WHITE PAPER

# Risk and Compliance Insights for FinTech Startups, Banks and Investors

StratisAdvisory™

# **FINTECH INNOVATION:** PROACTIVE RISK AND COMPLIANCE STRATEGIES FOR STARTUPS, BANKS AND INVESTORS

## Financial Technology Is Leading the Innovation Wave in Financial Services

The way we bank is ripe for disruption! That's the rallying cry heard consistently in conferences, articles and numerous forums. And it's for good reason. There is a clear – and growing – disconnect between banking solutions and expectations among tech-savvy consumers living in the world of cloud-based data, mobile apps and social media. Dealing with processes that require paperwork? Frustrating. Paying mandatory fees to use legacy systems that deliver clunky user experience? Unacceptable. Banks are racing to accommodate pent-up demand as financial technology (FinTech) startups create new and better ways to manage everything from micropayments to small business lending.

Financial institutions used to call the shots, bringing new products and services to market at their own pace and through their own channels. Now, they are actively tapping external innovation, both as a growth strategy and to defend their territory. Some are creating centers of excellence to gain insight into the innovation surrounding them. Others are creating venture groups and incubators to invest directly in early-stage startups to reap financial rewards and/or insource external research and development to improve their technology, consumer experience and market position.

While some aspects of the banking system, such as *solutions*, are indisputably in need of innovation, others, like *infrastructure*, are not. *Solutions* involve UIX, level of service and transaction friction — customer needs that can be addressed by a startup's value proposition. But any startup, no matter the brilliance of its team or the depth of its investors' pockets, will only be viable if it works within the parameters set by the regulatory *infrastructure* that governs the market the startup aims to disrupt. Simply put, the infrastructure represents the rules of the game, set by government, regulators and law enforcement, by which financial solution providers – banks, transmitters and others – must abide.

As the saying goes, "It takes a village to raise a child." Well, it takes an ecosystem to build the kind of startup that creates wealth while making a difference. Capital is the lifeblood of that ecosystem, and access to capital is an early filtering mechanism that separates surviving startups from those that fail. However, while money, at the end of the day, is a commodity, investors are not. Investors bring vital value to the table: connections, experience, advice, and, for FinTech, the knowledge of what it takes to thrive in a heavily regulated financial market.

Customers are so frustrated by their banks that, chances are, most FinTech startups will get some user buy-in even if they're not perfect. However, if a startup gets just a sliver of the infrastructure wrong, the startup will cede critical ground to a competitor while being stuck in a holding pattern. Worst case scenario, the company and its investors will end up on the defendant side of legal proceedings.

## Fundamental Requirements for FinTech Success

Whether or not a FinTech startup makes it depends, in large part, on its ability to master regulatory risk management and compliance operations from the get go. Any intelligent investor will strive to understand venture risk drivers like customer acquisition strategy and breakpoint dynamics before writing a term sheet. For FinTech, another core part of investment due diligence is evaluating the business model's exposure to regulatory risks. Does the team include a compliance officer with sufficient operational experience to establish and execute an infrastructure that adheres to evolving and increasingly complex compliance and regulatory reporting requirements? Based on that infrastructure, what is the probability of rapidly securing and maintaining a mandatory banking relationship? These are just some of the questions that should be asked by investors before committing capital.

## Why Is Regulatory Risk Management Critical?

First, business strategy impacts risk exposure and thus the complexity of compliance frameworks that must be developed, implemented and managed in order to meet relevant regulatory requirements. Investors knowledgeable in risk, including anti-money laundering (AML), will be able to measurably improve the chances of success for their FinTech portfolio companies.

Second, risk exposure can become a personal liability for board directors, against which neither D&O insurance nor willful blindness can protect. Unless the investor in question is a chartered financial institution, chances are, knowledge of compliance risks will be lacking. Financial infrastructure continually changes. New laws, regulations and practices take shape as markets and society evolve. The good news is that astute investors can partner with FinTech risk experts to advise the investors and the founding team on the best courses of action when strategy and compliance risk intersect. Additionally, they can advise the board of directors on ways to efficiently improve governance of the startup's risk and compliance operations.

Third, a key element of a startup's viability is its banking relationship. Not just the operational account, which handles checking, bill pay and payroll, but also the transactional account that enables the startup's users to do business with that money. Although not the de facto regulators of clients, banks are responsible for the risks their clients represent in the overall financial system and therefore must have a high level of confidence in their clients' risk management and compliance operations.

Delivery of payments-based FinTech solutions usually means operating as a "money transmitter." Most financial institutions already pause when it comes to approving bank accounts for traditional money service businesses, let alone taking on risk-inexperienced startups with business models based on new technology that engage in money transmission.

