

**Proponents view cash advance as a value-add and capital source; opponents suggest risk outweighs rewards**

# Winning and Losing With Cash Advance

By Lisa Dowling

## KEY NOTES

- ▶▶ Many companies view cash advance programs as a cash cow, yet few understand the risks.
- ▶▶ When used appropriately, cash advance programs can provide a strong value-added product similar to gift and loyalty cards or check conversion.
- ▶▶ Work with partners who are mindful of best practices and provide merchants with a responsible level of capital. (See ETA Cash Advance white paper summary on page 30.)
- ▶▶ Before adding cash advance to your portfolio, determine who is assuming the risk and how collections are handled.

**W**hile cash advance programs are the latest breakout idea for brick-and-mortar retailers, not everyone is convinced they're a winning strategy. Some view cash advance as a get-rich-quick scheme that builds little long-term business. Others say that with careful planning and attention to key relationships, cash advance can boost merchant portfolio valuation.

Cash advance is hardly a new concept: In the late 1970s, American Express began advancing money to merchants in the hospitality industry. The practice gained momentum as entrepreneurs realized this specialized program didn't have to be limited to one market and seized upon an opportunity to provide financial benefits to a variety of industries. It quickly picked up steam and started attracting a broader range of merchants. Its impact on the industry, however, has not been widely documented.

Today, decreasing margins and increasing competition have attracted the ISO community to cash advance to replace lost income. And ISOs also need a product offering to retain merchants lured away by companies offering funding.

While most ISOs have turned to third-party providers for cash advance, the challenge is selecting the appropriate partner. Within the last year, many companies have come onto the scene offering cash





advance programs because they see it as an easy way to make fast money. Unfortunately, too few seem to understand the risks involved or how to properly service the offering.

### Getting in the Game

When used appropriately, cash advance is a strong value-added product similar to gift and loyalty cards or check conversion, some organizations maintain. For most ISOs, any product that ties a merchant closer to them is a valuable asset. And with major processors now having technological capabilities to split batch funding, acquirers are diving into the cash advance pool. But like this burgeoning service, regulation of practices like split batch funding is evolving.

One of the first players on the cash advance field was AdvanceMe in Kennesaw, Georgia. Since 1998, the company has provided more than \$1 billion to more than 20,000 small to mid-sized retailers. That experience has helped the company craft a successful strategy that responds to the changing industry.

“Over past year, traditional lenders have continued to tighten their purse strings, making less money available to fewer people at higher costs with more restrictions,” says Glenn Goldman, CEO of Capital Access Network, the parent company of AdvanceMe. “We are able to provide capital to folks that traditional lenders are turning away, and we do it in a very responsible way.”

AdvanceMe works directly with retailers, and partners with processors and acquirers who can choose to private label the program. Because this may be viewed as a conflict of interest, AdvanceMe implements another practice to counteract concerns.

“We have arrangements with ISOs, acquirers, and processors in which we have a hands-off policy,” says Goldman. “This policy is in all of our control sales channels. We work with 13 different processors and make sure we’re not actively moving merchants from one of our partners to another.”

AdvanceMe markets its product directly into ISO and acquirer customer bases, assuming marketing expenses and paying the ISO a fee for every funding. Cash advance works for any merchant that has the sufficient margins to support the cost, maintains Goldman. The only potential drawback is working with the wrong type of partner—one who isn’t mindful of best practices and doesn’t provide a responsible level of capital to merchants.

“Our business model relies on renewals, and our profitability relies on high renewal rates,” Goldman explains. “We provide capital in a way that is very cash-flow friendly. If we give merchants more than their business supports, they can’t renew and everyone loses. The merchant goes out of business, the processor loses a customer, and the ISO loses residuals.”

