Cash Assist or Shark Loan? In Quest of Doing Well While Doing Good

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It was a sunny morning on Saturday, April 6, 2019 when Jim Kamal was sitting on the patio of a coffee shop located right across from the building where he was born in the western suburbs of Edmonton, Alberta, Canada. Just a few days before, Jim attended the last class of his four-year undergraduate studies in accounting at a local university. This came with a mixed feeling of both relief and anxiety. While he was happy to finally break away from the routine of being a student, he also felt lost and uncertain about what he should do next with his life. The one thing he knew for sure was that he loved "working with numbers" like accounting students typically did.

As he was sipping his maple leaf latte, Jim could observe a few people entering and leaving a payday loan store through the window of the coffee shop. He thought that was something he could do for a living. He immediately opened his bag, pulled out his laptop, powered it on, and started to browse the internet for relevant information about the industry. It did not take long after typing "payday loan in Edmonton" before he came across some puzzling facts. Certain reports suggested the industry offered exceptional returns, while others blamed it for unethical practices. Jim started to wonder whether the payday loan business would allow him to "do good while doing well" – a guiding principle he adopted since he learned it in one of his favorite courses at university.

1. THE ENTREPRENEURIAL KID WHO WANTED TO MAKE A DIFFERENCE

Jim Kamal, 24 years, has always been a social entrepreneur with a big heart and innate business sense. He was barely ten years old when he started selling pastry – his mother helped him make – at his school to raise funds for a newcomer family of refugees. His aunt, who was a successful entrepreneur herself, called him "an entrepreneur with a mission" and predicted a great entrepreneurial career for him.

With a solid education in Accounting, Jim thought he could find an entry-level job with a local business quite easily, but he really liked the challenge of starting and growing his own business. He did not only see the venture as a way of making a living; he also wanted to serve the community and help the needy. His parents, who immigrated to Canada a few years before he was born, nurtured his entrepreneurial spirit and encouraged him to pursue his dreams. His father was a full-time taxi driver, while his mother worked as a seasonal personal tax consultant with a small store that operated under a well-known franchise. While not rich by any means, both parents were committed to lending him enough seed money to jump-start a small business of his choice.

Jim realized his passion for "crunching numbers" and customer service throughout his undergrad years. He also enjoyed being involved with student clubs that promoted ethical values and social responsibility in business. Given his academic background and his mother's experience in tax preparation, he thought of various possibilities for his small business, including accounting services, tax filing, loan brokerage, and many other areas that required working with numbers. Since he finished his university studies, the idea of opening a payday loan store in the area in which he grew up started to consume his attention. However, the more he learned about how the whole industry worked, the harder it became for him to decide whether to proceed with such business.

2. THE PAYDAY LOAN MARKET

A payday loan is a short-term, unsecured small loan with high-interest rates and a pre-determined maturity date. Such loans were offered by lenders other than depository institutions like banks with the intention to help borrowers cover cash shortfalls till their next payday. By Canadian law, a payday loan could not exceed $1,500 or last beyond 62 days.[i] When a loan is not repaid on time, the borrower would be subject to additional fees and penalties. More specifically, in the case of non-repayment, the borrower could either roll over the loan for an additional fee, take out a new loan to cover the previous one, or default on the loan.

There were approximately 1,400 payday retail outlets that were members of the Canadian Consumer Finance Association in 2016. They catered to about two million borrowers a year across the country.[ii] In 2014, the licensed Canadian payday loans industry issued approximately 4.5 million short-term loans to households for a total value of $2.2 billion.[iii]

The use of payday loans increased consistently over the years. According to a report by the Canadian Consumer Finance Association (CCFA) in November 2016, the growth rate of the Canadian Payday Loan industry was much higher than the Canadian chartered banks. The annual compound annual growth rate of the value of the licensed Canadian Payday Loan industry was 16.1 percent between 2010 and 2014.[iv]

There were three main reasons for such popularity despite high-interest rates. The first reason was the *ease of access*. No credit history check was required, and the entire application process took less than an hour to complete. All a borrower needed to have was (i) a permanent home address, (ii) a valid identification, (iii) proof of regular income like the last two pay stubs, and (iv) a valid checking account[v]. The borrower was also required to complete a simple application form and give a post-dated cheque covering the loan amount and associated fees. This allowed the lender to withdraw the due amount directly from the borrower's bank account at the end of the loan term. In return, the borrower received either cash or direct deposit that could be accessed immediately.

