Feedback Statement

FS20/10: Coronavirus and safeguarding customers' funds: guidance for payment and e-money firms

9 July 2020

Introduction

1.1 On 22 May 2020, we published our consultation paper on coronavirus and safeguarding customers' funds. This proposed additional temporary guidance to strengthen payment and e-money firms' prudential risk management and arrangements for safeguarding customers' funds in light of the exceptional circumstances of the coronavirus pandemic (Covid-19).

1.2 In light of the risks from coronavirus, it is important that we provide our guidance to industry quickly. As a result, we have not conducted a full consultation, and instead we have carried out a short consultation on temporary guidance. However, in response to requests from trade associations and other industry participants, we extended the closing date for responses by a week.

1.3 The consultation closed on 12 June 2020. We received responses from more than 60 organisations, including payment firms, trade associations and law firms. In this document, we summarise and respond to feedback we received on our proposed guidance.

1.4 The main comments we received were about: customer funds being held by firms on trust, calculating capital adequacy, conducting compliance audits and the treatment of unallocated funds.

1.5 We also received comments which were outside the scope of our consultation, but which we may be able to consider in later consultations.

1.6 We hope to conduct a full consultation later in 2020/21 on changes to our Approach Document, which will likely include a proposal to incorporate our guidance on safeguarding and prudential risk management. This will give stakeholders a second opportunity to comment on any measures that we propose to apply permanently, building on this temporary guidance.

Additional guidance

2.1 In our consultation, we asked:

> **Q1. 'Do you agree that we should provide additional guidance on safeguarding, managing prudential risk, and wind-down plans? If not, please explain why.'**

2.3 Most respondents supported our approach of providing additional guidance, although some raised concerns about timelines and the impact of the guidance. Responses included concerns about:

- the short period for the consultation, and whether industry would have sufficient time to consider the implications of the proposed guidance
- how much time firms would have to implement the guidance, and whether those timelines would be proportionate to firms' circumstances and
- the impact of the guidance on the competitiveness of the UK's payments sector

Our response

Amount of time for consultation

2.4 Our payment services approach document (Approach Document) already gives firms guidance on safeguarding and managing prudential risk. But we have found evidence that some firms have not complied with the Electronic Money Regulations 2011 (EMRs) or Payment Services Regulations 2017 (PSRs) as we expect. Examples include commingling of customer and firm funds, firms keeping inaccurate records and accounts, and not having sufficiently effective risk management procedures.

2.5 Given our concern that the current economic climate caused by Covid-19 would affect firms' financial strength, and might affect the availability of their external funding, we held a shortened consultation on temporary guidance on safeguarding and prudential risk management. Our guidance aims to reduce the risk of harm to customers if firms fail by making the wind-down process as orderly as possible, and enabling customer funds to be returned in a timely manner.

Amount of time for implementation

2.6 Firms should familiarise themselves with our guidance as soon as possible, and take steps to ensure that their procedures and controls meet our expectations.

2.7 Some firms raised concerns about dependencies on third parties. For example, arranging audit firms or other professional advisors to review compliance with safeguarding requirements, or where they otherwise need to adapt their procedures and controls. We are clarifying that they should ensure this work is completed as soon as reasonably practicable.

Impact on the UK's payments sector

2.8 Our 2020/21 Business Plan explained that payment services are a priority for our supervision and intervention. Payment services providers (PSPs), including payments institutions (PIs) and e-money institutions (EMIs), continue to develop quickly. More firms and new products are entering the market and more consumers and businesses are using PIs and EMIs. We welcome the innovation and competition we are seeing in payment services. But, as with all growing markets, we are also monitoring it closely for any harm to consumers or market integrity.

2.9 Some payment services firms are growing rapidly and many are unprofitable in the early stages, while they try to grow market share. We are also concerned that the pandemic will affect these firms' financial strength and may affect the availability of their external funding.

2.10 We have taken into account the objectives of the Payment Services Directive 2015 to promote competition and innovation in the payments market. Our guidance aims to support these objectives by helping to strengthen the resilience of the UK payments sector.

Safeguarding

3.1 In our consultation, we asked:

Q2. 'Do you agree with our proposed guidance on safeguarding? If not, please explain why.'