AdvanceMe requires businesses to be established for more than one year and

process at least \$3,000 in monthly credit card transactions. To ensure the advance will be spent toward expansion, not a last-ditch effort to save the store, the company never funds more than 9 percent of any merchant’s total monthly revenue. And when it comes to collection, AdvanceMe has every incentive to keep the relationship of all parties intact.

“All our collection practices are designed around treating merchants respectfully so they’ll want to do business with us again,” says Goldman. “Our success relies not only on repeat customers but also on strong partnerships with processors and ISOs. If we don’t treat their merchants well, they won’t work with us.” Other providers view relationships as equally important, but for different reasons. RapidAdvance, with the help of consulting firm First Annapolis, advances more than \$100 million to merchants based on their future income streams. The catch is that these more than 5,000 merchants must use RapidAdvance’s processor—a requirement that all cash advance companies enforce. While opponents of cash advance programs perceive this approach as conflict of interest, RapidAdvance’s leaders disagree, claiming that they create an opportunity for ISOs to put a new value-added product into their tool bags.

“If we come across a merchant who is already working with our processor, we approach their ISO with the hope that since there is an existing relationship, we can help them keep that merchant,” says Jeremy Brown, co-founder, president, and COO of RapidAdvance, which has been operating a successful cash advance business since 2004. “It may sound harsh, but if an ISO already had a partnership with us, its merchants would not have to go to another processor to get an advance.”

“Cash advance is a solution for a small number of merchants,” adds Matt Freedman, COO of Total Merchant Services (TMS), which recently responded to the fall of home equity loans and standard lines of credit by adopting a cash advance process.

“We don’t recommend giving funds to merchants who can’t do something productive with it. It is a short-term financial solution that will have long-term results

when applied correctly, such as to increase inventory, make repairs, or build infrastructure. The merchants who use it to float their business are the ones who will fail. The money must be used strategically and not to finance a struggling operation.”

### Managing the Curveballs

Risk is certainly one area of concern in the ISO community. While some cash advance companies treat their product as a loan, others consider it a sale. Those considering it a sale assume significant risk because cash advances are traditionally unsecured with no personal guarantee or collateral.

And providers also differ over how to handle collections of the advances—an important consideration for ISOs. “We collect just like a bank would,” says Brown, explaining that the company’s underwriting process helps ensure merchants don’t take money that they can’t pay back.

United Bank Card (UBC) actually steers its merchants away from cash advance as much as possible. Although cash advance is among the company’s offerings, it doesn’t promote cash advance or push it as a lead-in product.

“I believe cash advance is fundamentally counter-productive for what we do,” asserts

Jared Isaacman, president and CEO of UBC. “We are in the business of recurring revenue, and cash advance is a very short-term residual. With cash advance, you don’t have any long-term security with a merchant. One or two life cycles of six months and the merchant is gone. And, with the type of high interest rate and repayment, your merchant’s business would have to do a 180-degree turn to survive it.”

A cash advance isn’t the same as hard money, says Isaacman. A loan at usury limit is still amortized over a few years with a pre-selected repayment date—not so with cash advances. The repayment structure can cripple businesses because they are paying back 25 to 35 percent interest each day and have no flexibility on cash flow, Isaacman says.

Still, many in the ISO community have embraced cash advance to balance lost earnings on equipment. Enticed by the prospect of making thousands of dollars upfront, many fail to consider the overwhelming short-term financial commitment on the merchant. Isaacman recommends alternatives such as taking a small business loan or asking family members and friends.

“If there is nothing else available, do the cash advance but don’t count on that merchant being there in 12 months,” he says. “That’s my opinion, but my personal views on products and services can’t influence the entire sales force of our company. We do have to give our agents all options.”

Today, companies eager to take on desperate merchants raise delinquency rates and prompt intervention and regulation, Isaacman explains. Income from cash advances could dwindle considerably and ultimately disappear.

Another problem is that neither Visa nor MasterCard likes anyone but acquirers touching settlement funds. That can be an issue when it comes to cash advance companies and in-house programs—another new avenue being pursued by some of UBC’s competitors to ensure merchant retention.

