CASHFAC

Enhancing Disrupter Fintechs

E-money Institutions

Payment Service Providers (PSP)

Foreign Exchange (FX)

Peer-to-Peer (P2P) Lending and Crowdfunders

Spread Betting and CFD Trading

About Cashfac

Cashfac is a global leader in back office cash management and Virtual Account Management (VAM) solutions.

Our open technology solutions plug into your existing systems giving corporate and client operational accounting solutions which are fully integrated with your bank's records, virtually eliminating the need for reconciliation.

Our platform is the world's most deployed virtual accounts solution, used by organisations across the global financial services sector from large banks and asset managers to smaller non-banking financial institutions.

Our products help these financial institutions improve productivity and provide greater visibility, automation and control over their critical cash management operations including compliance with Client Money and e-money segregation regulations.

For more information please visit
www.cashfac.com

Introduction and Background

The last ten years have seen tremendous changes in the financial services sector and this rate of change seems likely to keep growing.

Traditionally the large clearing banks have been the predominant major players in the financial services sector until now. While other financial organisations existed, they generally acted in a support capacity or as an extension of the services provided by banks rather than being viewed as their competitors.

This traditional model is being assailed on two fronts. Firstly, the financial crash in the last decade has left many banks underfunded, over-regulated, suffering a crisis of confidence and struggling to win back customer trust. Secondly, the banks are now finding that they are losing business to VC-funded, agile, lightly-regulated fintechs entering the market with better products and better technology. These fintechs are partnering and combining their offerings to provide more enhanced products to an increasingly tech-savvy customer base and are delivering to market at a pace only imagined by traditional banks. This has led to many predicting the fall of the traditional bank – **Gartner predict that by 2030** "80% of heritage financial services firms will go out of business, become commoditized or exist only formally but not competing effectively".

This paper will discuss the common challenges we believe these new fintech disruptors will face in 2019. It looks at the five main categories of disruptor in the market and the importance of having an adequate back office to support and connect with their internal and external systems to ensure efficient client money management, segregation and adherence to regulation.

Who are the Disruptive Fintechs?

Disruptive fintechs come in many shapes, sizes and combinations but they have some commonalities and face many of the same challenges. Five categories worth examining are:

1. E-money Providers

Electronic money (e-money) providers offer accounts that store customers' money on an electronic device (e-money) which is then used for making payments to third parties. One of the most common uses of e-money is in the prepaid credit card sector, with payments being made, or money withdrawn, through major credit card networks. For fifty years we have been promised a cashless society; these innovators are finally delivering it. The advancements in this sector are extensive with, for example, credit card numbers being used to generate payment tokens to drive mobile payment solutions such as *Apple Pay* and *Google Pay.*

> **For fifty years we have been promised a cashless society; these innovators are finally delivering it**

The e-money account can be paired with a real or virtual bank account to deliver a full bank current (transaction) account service offering direct debits and electronic funds transfers such as UK BACS and Faster Payments.

These institutions are relatively lightly regulated in Europe. In the UK the Financial Conduct Authority's (FCA's) **Electronic Money Regulations 2011 (EMR)** are applicable and e-money institutions' capital adequacy requirements are moderate relative to a bank's as they do not lend money and they are not part of the **Financial Services Compensation Scheme (FSCS).**

Any failure by an e-money institution can therefore run a significant risk of customer loss unless the e-money provider's segregation and protection administration are in exceptional order. Being a relatively new industry, the FCA is still perhaps feeling its way in terms of enforcement in this sector, but the regulations clearly indicate that the same standard of segregation protection is required under the EMR as under **Client Money regulations.**

2. Payment Service Institutions

Payment Service Institutions provide payment services as their core business activity. Many payment service providers are also e-money providers that offer a hybrid service in competition with traditional banks.

Like e-money institutions, payment service providers are also lightly regulated. The FCA's Payment Services Regulations (PSRs) apply the European rules in the UK and their capital adequacy requirements are low, and they are not required to join the FSCS. They are required to safeguard and protect the customers' money under the payment services regulations.