The second reason was the *lack of alternatives* for obtaining immediate and urgent cash for certain types of borrowers. Many payday borrowers had poor credit history, which disqualified them from receiving the credit from more conventional banking sources like credit cards or lines of credit.[vi] About 58 percent of payday loan users in Alberta reported they had chosen such a service due to the "quick and easy process," while 17 percent stated they had no other alternatives available to them.[vii]

The third reason was that many borrowers *lacked awareness of the actual costs* of payday loans (Exhibit 1).[viii] In 2016, 57 percent of payday borrowers were not aware such mode of financing was significantly more expensive than other short-term banking solutions like an outstanding account balance, a line of credit, or a cash advance on a credit card. This could be attributed to how payday businesses advertised the cost of their services. For instance, even when the allegedly stringent government regulations were applied, they still charged $15 fixed fees per $100 borrowed regardless of the term of the loan (between one and sixty-two days) chosen by the client.[ix]

To understand his potential clients further, Jim conducted additional research to depict the profile of a typical user of payday loans. About 30 percent of borrowers had an annual income below the 2016 official poverty line of about $37,500 for a family of four in Canada[xxi] (Exhibit 2). Moreover, 72 percent of them were of working age (25 to 54 years), and 55 percent rented their home.

Consistent with the general urbanization rate of the Canadian population, 83 percent of borrowers lived in urban areas.[xii] Jim also learned that many borrowers used payday loans regularly. Nearly 23 percent of them took six or more loans over three consecutive years. In Alberta, 65 percent of payday loans issued went to a customer who had previously taken a payday loan from the same company in 2017.[xiii] Jim was shocked to learn that 7 percent of borrowers took loans to simply repay another loan.[xiv]

In terms of competition, Jim identified about 19 noteworthy payday stores in Edmonton (Exhibit 3). Globally, market trends in Edmonton seemed to mirror those observed across the country. Albertan payday loan borrowers spent about $29 million in administrative fees and interests in 2017.[xv] Given that a third of Alberta's population resided in Edmonton, Jim forecasted that the gross earnings of a typical payday store in Edmonton would be $480,000 in 2019.

3. A "SHARK LOAN" INDUSTRY?

While doing his due diligence, Jim did not only learn about how the payday loans business worked and made money. He also discovered how bad the image of the industry was. Business practices within the industry were consistently depicted as predatory and unethical at best.

For instance, the local *Global TV* featured a woman that decided to leave the industry for ethical reasons. The article posted on the channel's website was titled "We Are Loan Sharks," and it highlighted certain industry practices the journalist qualified as unethical.[xvi] For example, employees at payday stores were asked to coerce potential borrowers and lend them the maximum amount they were eligible for, rather than the amounts they wanted and could pay back. Clearly, the objective was to garner the highest interest earnings possible, even if that meant pushing the client to a debt trap. Indeed, the practice often led to an unbearable debt burden or even default for borrowers. Once they plunge into a debt trap, they would have no option but to take new loans to repay old ones.

In the same vein, an article in *The Globe and Mail*[xvii] featured another person who first went to a payday loan store to borrow enough money to buy a Christmas gift for his daughter. When he returned to the store to repay the loan on time, the clerk persuaded him to take a new loan of a much higher amount, knowing that he would not be able to repay it on time. As a result, he had to take a new loan to repay the old one, and soon enough found himself in a debt trap. "I was in a terrible loop I didn't know how to get out of," the borrower said.[xviii]

Payday lenders were also accused of engaging in misleading advertisements[xix]. On the one hand, they made no hint to their exorbitant interest rates and fees (Exhibit 4). On the other hand, they typically highlighted that they offered "fast and immediate cash" with "no credit checks." According to industry reports in 2018, the average default rate[1] of non-mortgage loans to Canadian consumers was 5.43 percent[xx] , while the serious delinquency rate[2] of payday loans was 8.4 percent[xxi]. Consumer advocacy groups claimed the lenders targeted and abused uninformed groups of population[xxii] and qualified their practices as "deceptive" and "harmful." In 2016, they successfully lobbied Google to follow Facebook suit and ban payday loan advertisements from their platform.

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[1] Serious delinquency rates are 90 or more days past due for credit cards and 60 or more days past due for all other credit products.

[2] Default rate was calculated using dividing the value of defaulted loans by the total value of loans.