3.2 Most respondents supported receiving more guidance on safeguarding. Some suggested changes to the proposed guidance. Responses included:

- Concerns about our template acknowledgement letter for safeguarding banks, and its reference to customer funds being held on trust. They asked whether this could cause safeguarding banks to decline to counter-sign the letter, or change their risk appetite for operating safeguarding accounts. They also asked whether the form of acknowledgement letter was appropriate for jurisdictions outside the UK, and whether it could be amended.

- Uncertainty around safeguarding compliance audit reports. This included which types of firms should arrange and perform a compliance audit, what due diligence questions firms should ask potential auditors, what types of non-compliance audit firms should report; how frequently firms should arrange compliance audits and the purpose of compliance audits.

- Concerns about unallocated funds, and whether they should be treated as relevant funds.

- Uncertainty about what type of information which is disclosed by firms could be misleading to customers.

- Concerns about whether small payment institutions (SPIs) may be expected to safeguard, and

- Questions about safeguarding account names.

Our response

Safeguarded funds held on trust

3.3 Some respondents challenged whether there was a trust over safeguarded funds. A person who holds specific assets with a prohibition on own use and with a duty or power to apply them in a particular way will likely be a trustee, even if the word 'trust' is not used. We think payments and e-money firms act as trustees of their customers' safeguarded funds. This is consistent with both the purpose and the wording of the Electronic Money Directive 2009 and the Payment Services Directive 2015, both of which include clear indications of customer ownership. They refer to keeping the 'funds of electronic money holders' separate from 'the funds of the electronic money institution', and for 'payment service user funds to be kept separate from the payment institution's funds'.

3.4 Furthermore, the Court has recently found, in respect of a payment institution that used the segregation method of safeguarding, that the PSRs create a statutory trust (see *Supercapital* (in administration) [2020] EWHC 1685 (Ch). The Court found that "All the characteristics for [a statutory] trust being in existence are present. The segregation of funds received right from the inception as well as ensuring that they are identifiable is equally important. The fact that the company cannot use the funds in its own business and the position is made clear that the funds are only available to those beneficiaries in the event of an insolvency event are also important. In the circumstances, the Administrators are correct in their approach to treat the funds as being held by way of statutory trust." While the Court's finding was in relation to the PSRs, we consider that the same reasoning applies to the safeguarding provisions in the EMRs. As a result, we think it is right that our template acknowledgement letter, to be counter-signed by safeguarding credit institutions or custodians, refers to a trust over the safeguarded funds or assets. The acknowledgement by the credit institution or custodian of the fact that the payments services firm is holding the money or assets on trust, and that there are no rights of set-off, is fundamental to protecting consumers if a payments or e-money firm becomes insolvent. It helps an insolvency practitioner ensure that safeguarded funds or assets are protected from general creditors, and not subject to, for example, group netting arrangements.

3.5 Some respondents asked whether firms could prepare their own version of the template acknowledgement letter. We clarify that we have provided the template acknowledgement letter as an example of such a letter. Firms should get independent legal advice on the terms of the letter if they produce their own version. However, acknowledgement letters must make clear that the safeguarded funds or assets in the safeguarding accounts are held for the benefit of the firm's customers. They must also state that the safeguarding credit institution or custodian has no interest in, recourse against, or right over the relevant funds or assets in the safeguarding accounts.

3.6 Some respondents raised concerns about being able to get such an acknowledgement letter. Where firms cannot do this, they should still be able to demonstrate that the safeguarding credit institution or custodian has no interest in, recourse against, or right over the relevant funds or assets in the safeguarding account. This should be clearly documented and agreed by the relevant credit institution or custodian, for example in the account terms and conditions. We expect credit institutions and custodians which are regulated by us to work with PIs and EMIs to prepare any new documentation referred to in this paragraph. We may ask firms to provide us with copies of their documentation.

3.7 Respondents raised concerns about expectations of customer due diligence (or 'KYC') requirements for safeguarding accounts. The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulation 2017 ('MLRs') require a bank to identify its customers and any beneficial owners of these customers. A bank will do this before opening any relationship with a PI or EMI. Our guidance does not make any changes to these obligations. So a safeguarding credit institution or custodian should continue to treat the PI or EMI as their customer for these purposes. There is unlikely to be any need, when applying these requirements in a proportionate way, to identify the individual beneficial owners of a safeguarding account, unless specific risk factors require such information, when a bank is permitted by Regulation 39 of the MLRs to rely on information obtained by the EMI or PI. We note that a firm is currently permitted under regulation 37 of the MLRs to apply simplified due diligence to customers who are credit or financial institutions subject to supervision under the MLRs.