3. Foreign Exchange Service Companies

Foreign Exchange (FX) Service Companies provide foreign exchange services for individuals and corporates at more competitive rates than banks. Many foreign exchange companies can also be e-money providers and will hold and safeguard their customer's money under e-money rules.

4. Peer-to-Peer (P2P) Lending and Crowdfunders

Peer-to-Peer (P2P) lending enables individuals and businesses to borrow money without the use of a bank or other credit institution as an intermediary by connecting them with individual or institutional investors. P2P platforms match borrowers to lenders and administer the loan between them. Crowdfunders are perceived in two ways:

1. Extending credit to borrowers unable to get it through traditional financial institutions
2. Delivering that credit at lower rates than are offered by the banks

At the same time, Crowdfunders give lenders higher returns than they would get from traditional savings accounts but perhaps at a higher risk. Crowdfunding and P2P platforms may not underwrite the loans and, even if it does, many of these platforms have reserves available to cover any losses that arise should the loan go into arrears.

There are three flavours of P2P - consumer lending, SME business lending and property lending, each with a significantly different risk profile.

Crowdfunders are subject to the client money CASS rules which regulates their activities to protect customer's cash. The regulator has revised the CASS regulations for crowdfunders in recent years and a raft of further regulation seems to be on the horizon to ensure customers are protected.

5. Spread Betting and CFD Trading Businesses

A contract for difference (CFD) is a popular form of derivative trading. CFD trading enables you to speculate on the rising or falling prices of fast-moving global financial markets (or instruments) such as shares, indices, commodities, currencies and treasuries. While CFD providers have perhaps not disrupted a traditional bank function, they have impacted other traditional financial services markets such as stockbroking and wealth management. CFD providers face many of the same challenges as the banking disrupters. Like P2P lending they are regulated under the CASS rules for the protection of customers' money.

What are the challenges facing these Disruptors?

The primary challenge these disruptors face is in developing the most effective front end (customer-facing) system to deliver new products and onboard new customers as quickly as possible whilst observing applicable safeguards such as KYC and AML. Often, they will not just be developing new products, but also a new market. In these circumstances, first mover advantage can be the difference between success and failure.

With all in-house resources focused on this primary goal, fintechs' other challenges are often neglected. These challenges will typically include the following:

Ineffective Back-Office Systems

Fintechs will often struggle to recruit staff with the necessary experience in financial services regulations, finance and operations and may not have the time or talent to develop the administration layer in their systems if they are to win the race to be first with the new product. As a result, these companies can be left with ineffective back-office systems to administer their business.

Its operational finance teams can struggle with multiple complex spreadsheets to monitor risk, control customer cash positions and account for performance across multiple markets and currencies. If fintechs are successful and obtain their desired growth volumes, these spreadsheet-based control regimes can collapse and undermine the fintech's success. Most European regulators now do not look favourably on spreadsheet-based control processes. Any fintech facing a regulatory inspection or audit would should consider what steps they need to take to upgrade their approach.

> **With in-house resource focused on the disruptors' customer-facing systems, other challenges are often neglected**

"If fintechs are successful and obtain their desired growth volumes, these spreadsheet-based control regimes can collapse and undermine the fintech's success."

Lack of Accounting Control

Typically, non-bank fintechs will require accounting (sub) ledgers for customers' cash accounts and some basic corporate accounting for direct operational costs and revenues. While the accounting may not be complex, many fintechs struggle to deliver it. Without its operational financial controls, they are not robust and will not scale.

> **Client Money regulations under CASS 7 & Safeguarding rules under E-money and Payment Services Regulations are onerous**

Even if fintechs have an existing ERP (accounting) system, this may not be able to deliver the required accounting control solution. Most ERP systems do not offer operational accounting because they cannot handle the business's operational volumes or cannot be easily configured to generate and maintain the accounting records required using multiple third-party data sources from the business's front end and other systems. However, perhaps the biggest weakness for these fintechs is that their ERP systems cannot account for clients' positions on a cash basis rather than an accruals/accounting basis. Without this, the system cannot deliver an accounting record that can serve two purposes:

1. to account for the business's operations
2. to deliver the necessary regulatory compliance controls and reporting solution.