Various governments were also forced to step in and enact laws and regulations that put restraints on some practices that prevailed in the industry. In Canada, provincial governments had authority over payday loan regulations. In Alberta, Jim's prospective market, the government enacted a new set of laws entitled "An Act to end Predatory Lending" in August 2016. Among other restrictions, the new Act reduced the maximum borrowing rate on every $100 from $23 to $15 and restricted the term of payday loans to 42-62 days. The new Act also prohibited any payday lender from extending or rolling over an existing loan. The Service Alberta Minister, Stephanie McLean, stated in a news conference that "six hundred percent interest that prevents Alberta families from making ends meet are predatory. Loans that require you to take out loans to pay back loans are predatory. We're ending it, and we're protecting Albertans."[xxiii] She further added, "Currently lenders are able to charge very high interest rates to Albertans who are the least able to afford it."[xxiv]

4. THE "CASH ASSIST" INITIATIVE

The idea of investing in a payday loan business popped into Jim Kamal's mind when he observed customers entering and exiting a similar store on Saturday, April 6, 2019. Since then, he did more market research and crunched some numbers. He also went back to school and brainstormed with one of his former professors about the best way to get started in an industry that was totally new to him. He ended up deciding that adopting a franchise would have significant advantages, especially in terms of branding and operations. Jim had the qualities franchisers expected from their franchisees, including motivation, entrepreneurial spirit, customer service orientation, ability to lead and manage a business, and ability to learn quickly. He could also benefit from the franchiser's commitment to providing him with industry know-how, experience with regulatory agencies, operational and marketing support, and assistance in finding a location if necessary.

Jim considered a few local and global companies that offered franchising opportunities and concluded that *Cash Assist* would be a good fit for his business. They were based in Western Canada, and their marketing materials stated that the minimum initial investment to open a store would be around $100 thousand. This included franchise access fees, leasehold improvement, and working capital. Using information from different sources, Jim forecasted a total fixed cost of $350 thousand in the first year and $250 thousand in the subsequent five years (Exhibit 5). All in all, Jim forecasted his first store could generate a net income of $90 thousand the first year and at least $190 thousand the following years if the revenues and costs were to stay constant over time.

5. TIME FOR A DECISION

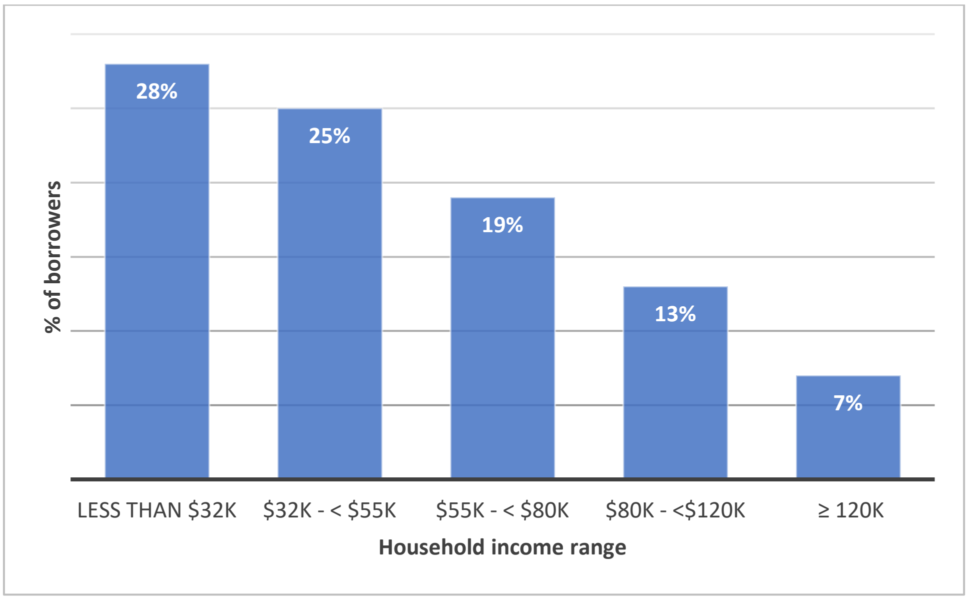
It took Jim Kamal several weeks to gather and analyze a significant amount of information about the payday loan industry in general and the Edmonton market in particular. Keeping true to his personal values, he thought about the users of such loans as both potential clients and "normal human beings." While looking into the demographics of the market, he could not help but think that his parents could have been his clients if they could go back to his childhood time. After all, he still could remember how hard it was for his parents to make ends meet financially at the end of every month when he was a child. Would it be fair for him to take advantage of the underprivileged population that formed the main clientele of payday loans? His ultimate dilemma was whether he could "do well while doing good" in such business?