3.8 A concern was also raised about whether the reference in the acknowledgement letter to a trust over safeguarded funds could cause safeguarding banks to change their risk appetite for operating safeguarding accounts. We remind credit institutions regulated by us that they must comply with the provisions of regulation 105 of the PSRs, and provide payment service providers (PSPs) with access to payment accounts services on an objective, non-discriminatory and proportionate basis. We also remind them of our guidance on regulation 105 in chapter 16 of our Approach Document. We expect credit institutions to recognise that the costs, risks and potential revenues associated with different business relationships in a single broad category will vary, and to manage those differences appropriately. Regulation 105 of the PSRs reinforces the need to determine applications for banking services by PSPs both by reference to membership of a particular category of business and in taking account of the individual circumstances of the specific applicant. This aligns with the expectations we set out for an effective risk-based approach to managing money-laundering risk by credit institutions.

Audit reports

3.9 Some respondents were uncertain about the purpose of safeguarding compliance audits. They asked which types of firms should arrange and perform them and what due diligence to undertake on potential auditors. We have clarified that firms which are required to arrange an audit of their annual accounts under the Companies Act 2006, should also arrange specific annual audits of their compliance with the safeguarding requirements under the PSRs/EMRs.

3.10 The purpose of the audits is to document reasonable assurance of compliance with the safeguarding requirements under the PSRs/EMRs, and to reduce the risk of harm to customers if firms fail. An audit firm should carry out these audits, as referred to in regulation 24(2) of the PSRs or regulation 25(2) of the EMRs, or by another independent external firm or consultant. A firm should satisfy itself that its proposed auditor has, or has access to, appropriate specialist skill in auditing compliance with the safeguarding requirements under the PSRs/EMRs, taking into account the nature and scale of the firm's business.

3.11 Some respondents asked about the scope and content of the audit reports. We expect the auditor to provide an opinion addressed to the firm on whether the firm:

- has maintained adequate organisational arrangements to enable it to meet our expectations of the firm’s compliance with the safeguarding provisions of the EMRs/PSRs as set out in chapter 10 of our Approach Document, throughout the audit period, and
- met those expectations as at the audit period end date.

3.12 We also expect firms to consider whether they should arrange an additional audit in accordance with their conditions of authorisation, if any changes to their business model may materially affect their safeguarding arrangements. Examples of these changes may include an e-money issuer providing payment services unrelated to issuing e-money, or using insurance as a method of safeguarding instead of, or as well as, account segregation.

3.13 Some respondents asked what types of non-compliance audit firms should report. As paragraph 10.58 of the Approach Document sets out, a firm's auditor is required to tell us if it has become aware in its capacity as an auditor, of a breach of any requirements imposed by or under the PSRs or EMRs that is of material significance to us (regulation 25 of the EMRs and regulation 24 of the PSRs 2017). Examples of the type of non-compliance we expect to be notified about are not keeping up to date records of relevant funds and safeguarding accounts, or where a firm cannot comply because a safeguarding credit institution has decided to close a safeguarding account.

3.14 As explained in paragraph 10.66 of the Approach Document, firms should also notify us in writing without delay if in any material respect they have not complied with, or are unable to comply with, the requirements in regulation 20 of the EMRs or regulation 23 of the PSRs 2017, or if they cannot resolve any reconciliation discrepancies in the way described in paragraph 10.65.

Unallocated funds

3.15 In some cases, a firm may not be able to identify the customer entitled to the funds it has received. In our consultation, we proposed that these funds were not relevant funds, but they should be protected according to Principle 10 of our Principles for Business. However, 1 respondent suggested that these funds would be relevant funds, if an EMI issued an equivalent value of e-money in a separate account, pending identification of the customer or return of the funds.

3.16 Having taken into account consultation responses on this issue, we have amended our guidance. We have clarified our view that where funds are unallocated, but the firm can still identify that the funds were received from a customer to execute a payment transaction or in exchange for e-money, the funds are relevant funds and should be safeguarded accordingly. We expect firms to use reasonable endeavours to identify the customer the funds relate to. Pending allocation of the funds to an individual customer, firms should record these funds in their books and records as 'unallocated customer funds'. They should consider whether it would be appropriate to return the money to the person who sent it or to the source from where it was received.

