ON-DEMAND PAY ASSETS: PRIMER

EDITION II

DAILYPAY CAPITAL MARKETS

KEY POINTS

- *Generational and demographic changes have impacted how employees approach their pay. Thanks to technological improvements, employees now are able to access their pay instantly.*
- *To service this increased demand, providers of on-demand pay have emerged in the marketplace. However, while their missions may seem similar, on-demand pay providers come in a variety of business models, which leads to significant variance in the nature and quality of the assets each provider originates.*
- *This paper provides an overview of the market, with the goal of helping readers gain familiarity with this asset class. This overview will cover the characteristics of the market today and the potential risks to investors interested in financing or investing in on-demand pay assets.*

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I. INTRODUCTION TO ON-DEMAND PAY ASSETS

Generational and technological changes have impacted the U.S. workforce in many different ways, including the way Americans approach work. One of the current discussion points among Human Resources specialists and the C-suite is finding a solution to the high attrition rate (and its corresponding cost) affecting corporate America. One solution has emerged: the daily pay or on-demand pay ("ODP") benefit.

The ODP benefit is one of the first innovations in payroll since direct deposit came about more than 50 years ago. While the payroll industry has been slow to adopt new solutions, market changes have made this benefit an increasingly vital requirement for many businesses. ODP generally refers to payments made by a third-party vendor/provider to an employee prior to a scheduled payday. The payment amounts are repaid at a future point in time, typically on payday, either by the employer or employee. These payments can be thought of as assets and the third-party vendors/providers as asset originators.

In the last few years, a myriad of technology firms have emerged in the marketplace to offer on-demand pay. Although they may share a common mission - to provide early access to pay - these ODP providers differ drastically. Since each ODP provider offers a unique product to its client, the assets originated by these providers have a different legal, risk and reward profile. In order to distinguish between the assets, it is important to focus on three primary aspects with respect to the way providers originate assets: **(1) Repayment Source, (2) Worked Hours Validation Process,** and **(3) Fee Structure.**

These distinctions are the key differentiators between ODP assets. They lead to vast variance in the quality and nature of the ODP asset (e.g., receivable vs. loan, employer credit risk vs. employee credit risk, etc.). This paper aims to provide an overview of the market forces that led to the emergence of these ODP providers, and the key risks that investors must be mindful of in pricing ODP assets.

II. WHAT IS THE DRIVING FORCE BEHIND THE CREATION OF ODP ASSETS?

The makeup of the U.S. workforce is changing. According to Forbes[1], millennials and Gen Z will comprise more than 75% of the workforce by 2025; they have very different needs and expectations from previous generations when it comes to how they want to be paid. In addition, 78% of all Americans in the workforce are living paycheck to paycheck[2], with little to no savings should an unexpected expense arise.

These market trends have led to the identification of two distinct types of employees who will come to expect a daily pay benefit as the norm.

The first of these two groups are **ERINs** (**E**mployees **R**equiring **I**ncome **N**ow). ERINs require their pay today and can't wait until payday because they have bills due before then. Many employees in this class represent those 78% of Americans who are living paycheck to paycheck. A large number of ERINs are hourly employees in service-based industries, such as healthcare, hospitality, quick service restaurants, retail and nursing.

The second group are **MAGGIEs** (**M**illennials **A**nd **G**en Z who **G**et **I**nstant **E**verything). These are the two generations in the workforce who grew up as digital natives. As adults, they appreciate apps and technology that give them control and provide instant value. Accessing all

[1] https://www.forbes.com/sites/workday/2016/05/05/workforce-2020-what-you-need-to-know-now/#164

[2] https://www.cnbc.com/2017/08/24/most-americans-live-paycheck-to-paycheck.html

