take it to the next level. This leaves it up to established lenders to bring the next wave of embedded lending to the market.

So, how can established firms take advantage of this new market opportunity? With the right technology.

Next-generation fintech for the next generation of lending

To beat the fintechs at their own game, established players need their own innovative technology. Yet, studies have shown that over 70% of attempts at digital transformation fail with no return on investment.

Innovative lenders need to delay their digital transformation in order to focus on entering the fintech market with tools that enable their existing systems to embed next-generation lending services into third-party retail journeys. No-code/low-code fintech tools enable high-productivity fintech infrastructure to sit on top of legacy systems and act as the digital glue that connects your current estate to the fintech market.

This will enable established lenders to confidently offer next-generation lending services without an expensive and risky digital transformation. That's the future of the lending market.