Onerous Regulatory Requirements

While fintechs are lightly regulated compared to banks, that is not to say that compliance is still not extremely challenging. The Client Money regulations under CASS 7 or the Safeguarding rules under the E-money and Payment Services Regulations are onerous, and the regulators have a zero-tolerance approach to failure. Many of these disruptors do not have the necessary skill, knowledge or experience to appropriately incorporate CASS / other regulatory requirements to their framework.

Building a system that can allow you to deliver the 100% compliance standard required by these regulations is extremely challenging. Any failure can lead to an existential threat to fintechs, especially if it happens just as its potential investors start their due diligence. Very often fintechs are in a position where they struggle to understand and apply the regulations of their industry to their new product and company. They may struggle to get qualified personnel capable of implementing systems and operational process solutions to these challenges.

A need for Multiple Bank Accounts

A fintech may need multiple bank accounts to administer its business efficiently and in a compliant manner. For example, it may need to segregate cash for different products, especially if the products are subject to different regulations. Alternatively, it might wish to give each client their own bank account to ensure complete segregation and safeguarding of funds. Opening numerous bank accounts can be expensive, time consuming, hard to administer on standard banking platforms and can lead to significant delays while the company completes the banks' increasingly arduous account opening processes.

Ineffective Reconciliations Processes

Any fintech in this sector that is focused on growing will require an automated bank reconciliations process which can handle all forms of transactions and be capable of scaling to deal with volume increases.

One of the biggest challenges with bank reconciliations will be the incoming payments initiated by the customer which can be poorly referenced. This makes cash allocation to the correct client account difficult. Delays or errors in allocating customers' cash can lead to poor service, difficult reconciliations and ultimately regulatory breach as under CASS 7, cash must be allocated to a client's account promptly and at the very worst within 10 working days.

2019 Disruptors Challenges

A need for Several Banks | Ineffective Back-Office Systems | Lack of Accounting Control | Onerous Regulatory Requirements | A need for Multiple Bank Accounts | Ineffective Reconciliations Processes