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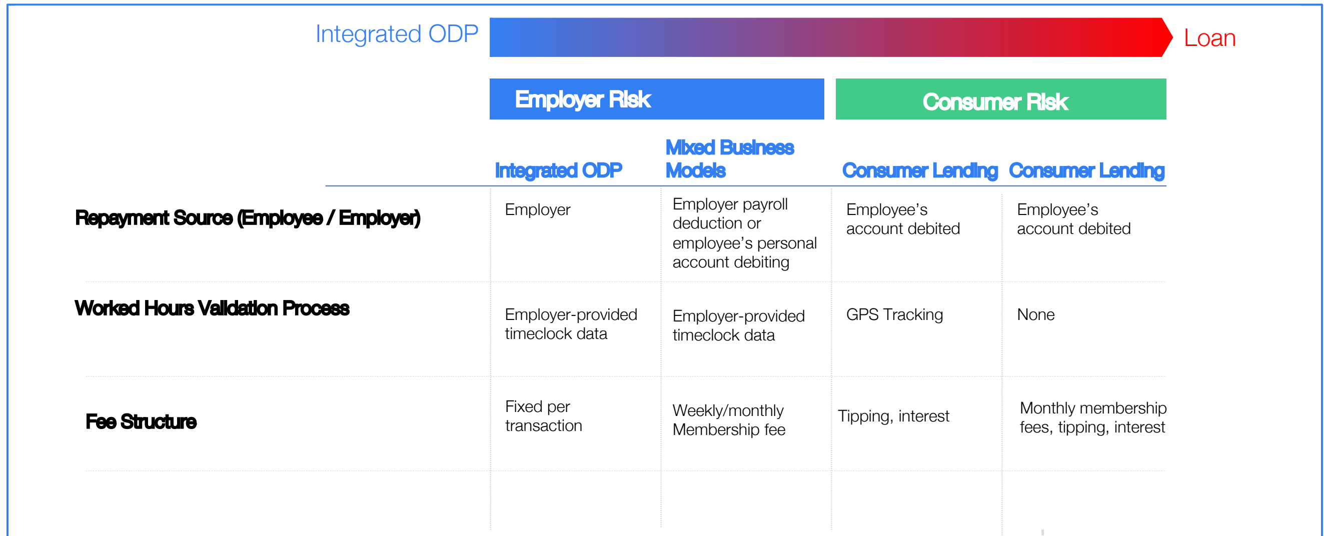
FIGURE 1



	Integrated ODP	Mixed Business Models	Consumer Lending	Consumer Lending
Repayment Source (Employee / Employer)	Employer	Employer payroll deduction or employee's personal account debiting	Employee's account debited	Employee's account debited
Worked Hours Validation Process	Employer-provided timeclock data	Employer-provided timeclock data	GPS Tracking	None
Fee Structure	Fixed per transaction	Weekly/monthly Membership fee	Tipping, interest	Monthly membership fees, tipping, interest

Figure 1: Spectrum of ODP assets originated varying according to the business model

kinds of information via technology, they often seek and expect immediate feedback, including instant access to money they've already earned. For MAGGIEs, the mere fact that they don't have access to their pay on-demand is contrary to every other aspect of their lives.

Employers need ways to attract and retain qualified workers (particularly ERINs and MAGGIEs) in notoriously high turnover/tight margin industries. For entry-level positions, it costs roughly 16% of an annual salary to replace a worker who leaves. For mid-range positions, it costs approximately 20% while high level/highly skilled positions can cost up to 213% of an annual salary to replace. High turnover also leads to other complications for the employers (e.g., lost productivity, decreased morale).

Many employers look for solutions that meet employees' exigent requirements. Flexible schedules, learning and development programs, and wellness benefits are some of the solutions employers are implementing to tackle turnover. ODP in the form of a daily pay benefit is another one.

Our own research shows that employers, on average, have seen a 41% decrease in turnover as a direct result of offering a daily pay benefit. They also find that they fill open positions 52% faster than organizations that don't offer a daily pay benefit. For many organizations, offering the ODP benefit through the right provider is also cost-effective[3].