“Merchant-level salespeople (MLS) need to consider what they are mixing there,” says Isaacman. “Is your ISO appropriately separating settlement funds? Every decision I make reflects on my agents’ residual streams. If I make a bad business decision, it puts their revenue in jeopardy. If I take cash advance in-house, and the FTC chooses to

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make me an example and shut me down, it shoots down all our MLS residuals. In-house programs heavily co-mingle cash advances with Visa and MasterCard funds. I don't see how they're going to allow it."

Isaacman advises ISOs looking to offer cash advance to concentrate only on merchants that really need it and be aware that it is a solution to satisfy a short-term need. It shouldn't be the mainstay of any portfolio.

Abuses are happening, especially by companies that have expectations of easy money. TMS's Freedman believes irresponsible advancements will only lead to financial ruin. But if companies establish real relationships with their merchants, they are more likely to stay in those relationships.

"Don't give them too much money up front. If you advance them up to two times what they make in a month, you'll create a long leash with a lot of slack in the line. If you're waterskiing and try to make a turn with that much slack, you'll crash and go under. It's the same when you underwrite a deal," says Freedman.

TMS reviews each merchant's personal credit history, the type of business, and how long it has been in business. The company also considers the consistency of the merchant's processing volume and evaluates the merchant's expenditures and stability;

### Pick Your Players Wisely

Thinking of adding a cash advance partner to your team? Due diligence is key. Jeremy Brown of RapidAdvance suggests asking yourself these questions:

- Does the provider have the same standards of conduct as you?
- Does the provider have an underwriting approach that is easy to sell?
- What is the provider's financial situation? Who holds the purse strings?
- Is the current credit crunch affecting this provider's financing?
- Are you receiving a competitive commission rate?

requires the last three months' credit card, checking, and bank statements; and matches up batch depositions with statements to ensure no one is split funding. Additionally, TMS makes sure the merchant doesn't already have a cash advance with another company and conducts a UCC search to determine if any federal or state tax liens have been levied against the merchant.

"We even check with the merchant's landlord to see if they are current with their rent," says Freedman. "If not, we'll split the cash advance and give the landlord a portion of the money to get that merchant current with their rent. We look at everything because we want them to stay in business."

TMS is conservative when it comes to cash advance limits, offering less than half of the industry norm of \$250,000 and focusing on having accounts between \$5,000 and \$50,000 in advance funding, rather than a few with huge amounts. "We also have an interest ceiling, never exceeding 20 percent," says Freedman. "If a merchant can't survive with that, I won't advance them any money."

This conservative policy has paid off: About 90 percent of TMS's advances get paid and refinanced, and the company currently services more than 500 merchants.

"I believe cash advance will become the next business standard because merchants need an alternative credit facility," says Freedman. "I can't reiterate enough that it must be done occasionally, strategically, and productively—and not seen as a constant way to finance your business. Our main focus is and always will be credit card processing and not cash advance. We offer it as a courtesy to our existing merchants and as an additional way for our sales reps to acquire new customers." **TT**

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# ETA Cash Advance Best Practices

The rapid growth of the merchant cash advance (MCA) marketplace has provided many merchants with an alternative source of funds for business development while offering ISOs a profitable new revenue stream that can help offset pricing pressures in the hyper-competitive card processing business. While there have been no major reports of increased loss to acquirers that have partnered to offer MCA programs, this growth has led to reports that some organizations may be engaging in questionable sales practices that threaten the reputation of the merchant acquiring industry and attract unwanted attention from federal and state lawmakers and regulators.

Consistent with the principles established in its Code of Conduct, the ETA Risk and Fraud Management Committee has established a set of best practices that set forth a framework for acquirers and ISOs to assess the business practices of the merchant cash advance companies (MCACs) they select as vendors or with whom they otherwise have relationships. These practices foster ethical behavior, which furthers industry success and growth.

