WHITE PAPER

Risk Insights for FinTech Entrepreneurs and Company Boards

StratisAdvisory™

RISK INSIGHTS FOR FINTECH ENTREPRENEURS AND COMPANY BOARDS

When you build a FinTech startup, you open a new direct-access channel into the global financial system. Whether you plan to direct market traffic, manage customers' money, or provide technological tools for financial operations, robust risk management must be a core element of your business strategy.

As you conceptualize your company's vision, define its mission, and establish the value proposition, market dynamics will periodically mandate iterations that will enable growth and success. However, whenever you alter the venture's foundational go-to-market strategy to incorporate new product features or services, it is critical to evaluate any regulatory risks those features or services may introduce. Investment partners and regulatory compliance authorities may not look kindly on additional exposure to financial fraud and money laundering, for example.

A FinTech startup should expect to undergo due diligence that appraises the startup's knowledge of and compliance with relevant industry regulations, as well as its operational risk management expertise. Be prepared to demonstrate the ability to recognize, assess and mitigate risks your company potentially interjects into the financial system before you are granted access to it.

Recognize inherent risk in your business model

It is important to have a transparent view of all risks your business model may impose on customers and other participants in the global financial system. Financial services providers are required to safeguard all points of access into their systems to ensure that assets are protected from theft and criminal abuse. Platforms that collect personal information must protect confidential data from compromise by a leak or cyberattack that could cripple business continuity and brand reputation.

Understanding the letter of the law and any applicable regulatory requirements is basic good practice. Equally important is calculating the impact of noncompliance so that you can accurately gauge how various business decisions might increase risk but also open runways to achieving success. One path, for example, may lead to no regulatory impact; another may lead to some level of impact that is perhaps worth the risk; and a third may lead to significant impact that must be avoided. Entering a regulated market without proper assessment may result in ramifications that undermine essential banking relationships. The more you know about the potential risk impact of different forks in the product roadmap, the better positioned you will be, especially during funding rounds, to avoid wasteful cash burn, meet investor expectations, and maintain a harmonious banking relationship.

Justifiably or not, financial institutions and market regulators often view startup business models as having high levels of inherent risk. Be proactive and do your homework so that you understand what your business looks like from their perspective; learn what methods they recommend in order to mitigate the inherent risks to your business. Implement these approaches early on and embed them in your blueprints for technology development, user experience design, product roadmaps, back-office processes, and third-party system integration.

Invest in your banking relationship

A banking relationship becomes a trusted partnership only when both parties understand and respect each other's priorities. Approach this collaboration with full transparency regarding your business plan, target markets and growth aspirations. Once the alliance is established, consistently communicate any contemplated pivots that will change the business baseline, and solicit feedback well in advance about how iterations may affect the bank's side of the risk equation.

For example, let's say a startup is humming along, gaining market share. Suddenly it discovers an untapped revenue source in its existing user base and flips the switch to unlock the opportunity. The number of transactions that are processed through its bank account surges, which triggers alerts to the financial institution's risk team. The bank's relationship team is deployed to investigate; the startup is found to be in violation of its master agreement, resulting in account lockout. The startup finds itself at a crossroads. Should it maintain the new functionality and try to find another bank to process transactions? Or should it turn off the enhancements and invest the time and effort required to prove to its current bank partner that appropriate risk mitigation controls are in place?

Scenario: Startup enhances product offerings without assessing risk

An e-commerce startup launches an online marketplace to match buyers with sellers. The company gains the critical mass necessary for a viable business model, and its founders decide to geographically scale the business. To do so, they need capital. As a condition of Series B round funding, institutional investors want to see greater retention and monetization of customer mindshare in order to boost profitability. So the company decides to introduce a new feature that allows users to hold funds in escrow and later transfer to third parties, but unanticipated problems arise while enabling this enhancement via the banking partner. The new offering requires the company to operate as a money services business, change numerous processes to become compliant with regulations now governing their operations, undergo specialized audits, and incur additional costs. Plus, the bank imposes additional scrutiny on the startup's account relationship. The company's founders propose an alternative plan, but not in time to avoid damage to the banking relationship and a loss of investor confidence.

A smart strategy involves partnering with the bank's relationship team and risk group from the onset, before flipping a switch. This gives the bank time to fully understand any new course of action (and the risk impact of that course of action) as well as the best way to shape the account agreement accordingly. Better yet, if the bank recognizes revenue potential, it may find ways to accommodate the shift in direction. Transparency wins by protecting the harmonious banking relationship that is critical for startup success and for delivering value to investors.

Incorporate risk management into the business strategy

The ability to mitigate inherent risks correlates directly with potential to scale the business. Effectively leveraging technology, resources and capital, FinTech startups must devise strategies and tactics that are precisely aligned with the unique risk profiles of their businesses. Generic approaches and policies, by definition, will be misaligned and may threaten business credibility. How you design, execute and operationalize risk mitigation matters—it can impact business continuity and the success of institutional funding rounds. Moreover, failing to integrate effective risk management into your enterprise strategy can have costly implications for time to market and your bottom line.

Scenario: FinTech expands business after strategic analysis

A rapidly growing FinTech company headquartered in Israel plans to expand geographically into European, Asian and US markets. Customer research insights indicate that Europe and the US should take priority over Asia. Management assesses the European and American regulatory jurisdictions to inform the company's decision on which market to target first. After conducting a comprehensive review of the regulatory landscape specific to its business model and roadmap,the company decides to open an office in the EU. This enables business expansion and revenue growth while the company prepares to comply with additional regulatory requirements specific to the US market. This chosen path also enables the startup to anticipate how an iterated business model may impact its successful banking relationship.