III. DISTINGUISHING ODP PROVIDERS AND THE ASSETS THEY ORIGINATE

At first glance, these companies appear to share a common mission - to provide early access to pay. However, unlike in some other asset classes (such as residential mortgages) where standardization and pricing protocols exist, it would be a mistake to believe that all ODP assets are created equally. ODP providers drastically differ in their business models (for example, in the way the advance payments are repaid). This results in significant differences in risks and rewards for the ultimate assets originated. Indeed, to distinguish between the

[3] Internal DailyPay Data

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assets originated by these providers, we must focus on three parameters: **1. Repayment Source, 2. Worked Hours Validation Process,** and **3. Fee Structure.**

Figure 1 categorizes the different ODP providers business models based on the three parameters outlined above. We have grouped these business models into the following general categories:

- **Wage Receivable "Purchase":** Under this approach, the ODP provider "purchases" the wage receivable an employee has against his/her employer against the payment of a fixed fee. The available balance (and thus exposure) is determined based on employer's data and the obligor is the employer.

- **Income Lending:** This model relies on employee provided information to provide loan-like advances. The exposure is determined based on employee's work data and credit risk is to employee.

- **Cash Flow Lending:** This model relies on estimated cash flows (work and non-work-related cash flows) based on historical analysis by ODP provider. The exposure is determined based on the ODP provider estimates and credit risk is to employee.

- **Mixed Business Models:** This model relies on two distinct cash repayment models. The rationale for having a mixed model is to circumvent state regulations - in the U.S. states where payroll wage deductions are prohibited, employee's current account debiting is used. The exposure is determined based on employer's data but the obligor is either the employer or the employee.

The parameters described are explored in greater detail below.

1. Repayment Source

The likelihood of repayment for ODP assets depends on who the obligor is. By and large, there exist two repayment sources: employee or employer.

In the employee payback model, the vendor assumes unsecured consumer credit risk and directly debits the consumer's personal bank account in order to recoup any payments made. Though these models purport to be "non-recourse," they require direct payback from employees, which is a typical characteristic of an unsecured consumer loan. These models resemble the payday lending framework (reliance on debiting the consumer 's personal bank account, payday lending collection practices, overdrafts/NSF fees to the employee). Generally, employee's personal account-debiting models are considered consumer lending, where the ultimate credit risk is to the individual employee.

In the employer payback model, the vendor relies on the employer's ability to fund payroll to make the ODP provider whole for advances. In this way, it is akin to corporate lending, especially in the case where the ODP provider relies on employer's data to determine the face value of the ODP asset. For example, in the WRAP model (see below), the ODP provider integrates its instant pay process into the employer payroll process. In this construct, the vendor assumes the risk of non-payment from the employer (i.e, bankruptcy/credit risk). There is no interaction with the consumer as it relates to any payback of funds. There is no collection from the consumer, including in the event the employer fails to make payroll. This method protects the transaction from being characterized as consumer lending. The advances are made to the employee, but the

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source of repayment/ultimate obligor is the employer.

2. Worked Hours Validation Process

Employer Integration vs. Bank Account Access

The value of an ODP asset is linked to the number of hours worked by the employee requesting the advance. ODP providers use different methodologies with varying degrees of accuracy to calculate the value of the ODP assets.

Certain ODP providers integrate directly with an employer's time management system ("TMS") to determine the number of hours/days worked at any given time for any given employee. Having a direct connection to an employer's TMS, updated on a daily/regular basis, allows an ODP provider to accurately calculate ODP assets as directly tied to the hours actually worked by the employee. However, since most employers' payroll processes are iterative, more sophisticated ODP providers are able to validate employees' available balance amounts by reconciling the flow of raw data provided by employers within a pay period and/or between pay periods (see WRAP model below). This creates an additional layer of protection, reducing operational risk.

Other ODP providers approach the exposure determination differently. These ODP providers attempt to estimate the amount of advances on the regularity and size of cash flows through access of an employee's bank account. This methodology is subject to significant variability and risk, as it cannot be ascertained whether or not an employee has worked or is still employed. Inaccurate data can result in ODP providers advancing funds in excess of the wages earned; this may force those ODP providers to adopt the behaviors of payday lenders, such as employee personal account debiting methods and aggressive collection practices.