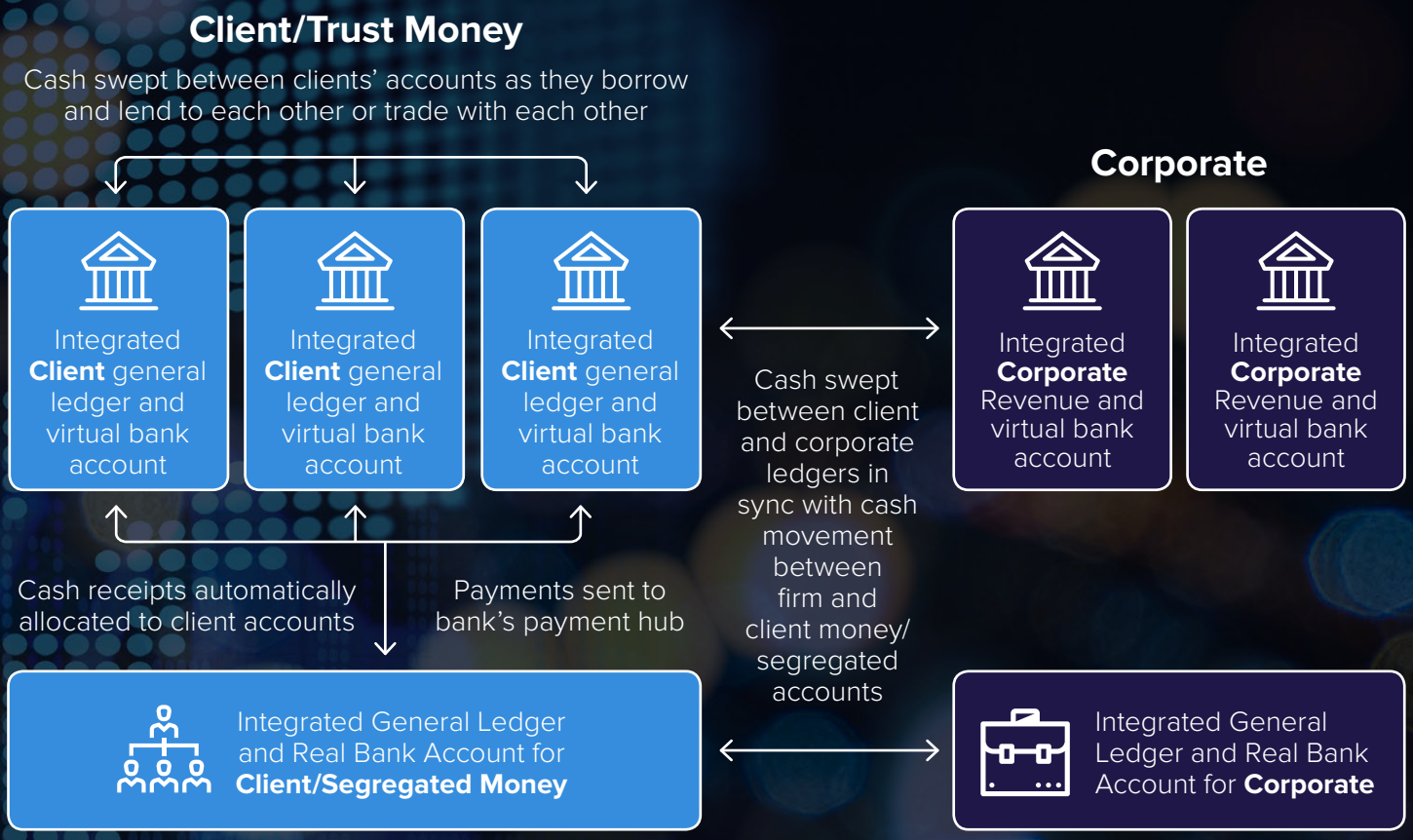
A need for Several Banks

Fintechs may need to use several banks to deliver their service. This can be for many different reasons and examples that include, the banks need to restrict service to "high risk" fintechs, or because the fintech operates in several jurisdictions, or because it wants to ensure that it gets a competitive service. The additional administrative burden of managing several bank interfaces can be substantial, preventing the standardisation of payment processing, bank reconciliation and other processes.

How can Cashfac help?

At Cashfac we understand that fintechs may need help interpreting and applying the regulations, developing operational finance procedures and the systems to support their business. They can struggle to develop systems that will quickly scale when the fintech is successful. In other words, they don't have the time to do the tasks that don't give them an advantage over their competition, but which, if they remain unaddressed, can still put them out of business.

Our back office and bank-in-a-box system combined with our highly experienced consultancy team offers a complete solution to all these challenges.



Our **Virtual Bank Technology® (VBT)** platform offers full back office functionality including an operational trial balance complete with client cash accounts and full corporate accounting to handle operational revenues and expenses. As our solution integrates banking and accounting records, the accounts can be delivered on a cash basis (actual settled/actual cleared basis) exactly linking and reconciling each accounting entry to its bank statement movement.

For the typical implementation illustrated above, transactions are posted to the general ledger accounts in Cashfac when they are generated by front office and counterparty systems. The transactions are posted in an uncleared/unsettled status. When the transaction clears the firm's bank account, Cashfac picks up the bank movement and updates the status of the transaction to cleared/settled. This allows the firm to report on both an accruals/due basis or on a cleared basis for Client Money segregation purposes. This complete integration of the accounting record and the banking record minimises the requirement to reconcile and gives all the necessary data for effectiv treasury management.

Each client ledger account on Cashfac is a fully functioning virtual bank account from which the fintech can offer a full banking service.

The accounting structure can also account for operational revenues and charges as they are levied, not only accounting for the profit and loss but also automatically moving cash between the client money segregated accounts and firm's bank accounts to meet the requirements Client Money/ segregation compliance.