Best practice dictates the building of foundational risk management and governance frameworks from the get-go. Know and own your risk exposure. In the very early stages of launching a business venture, current and future risks should be estimated based on the product roadmap and revenue growth plan. At the same time, processes must be implemented for continuous risk monitoring, reporting on key metrics, and mitigating identified threats. Additional risk oversight at the board level—mandated at later stages—can serve as a bonus asset early on in the trajectory of a startup.

Select an experienced board of directors

Some startups create advisory boards to make introductions, provide business acumen or enhance brand influence. Corporate policy dictates a board's formation and structure. Typically, venture capital funders will seek seats on the board to protect their investments and keep an eye on an exit strategy. Most importantly, board composition should reflect the startup's marketplace, keeping in mind that domain experience is critical for effective risk management. In fact, personal liability for a lack of operational compliance is now a common occurrence. A board seat is not a passive duty without implications. A FinTech board seat can turn into a "hot seat" if the startup runs afoul and the board lacks the expertise to recognize the issue before it's too late.

Selecting knowledgeable board members early on can provide a startup with critical experience-based insights that can be leveraged for a successful exit strategy. The right mix of tuned-in management, investor and independent directors is essential for insightful board composition, and members must have the bandwidth to attend meetings and demonstrate the dedication to proactively participate in collaborative discussions and informed decisions about the company's risk management posture.

An effective board helps the startup manage risk. In today's marketplace, business model pivots are often required in a heartbeat, and new or heightened risks can arise instantly. If the board lacks domain expertise, limited visibility of risks may lead to flawed decisions. Also important to consider is the fact that the CEO and management team may lack the risk management experience required to share critical and actionable information with the board.

Faulty communication between management and an inexperienced board will block the path to success. A misinformed board may allow a risky but viable and potentially profitable business strategy to be poorly executed due to a lack of knowledge and transparency, unnecessarily exposing the startup to risk. Conversely, a board comprised of engaged and informed domain experts will be able to recognize the immediate and long-term impacts of business model pivots and ensure implementation and execution of a comprehensive risk strategy that positions the startup for success.

ABOUT THE AUTHORS

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Brian Stoeckert, a partner in Stratis Advisory, is a recognized risk management expert with more than 15 years of experience in providing startups through Fortune 500 companies with strategy intelligence, advisory services and witness testimony. At Stratis, he manages an international portfolio of FinTech startups, money service businesses, financial institutions, government agencies, universities, and entertainment companies. Brian has served as an expert witness in domestic and global civil and regulatory matters related to anti-money laundering (AML) and digital currency compliance.

Previously, Brian led Booz Allen Hamilton's San Francisco-based strategy and risk practice, advising boards of directors, audit and compliance committees, and executive management teams of financial institutions, money service businesses and global intelligence firms.

Brian has also served as a guest lecturer at New York University's Law School and Stern School of Business on AML laws, regulations and digital currency compliance, and he is a frequent presenter at global risk, compliance and FinTech conferences. He is a member of the National Association of Corporate Directors, chairman of the ACAMS Chapter Steering Committee, and an executive board member of the award-winning ACAMS Northern California Chapter.

Brian received his JD from New York Law School and his BA in Political Science from Stony Brook University. In 2014, he received the university's Top 40 Under Forty Award.

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Prior to Stratis, Maria served as the head of R&D at SVB Financial Group, where she helped create several new business lines for long-term EPS growth. Before SVB, she was founding partner, chief investment officer and chief compliance officer of Green Alpha Advisors. Maria previously led investment research, portfolio management, product development and regulatory compliance at a boutique investment management firm with more than $2 billion in assets under management. Maria has also served as a C-level officer, board director and investor at several FinTech and software startups. She started her career as a research analyst at the European Bank for Reconstruction and Development and the Federal Reserve Bank of San Francisco. Maria is a Chartered Financial Analyst, a member of the CFA Institute, and a member of the National Association of Corporate Directors. She has also served as a board member of the CFA Society of San Francisco and the Financial Women's Association of San Francisco.

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About Stratis Advisory

Stratis Advisory was founded by seasoned executives, consultants and serial entrepreneurs who believe in the transformative power of innovation and technology. We offer clients our 40+ years of combined experience in strategy, risk and compliance. Stratis serves a global portfolio of FinTech startups, financial institutions, venture capital firms, money services businesses, government agencies and entertainment companies.

Stratis is 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 of the appropriate size for their growth stage and business scale. We provide insights and informed decision making through market intelligence and help tailor due diligence, onboarding, ongoing review, reporting and training to build a successful and compliant FinTech enterprise.

As a venture-savvy partner, Stratis provides the expertise, flexibility and critical industry knowledge—from new financial technology platforms to app-based payment systems—that help protect a company's competitive advantage. Our tailored solutions for FinTech startups deliver the market insight, risk strategy, governance, and operational compliance expertise you need to reduce risks and maximize success.

Stratis principals are certified Anti-Money Laundering (CAMS) and Anti-Fraud (CFE) professionals, as well as Chartered Financial Analysts (CFAs), and we are members of the National Association of Corporate Directors (NACD). Our experts have been featured in a wide range of publications including the *Wall Street Journal, Bloomberg Businessweek, Salon, American Bankers Association Banking Journal, Payments Source, Compliance Week, CoinDesk, ACAMS Money Laundering, and Main Justice.*