As one can imagine, the source and quality of the wage data is a sizable component in determining the quality of the receivable.[4] It is helpful to take a more specific look at the manner in which each model estimates pay data.

Data Sourcing Segmentation

There are 4 types of data sourcing, ranked by degree of accuracy:

- **Employer-provided raw data with cross validation**

  Direct feed from TMS of companies or third-party payroll providers, with intra and inter period cross-validation of employer data.

- **Employer-provided raw data**

  Direct feed from TMS of companies or third-party payroll providers.

- **Employee-provided data (income-based model)**

  GPS location or other non-employer-based ways to ascertain employees have performed work through bank account access.

- **ODP provider estimates or projections (cash flow-based model)**

[4] It must be noted that daily payroll funded by the employer do not constitute an ODP asset since the funding/advance are provided by the employer - consequently such assets have not been included in our analysis.

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Estimates of cash flows from employee bank account activity through bank account access.

FIGURE 2

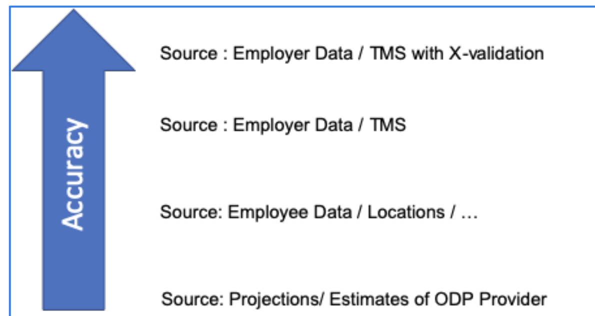

Figure 2: Data sourcing accuracy scale

The pricing risk of each model described increases as one goes through the sources of data in order (see Figure 2). It is important to consider the manner in which timekeeping data is gathered and utilized by originators in the ODP space.

3. Fee Structure

Fees to ODP providers also depend on the business model of the provider. Certain ODP providers utilize a fixed fee that does not vary regardless of size or duration of a transaction. Other models rely on periodic subscription charges to either the employer or employee, regardless of the service being used or not. Finally, consumer-based ODP providers rely on variable fee such as tips or interest that are dependent upon size, duration and number of advances, and represent notional-based calculations per transaction (similar to lending).

The differentiation inherent in providers who utilize various elements of the feature sets described above can definitionally alter the nature and quality of the asset provided. Below, we assess two examples of ODP provider models that clarify the practical impact of these differences.

4. ODP Asset Examples: two opposite models

To illustrate the above, we have described the characteristics of two typical asset classes originated by ODP providers that have diametrically opposed business models.

- **Model A - WRAP Model (Employer Risk / Employer Data / Fixed Fee)**

  In its simplest form, the origination process for an ODP asset is similar to that of a factoring-like transaction. In substance, an ODP provider "purchases" from the employee the right to collect the payments owed (for unpaid but earned wages) under her employment agreement with her employer. In exchange for receiving her wages early, the employee pays a fixed fee (or a discount) to the ODP provider. This origination process is commonly referred to as Wage Receivable Asset Purchase ("WRAP transaction," and by extension the receivables originated as "WRAPs"). After the WRAP transaction, the employee has completed his/her part of the transaction and the ODP provider has recourse to the employer as the obligor of the wage receivable (but no recourse whatsoever to the employee). It is important to note that the ODP provider does not provide a loan against future wages.