*When selecting an MCAC, acquirers and ISOs should confirm that the MCAC adheres to the following practice and guidelines:*

**Be Fair and Sustainable.** Due to a variety of factors, merchants who apply for a cash advance based on payment processing often are not able to obtain funds from traditional methods (such as bank lending or corporate financing). As such, it is important that the retrieval percentage be fixed and set at a reasonable level to ensure that merchants are able to maintain an appropriate and predictable cash flow to operate their businesses. In the underwriting process, pay careful attention to the merchant's processing history, business plan (including proposed use of funds), cash flow position (including the cash flow once payments are being made), profit margins, and the overall health of the business prior to establishing the retrieval percentage.

**Disclose Terms and Conditions and Accurately Present the Product.** All marketing materials and contractual documents for a cash advance should accurately represent the terms and conditions of the product and all the principles involved in the product offering to the merchant. Contracts should clearly and conspicuously disclose:

- the name of the funding source
- the actual repayment/pay-back percentage
- the purchase price paid
- the value of the receivables sold
- all fees.

Additionally, when marketing the product, the criteria for qualification should be clearly and conspicuously disclosed. Any change in the terms or conditions of the cash advance must require the written consent of the merchant.

**Avoid Merchants with High Chargeback Levels.** The majority of cash advances are given to face-to-face merchants with a minimal number of chargebacks on their processing statements. Chargebacks should not be the normal course of business of any merchant receiving an advance because they threaten the integrity of the payments system.

**Avoid Merchants with Existing Cash Advances.** Most cash advance contracts require merchants to disclose outstanding obligations. However, some merchants may knowingly withhold the existence of obligations to obtain additional funding. This issue is further complicated by the fact that MCAC inquiries may not be readily apparent on a credit report because they are not a specifically identified business category to the credit bureaus. (MCACs do not generally report advances to the credit bureaus because most do not involve a personal guarantee). To the extent an MCA provider obtains consumer credit reports, procedures should be in place to identify an inquiry as one from an MCAC where possible.

**Limit Multiple Advances to a Single Merchant.** To effectively manage risk and prevent a merchant from becoming over-extended, do not allow merchants to "stack" advances (receive an additional advance while they have an outstanding balance on a previous advance). In the event additional advances are sought, the original advance should be paid off directly to the previous MCA provider by the new MCA provider (to ensure that the merchant doesn't keep money owed to the previous MCA provider) with a portion of the proceeds given on the current advance.

**Review Merchant Activity.** MCACs should diligently monitor the processing volumes of their merchants on an ongoing basis to identify any significant changes that could indicate an issue with a merchant and should be investigated.

**Educate Merchants and Set Customer Service Principles.** The MCAC must have practices and procedures in place to ensure the merchant understands the terms of the advance. Additionally, the MCAC should establish benchmarks for customer service response (for example, inquiries must be addressed within 24 hours) to provide ongoing support to the merchant and strengthen the processing system.

**Ensure PCI Compliance.** MCACs that handle sensitive payment related information subject to the Payment Card Industry Data Security Standards must fully comply with the standards.

*When performing services on behalf of MCACs, acquirers and ISOs should adhere to the following practices and guidelines:*

**Adhere to Applicable Regulations.** To preserve the accounting integrity of the card payment system, any repayment processes established by acquirers and ISOs to forward funds to MCACs must comply with all applicable operating regulations and guidelines issued by the payment networks. Acquirers and ISOs are expected to clearly and conspicuously disclose to merchants the procedures established for repayment, or verify that the MCAC is doing so.

**Share Information.** Acquirers, ISOs, and MCACs should work together to create a process for identifying merchants that have fraudulently obtained cash advances. Additionally, acquirers and ISOs should, to the fullest extent possible, work together to coordinate ongoing risk monitoring of the merchant as well as to ensure adequate levels of customer support and awareness are provided to the merchant.