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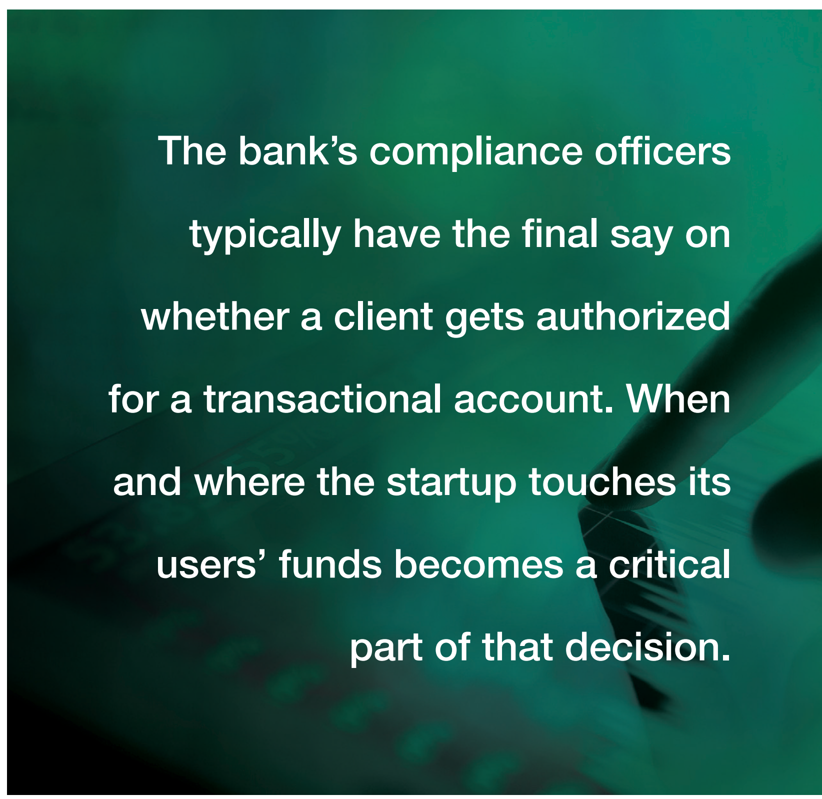
To onboard a FinTech startup, a bank must gain a comfort level with the company, its owners, its commitment to risk mitigation, and its overall transparency as an organization. That means the bank's executive management team, risk managers and compliance operations leaders all have to agree the company is an acceptable risk. The bank's compliance officers typically have the final say on whether the startup gets authorized for a transactional account. When and where the startup touches its users' funds becomes a critical part of that decision. Yet FinTech founders seldom have the risk and compliance know-how to build the frameworks that banks require to obtain and keep a transactional account.

This can present a vexing challenge to going live – one that can put an indefinite hold on providing services to potential clients and cause a startup to quickly burn through its funding without any traction to show for it. Banks are rightfully concerned about whether the FinTech team, on paper and in person, is qualified to manage risk and compliance operations, not only on day one but also as the business scales. Banks are often left to wonder whether the paper commitments submitted as part of the startup's onboarding process are actually executed. Thus, banks often must increase their due diligence efforts beyond reviewing checked boxes on forms by proactively engaging with the startup.

Typically, banks rely on an independent test – essentially a risk audit – to address this concern. While an independent test may provide some level of clarity, where FinTech startups are concerned, this test does not provide the bank with sufficient visibility of the startup's daily operations. These independent tests often barely scratch the surface. Pivots that amend the business and the operating model are common in early-stage companies and can quickly turn the independent test from relevant to irrelevant within a matter of months or even weeks. Furthermore, a poorly executed independent test can negatively impact a banking relationship quickly and reflect badly on the startup's management team if it hired a sales-centric tester to provide a clean bill of health instead of a qualified tester to deliver pertinent findings. The severity of the findings and who will fix them is the ongoing concern for the bank maintaining the startup's banking relationship.

## Overcoming Risk and Compliance Challenges

Many FinTech startups with great teams and innovative ideas have received early-stage funding only to wither on the vine as a result of a weak risk infrastructure and an unclear risk management strategy. Often, banks have exited revenue-positive companies due to the lack of compliance operations, risk mitigation, and ambivalent board directors who seem to be trying to understand the basic fundamentals of "why?" as opposed to governing the risk management strategy. Many investors have entrusted teams to manage market entry in a maze



of critical requirements that impact cash burn and revenue targets – basically navigating high seas without a map and a compass, only to see well-guided competitors sail on by.