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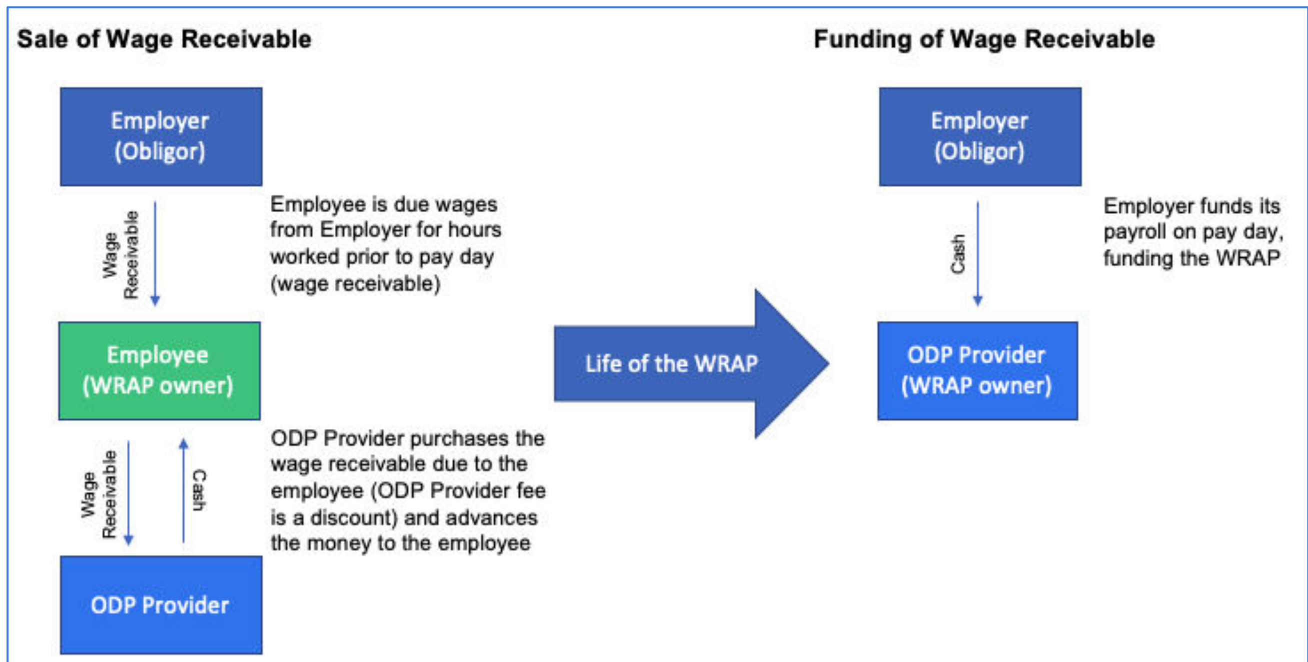

FIGURE 3

Figure 3: Creation of wage receivable asset

- **Model B - Consumer lending (Employee Risk / Cash Flow Projections / Variable Fee)**

  The consumer lending model for an ODP assets is not based on the "purchase" of employee receivables earned via her labor. Instead, the ODP provider fronts money to the employee, and debits the employee's personal account for repayment. The ODP provider estimates the value of the receivable by estimating cash flows based on prior movements in the bank account of the employee, and before those payments are due, the ODP provider will debit the employee's personal bank account. Since money comes out of the employee current account to fund the receivable, the transaction resembles a loan because the recipient of the advance is the source of repayment. In some cases, the ODP provider is compensated for the transaction by a "tip" that may be variable according to amounts and size of the transactions. The debiting and tip payment can cause issues for employees, as an employee may be unaware of the debit and may not have enough money in their account to fulfill the debit, pushing the employee into overdraft fees.

As discussed in the above, the business models of ODP providers lead to a variety of assets being originated. On a spectrum, WRAP transactions are regarded as the safest as they rely on the employer's TMS data and the credit risk of the employer. On the other hand, consumer lending that relies on projections of future cash flows based on previous cash flows regardless of whether an employee worked or not, or assumptions regarding the amount of money in an employee's bank account based on non-work-related sources, not only expose investors to consumer credit risk, but can lead to other regulatory or