Exhibits

Exhibit 1: Cost comparison of Payday Loans with other ways of short-term borrowing

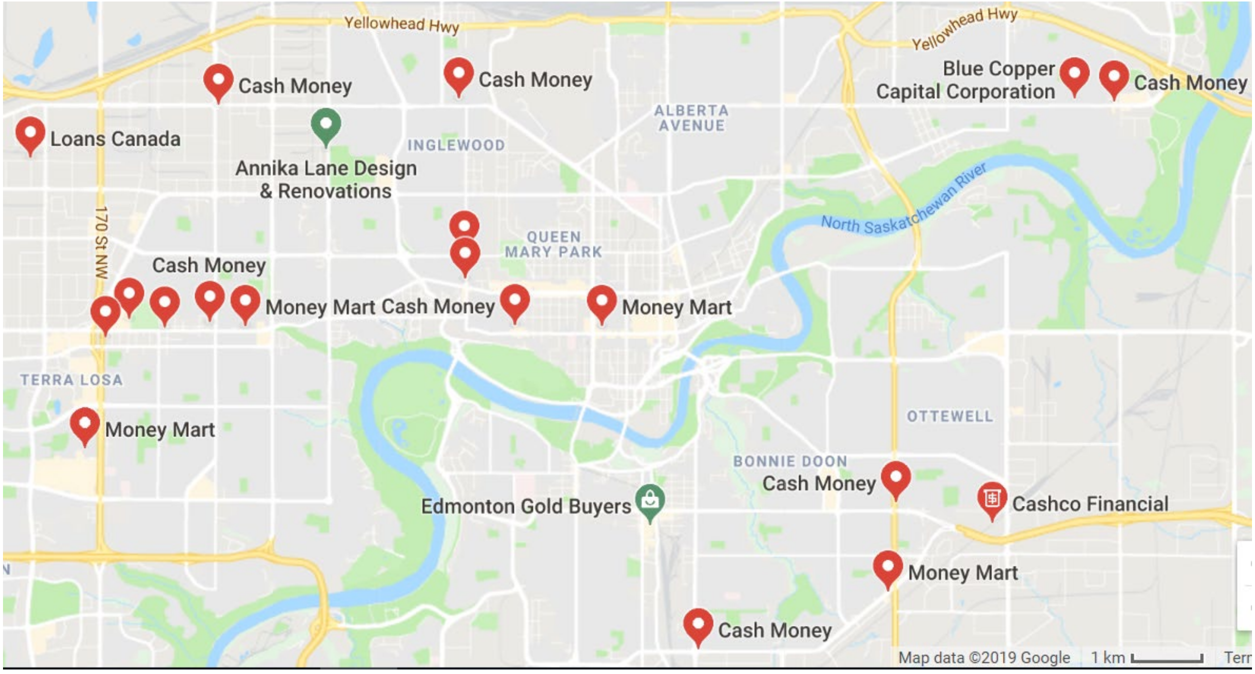
Source: Adapted from the "Payday Loans: Market Trends" report by Financial Consumer Agency of Canada, October 25, 2016.

Exhibit 2: Income Profile of Payday Loan Borrowers



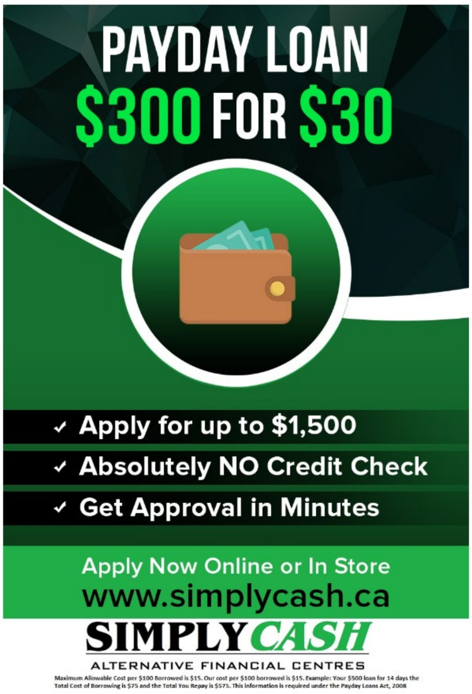
Source: Adapted from the "Payday Loans: Market Trends" report by Financial Consumer Agency of Canada, October 25, 2016.

Exhibit 3: Distribution of Payday Loan Stores in Edmonton



Source: Authors' web search for payday loan stores in Edmonton (April 15, 2019)

Exhibit 4: Sample advertisement for a payday loan in Canada



Source: www.simplycash.ca/franchise.html

Exhibit 5: Operational and Franchising Costs of a Payday Store in Edmonton

Start-up Cost (one-time, first year only)		***Operating Costs (recurring, yearly)****	
Franchise access fee	$30,000	Rental Fee	$30,000
Legal fees	$10,000	Utilities	$10,000
Other Startup Costs: Improvement, training, software, signage	$60,000	Extra employee	$60,000
		Working Capital	$150,000
Total	$100,000	Total	$250,000

* In addition to the above fixed costs, franchisees pay an ongoing royalty fee of 8% of gross earnings.

Source: Compiled by the case authors based on public sources.

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