Integrated Accounting and Banking Functionality

The Cashfac back office solution offers integrated accounting and banking functionality gives a proven solution to the challenges of Safeguarding under the e-money and payment regulations and Client Money protection to meet the requirements of CASS 7 and 10.

To achieve this, we offer full virtual bank account functionality. Each client can be given its own integrated virtual bank account/client account, delivering automatic segregation and safeguarding of customers' funds.

The Cashfac solution allows e-money providers to link each of its e-money accounts to a Cashfac virtual bank account. Using this functionality, the e-money provider can extend the full current (transaction) account banking service to its clients. This service can then include direct debit and electronic funds transfer payments like BACs and Faster Payment.

Virtual IBANs

The Cashfac virtual bank can also have its own virtual IBAN (unique bank account identifier recognised by the banking payments networks). The virtual IBANs allow automatic cash allocation of cash received from the customer. Customers can use the virtual IBAN, or one of several other customer account identifiers that Cashfac's system can store, to ensure cash received into the fintech's bank account and is automatically posted to the correct client virtual account on receipt. This ensures good service and the highest levels of compliance.

Platform and Bank Agnostic

The Cashfac solution is platform-agnostic, working symbiotically with the fintech's front-end platform. Cashfac can take extracts of front-end system entries and map them to its accounting engine to create full double entry accounting for each transaction. It then posts these entries to the Cashfac thick* general ledger to fully record the transaction. The operational trial balance from Cashfac can then be posted to the fintech's ERP, if required, to give consolidated accounting.

The Cashfac solution is also bank-agnostic. It has pre-existing links to most UK banks and several international ones. Its existing banking hub can quickly be connected to most bank systems using ISO standard messages or API calls.

These connections enable the Cashfac system to:

- Extract statements in near real time to generate operational accounting, drive cash allocation and enable automatic reconciliation, and
- Automate payment instructions from the customers' accounts on the Cashfac system to the fintech's bank(s). The Cashfac solution offers full payments connectivity to the payment hub used by the fintech, generally it uses its bank's hub. Cashfac allows customers' and corporate payments to be raised, authorised and processed via BACs and Faster Payments. Cashfac can also process direct debits onto the virtual accounts giving full bank account functionality.

*With the thick general ledger approach all the information traditional held at sub-ledger level is held at the general ledger level instead. In this model each client or counterparty would have their own general ledger account. This approach removes the need to reconcile between client sub- ledger and the general ledger.

Multi Bank Enabled

Cashfac, as well as being bank agnostic, allows clients to run multiple bank interfaces in parallel. This standardises the interaction with each bank on one portal with one look and feel. The Fintech can use our functionality to select the most cost-effective service offering from each banking provider and stay with limitations enforced by any individual banks.

Cost-Effective and Future-Proofed

The Cashfac solution is used by some of the biggest global financial institutions in the world to process high volumes of accounts and transactions while meeting ISO27001 standards for security and resilience. However, our solution is also used by many smaller and start-up companies that have found us to be a cost-effective proposition which also gives them cover for their projected growth plans.

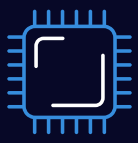
For any solution a fintech buys, it wants an assurance that its choice is future-proofed against changes in the financial services industry such as those driven by the requirements of the Second Payment Services Directive PSD2. Driven by the requirements of our existing global customer base, Cashfac is committed to supporting this sector and to driving the change agenda in it. This allows fintechs to take advantage of new innovations as they are put live.

Cashfac VBT

Business Consultancy

Integrated Accounting & Banking Functionality

Virtual IBANs



Platform and Bank Agnostic

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Business Consultancy

Finally, Cashfac does not only offer the technology for the solution, its team of business consultants can work with the fintech and its advisors to devise the correct process design, systems configuration and build of the solution to deliver the right result for the fintech. Our team, with its many years' experience in devising systems solutions for regulated companies, will work with you to deliver a total solution to your fintech's compliance and operational challenges in the back office.

CASHFAC

For product information, to request a demonstration or answer any questions about your business needs please contact us at

www.cashfac.com/contact