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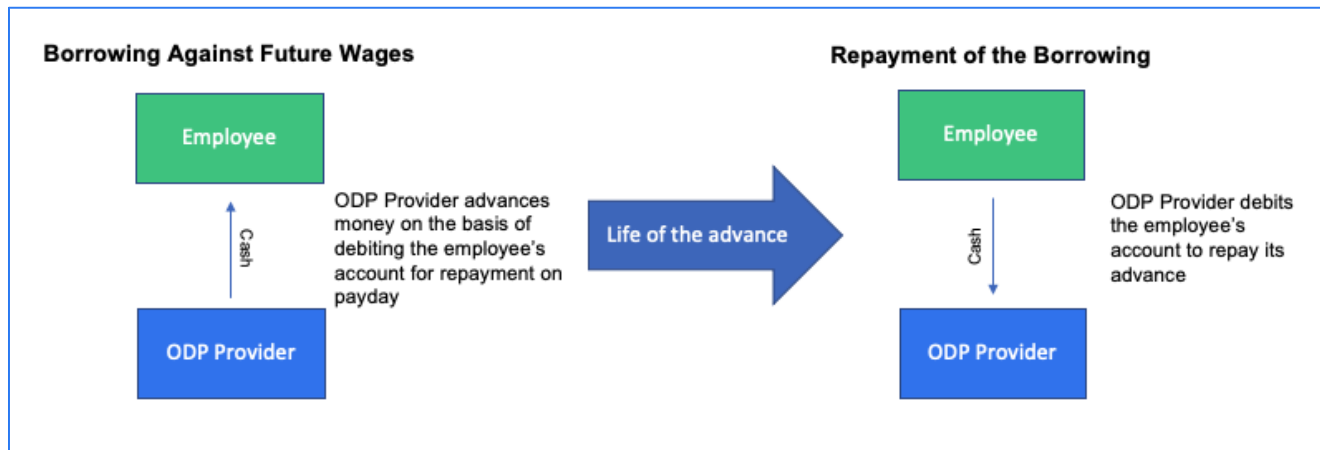

FIGURE 4

Figure 4: Creation of wage-based consumer loan

legal actions. For example, some exposures could be reclassified as payday loans or the validity of the ODP provider claim could be challenged. Below, we will explore the risks that certain of these receivables may present to an investor.

IV. WHAT ARE THE RISKS LINKED TO ODP RECEIVABLES?

In order to support the sorting and ranking of ODP assets, we have focused our attention on two main risk classes that are driving the actual value of ODP assets - credit risk and operational risk. In addition to those two risk classes, we have provided further background to non-core (i.e. basis) risks inherent to this asset class.

1. Credit Risk

Credit risk is most simply defined as the potential that a counterparty will fail to meet its obligations in accordance with agreed terms. More specifically, in the context of ODP providers, credit risk is the risk that the ultimate obligor fails to reimburse an advance made by an ODP provider. To assess this credit risk, investors should rely on the fundamental credit analysis used in the account receivables financing. In other words, in analyzing an ODP Asset, one must try to determine the probability of a failure to receive repayment (**Probability of Default**) over the maturity of the exposure (**Exposure Duration**), by determining how much exposure one has to the obligor (**Exposure at Default**) at any point in time, and if the obligor defaults, how much money one will actually lose (**Loss Given Default**).

In the context of ODP assets, we define the above credit risk parameters as follows:

- **PD (Probability of Default)**

  a. *Corporate credit risk:* the probability that an employer company will not have sufficient funds to meet its business-as-usual payroll obligation, either on time or at all.
  b. *Consumer lending - Consumer credit risk:* the probability that an employee will not have sufficient funds in his/her bank accounts to cover advances made.

- **LGD / Loss Rate (Loss Given Default)**

  The amount of actual loss incurred upon the default of the obligor (either employer or employee). For example:

a. *WRAP transaction:* In determining recovery, the priority ranking of wages and salaries in bankruptcy must be considered in. The priority treatment of wages in bankruptcy supports assumptions of higher recovery compared to unsecured credit risk present in most account receivables.

b. *Consumer lending:* Consumer finance recovery is extremely difficult to quantify and thus must be approached conservatively.

c. Mix of the above.

- **EaD (Exposure at Default)**

  The total amount of advances made during a payroll period. The advances can be based on multiple methodologies - e.g., based on an estimated available balance amount to be transferred, after taking into account all possible deductions that will occur during processing of payroll. In addition, an advance rate (as a percentage of the exposure) may be applied to the estimated balance of hours.