At its core, the challenge is this: Without in-depth knowledge of the entire regulatory framework governing financial services, it is nearly impossible to know what parts of it apply to a given business model.

Two pitfalls that well-meaning startup teams often fall into are to hire a compliance executive or build a homegrown risk management program. Insourcing an expert typically comes with a corporate salary price tag that materially speeds up cash burn and often comes with a strong headwind of questionable culture fit. All too often, the startup is left with depleted cash and little to show for it. While winging it on your own definitely offers cost savings, it comes with a serious risk of poisoning the well with the bank by falling short on quality and raising concerns during regulatory examinations.

Here are some effective ways to solve these challenges:

- Build as you go. Partnering with an expert to advise on best strategy and tactics, given the ongoing business plan and pivots along the way, will increase the team's knowledge, improve overall chances of business success, and satisfy banking partners.

- Do the diligence. For a bank seeking to expand into new areas for revenue growth, brand recognition, or exploring a new client base; for a startup leveraging partners and relationships to execute a compliant platform; and for investors trying to understand whether a team can secure a banking relationship and avoid compliance pitfalls, the diligence provides actionable risk and compliance intelligence.

- Test it. Look beyond the surface to understand the level of compliance and risk from a third-party perspective. Sometimes statutory, other times proactive or reactive, however, each is a snapshot in time rather than ongoing oversight of existing operations.

- Stay connected. While banks engage in onboarding due diligence and periodic reviews, they are often resource-limited to manage their own day-to-day client risk. Startups partnering with FinTech experts on an ongoing basis provide increased transparency and comfort to banking partners who know experts are providing a skilled eye toward risk management.

## ABOUT THE AUTHORS

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Brian is a Managing Partner of Stratis Advisory with more than 15 years of experience in strategy, risk, legal, and compliance serving startups through Fortune 500 companies. He manages an international portfolio of FinTech startups, money service businesses, financial institutions, government agencies, universities, and entertainment. Brian has served as an expert in civil and regulatory matters related to AML and digital currency compliance, and international bond swaps. Moreover, he has testified before domestic and foreign governments.

Brian previously co-founded CoinComply, the first risk and compliance solutions provider devoted exclusively to the FinTech and digital currency ecosystem. Prior to CoinComply, he led Booz Allen Hamilton's West Coast strategy and risk practice on advising boards of directors, audit and compliance committees, and executive management of global financial institutions under consent orders for AML deficiencies, money service businesses, and international intelligence firms.

Brian is a recipient of Stony Brook University's 2014 Top 40 Under Forty Award. He serves as a Non-Executive Director for a global FinTech firm and is a member of the National Association of Corporate Directors, the

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Maria is a Managing Director of Stratis Advisory with 20 years of experience in business strategy, strategic R&D and risk management. She started and ran 11 new ventures in finance and technology. Prior to Stratis Advisory, Maria served as Head of R&D at SVB Financial Group where she helped create several new business lines for long-term EPS growth. Before SVB, Maria was the Founding Partner, Chief Investment Officer and Chief Compliance Officer of Green Alpha Advisors, Board member of the CFA Society of San Francisco and Board member of the Financial Women's Association of San Francisco.

Prior to that, Maria led investment research, portfolio management, product development and regulatory compliance at a boutique investment management firm and a single-family office with over $2BN in assets under management. Earlier, Maria was a C-level officer and Board director at several FinTech and software startups. She started her career in 1996 as a research analyst first at the European Bank for Reconstruction and Development and then at the Federal Reserve Bank of San Francisco.

Maria holds an MBA from Imperial College of Science and Technology in London and a BA in Economics from Boston University. Maria is a Chartered Financial Analyst, member of the CFA Institute and member of the National Association of Corporate Directors.

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## About Stratis Advisory

Stratis Advisory was founded by seasoned executives, strategy and management consultants, and serial entrepreneurs who believe in innovation and technology. We are certified as Anti-Money Laundering (CAMS) and Anti-Fraud (CFE) Professionals and are Chartered Financial Analysts (CFA) and members of the National Association of Corporate Directors (NACD) with a combined total of 40+ years in strategy, risk, and compliance.

Stratis serves as an objective resource in the FinTech ecosystem, connecting the dots between companies, investors and banks by integrating deep regulatory risk domain expertise into the broad context of business strategy, risk management and compliance operations that are right sized for the growth stage and business scale.

We provide a trusted risk advisor relationship that connects the startup and the bank, and can materially improve the chances of success through proper use, maintenance and retention of the transactional account permitting the startup to conduct user transactions. Our tempCCO solution delivers on-demand risk, strategy and compliance expertise to FinTech startups, their boards of directors, investors and banking partners.

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