- **M (Exposure Duration)**

  Duration of the advances is in general very short. Typically, the duration is 1 to 2 weeks.

2. Operational Risk

As is customary in the financing of account receivables, the determination of the actual amount owed is an important factor in the investment decision. Alongside credit risk, there are a variety of other risks attached to the financing of receivables. In the following section, we will focus on the operational risks inherent to this specific asset class. Unlike other asset classes, ODP assets are dependent on the ability to estimate with accuracy the amount of money earned by the employee requesting the advance.

For example, in the WRAP transaction model described above, the calculation of the available balance starts with raw hours data from the TMS. The ODP provider receives from an employer their employees' unapproved hours from the TMS. The determination of the amount owed is dependent on the data accuracy of the TMS **(Data Accuracy Risk)**. In addition, the ability to dynamically calculate this exposure as the number of hours are being accrued, the amount of deductions, and garnishments as the value changes over time is an equally important factor (**Available Balance Determination Risk**). As part of the payroll process, intermediaries may be used to process all of the steps required (hours calculation, hours validation, funding and payments of payroll), and the higher the number of intermediaries, the higher the risk (**Payroll Intermediary Risk**). By the nature of the business model, the WRAP transaction structure is less risky from an operational perspective as it relies on well-established corporate practice rather than a large pool of consumers with idiosyncratic behaviors and unpredictable risk metrics.

In the context of ODP assets, we define the operational risk parameters as follows. Again, because of the disparity in the business models, it is difficult to group all ODP providers under one mantle.

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FIGURE 5

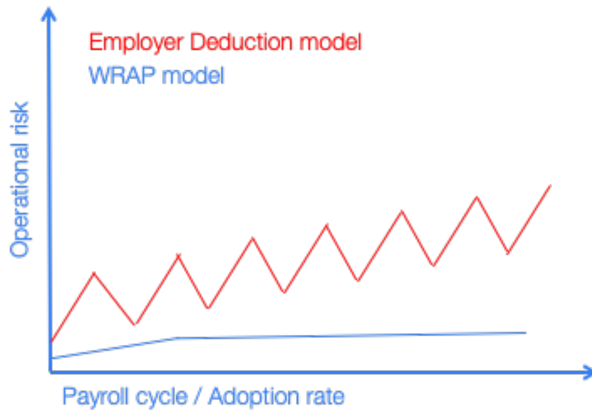

Figure 5: Changes in the operational risk as the number of users increase over multiple payroll cycles

- **DAR (Data Accuracy Risk)**

  Risk of not having or having imperfect access to accurate employment data (hours/days worked, employment status, garnishments, deductions etc.) that can lead to overpayment/underpayment.

  a. *Corporate sourced information*: Though these providers rely on employer data, there is risk of miscalculation if no cross-validation is performed.

  b. *Consumer lending*: For ODP providers relying on prior cash flows and bank account tracking, the analysis must be more thorough but is more volatile in nature, based on the strong possibility of inaccuracy. This risk impacts the exposure value.

- **ABDR (Available Balance Determination Risk)**

  a. *Corporate sourced information:* These ODP providers receive work attendance information directly from the employer's TMS and thus may dynamically (if technology permits) and accurately estimate the amounts available for transfer.

  b. *Consumer lending:* Consumer-based ODP providers may rely on estimations and simplifying assumptions to determine the available balance for end-users.

  While both methods come with a determination risk, the latter since it relies on assumptions is more uncertain and risky.

- **PIR (Payroll Intermediary Risk)**

  Simplicity is key in the payroll payment process. The more steps or intermediaries involved in the processing and payment value chain, the higher the risk. For example, certain employer-based ODP providers may request changes to employer payroll payment processes (e.g., employers withholding advances from pay). Any changes to the existing payroll process can lead to operational losses for the ODP providers and investors.

- **PIR (ODP Provider Integration Risk)**

  As per above, avoiding complexity in the payroll process helps reduce operational (and fraud) risk. An additional source of risk arises from ODP provider integration in the existing payroll process of an employer. This risk only applies to ODP providers that are facing employer credit risk. To reduce this risk, it is paramount that the number of operations effectuated by the payroll department as a consequence of the ODP benefit is not significantly increased on an on-going basis. For instance, certain vendors utilize

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deductions for payback. This requires the employer's payroll department to update at every single pay period the amount of advances provided to the employee during the corresponding pay period. Consequently, as the employee base using the benefit increases, the number of operations (and thus related errors) increases, and cannot be reduced or eliminated (figure 5).

3. Other Risks / Basis Risks

Below are several other areas of risk that an investor must consider in his/her analysis of ODP assets.

- **Asset Growth Risk**

  The advance rate provided by ODP providers may be 50% or less of the net earnings because of the providers' inability to accurately estimate the net earnings of an employee. This has an impact on the ability of the ODP provider to grow the asset pool. Investors must thus be mindful that increase in the number of user employees does not necessarily translate into a proportional increase of the asset pool, thereby reducing the gross returns for investors.

- **Regulatory Risk**

  Some business models share similar characteristics to the lending industry. While not regulated as such, an investor must understand the fluid regulatory framework and the impact that regulatory reclassification may have on the value of an ODP asset. Investors must specifically focus on avoiding vendors who utilize practices such as personal account debiting, as they are very similar to existing payday lenders.

- **Tax**

  Because of the complexity of the tax regime and the income diversity of the U.S. workforce, taxation/deductions estimates may negatively impact the value of an ODP asset if incorrectly assessed.

- **Fraud**

  In brief, 3 types of fraud can occur.

  a. **Employee related:** this captures instances such as employee account takeover by a hacker or employee purposefully misrepresenting cash flows or earned wages.
  b. **Intermediary related:** this captures instances like an intermediary's account takeover by a hacker or intermediary diverting employers'/employees' money fraudulently to another account.
  c. **Employer related:** this captures instances such as employer's payment account takeover by a hacker or employer diverting employees' money fraudulently to another account.

V. CONCLUSION

Technological improvements in the employment benefits space have led to the rise of the on-demand pay benefit. While the providers of this benefit may have commonalities, the product they offer, and thus the asset they originate, is as diverse as the workforce they service. Investors must be mindful of the classification differences, such as the Repayment Process or the Available Balance Determination Risk, in making their investment decision as they lead to significant variance across the assets.

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The following list outlines considerations investors may take into account in their investment decision in On-Demand Pay assets. The following list is for illustrative purposes only and is not exhaustive. In addition, this list has been sourced by the DailyPay Capital Markets internal team based on discussions with investors.

DUE DILIGENCE QUESTIONNAIRE

1. Credit Risk

Review of the credit underwriting process and criteria

Review of the complete historical data tape, with historical and cumulative loss, past-due items and exposure per counterparty

Review of the breakdown of corporate risk versus consumer risk in your asset base

Review of expected recovery rate of your asset base. Review the type of recovery per asset (corporate recovery versus consumer lending recovery)

Review of the average advance rate per counterparty (including the number of counterparties advances are limited to 50% of net earned wages).

2. Operational Risk

Review information on the process to validate worked hours including hours/ days worked, employment status, garnishments, deductions etc.

Review information on company's process to dynamically estimate the available balance for advances

Review whether changes to the payroll process of the employer are required on an on-going basis?

Review the number of added steps in the payroll process due to the integration of the On-Demand Pay benefit in the payroll process

Review the number of intermediaries (TMS provider company, payroll processing companies) in the payroll process for each employer

3. Other Risks

Review the tax classification of the ODP asset you originate

Review the number of business models used to originate the assets. For example, employer deductions and employee's personal bank account debiting in states where employer deduction is not permitted

Review the regulatory analysis of the ODP asset (including loan versus receivable classification)

Review whether there are limiting factors to the exposure growth (e.g., advance rate below 75% of net pay)?

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