Misleading wording

3.17 One respondent asked us to provide examples of safeguarding wording which would be misleading to customers. Examples include:

- a firm implying that customer protections from safeguarding extend to the firm's non-regulated business, or
- a firm implying that if the firm becomes insolvent, customers' claims for repayment of their funds would be paid in priority to the insolvency practitioner's costs of distributing the safeguarded funds.

Small Payment Institutions (SPIs)

3.18 Some respondents asked whether our guidance required SPIs to safeguard customer funds. We clarify that SPIs do not have to safeguard under the PSRs, but they are required to apply Principle 10 in our Principles for Businesses. Our guidance does not change this, but it does set out the minimum expectations we have of SPIs when complying with Principle 10. Principle 10 requires all firms including SPIs, to arrange adequate protection for clients' assets when they are responsible for them. In our guidance, we explain that all firms, including SPIs, should keep a record of the customer funds that they hold.

3.19 We also remind SPIs that we provide guidance in paragraph 10.10 of our Approach Document in relation to SPIs which choose to comply with the safeguarding requirements in the PSRs.

Account names

3.20 Paragraph 10.38 of the Approach Document states that the safeguarding account in which the relevant funds or equivalent assets are held must be named in a way that shows it is a safeguarding account (rather than an account used to hold money belonging to the firm). In our consultation, we proposed that the account name should include the word ‘safeguarding’ or ‘client’. Having taken into account responses, we are clarifying that the account name should include the word ‘safeguarding’, ‘client’, or ‘customer’. If the credit institution or custodian cannot make the necessary designation evident in the name of the account, we expect the payment/e-money institution to provide evidence, such as a letter from the relevant credit institution or custodian, confirming the appropriate designation.

Prudential risk

4.1 In our consultation, we asked:

> **Q3. ‘Do you agree with our proposed guidance on managing prudential risk? If not, please explain why.’**

4.2 Some respondents suggested changes to the proposed guidance. Responses included:

- Concerns about capital adequacy and the potential impact of deducting intra-group receivables from capital, to reduce intra-group risk, including potential disadvantage to UK firms. There were also questions about what we mean by ‘intra-group receivable’ and ‘best practice’, what an acceptable netting agreement is and how it differs from an intra-group loan, what types of firms our guidance applies to and how often firms should carry out capital adequacy assessments.
- Uncertainty about our expectations of the types of stress testing firms should carry out, and which firms should carry out stress testing, and
- Uncertainty about which firms our liquidity risk management guidance applies to.

Our response

Stress testing

4.3 Some respondents asked us to clarify our expectations on stress testing, including which types of firms should carry-out stress testing. We clarify that the following types of firms should carry out liquidity and capital stress testing:

- authorised payment institutions (APIs)
- authorised electronic money institutions (AEMIs), and
- small electronic money institutions (SEMIs)

4.4 This should analyse the firms' exposure to a range of severe business disruptions, or the failure of one or more of their major counterparties, and assess whether they would cause the firms' business to fail.

4.5 Firms should use these test results to help ensure they can continue to meet their conditions of authorisation and own funds requirements. In particular, they should use these results to inform their decisions on adequate liquidity and capital resources, as well as to identify any changes and improvements to required systems and controls.

4.6 Stress testing should be appropriate to the nature, size and complexity of the firm's business and the risks it bears. 'Business failure' in the context of stress testing is the point at which the market loses confidence in a firm and this results in the firm no longer being able to carry out its business activities. An example of this would be the point at which all or a substantial portion of the firm's counterparties are unwilling to continue transacting with it or seek to end their contracts. Another example would be the point at which the firm's existing investors are unwilling to provide new capital where this is required for the firm to continue operating its existing business. Such a point may be reached well before the firm's financial resources are exhausted.

4.7 A firm should document, review and approve the design and results of their stress testing at least annually by its senior management or governing body. A firm should also carry out stress testing if it is appropriate to do so in the light of substantial changes in the market or in macroeconomic conditions.

4.8 If the firm is a member of a group, it should carry out stress testing on a solo basis taking into account risks posed by its membership of its group.

Capital adequacy

4.9 Some respondents raised concerns about the impact of our best practice guidance on deducting intra-group receivables from capital when a firm is assessing its capital adequacy. These respondents asked us to clarify our expectations. The capital requirements set out in the PSRs and EMRs are designed to ensure that there is an adequate level of financial resource within each individual regulated entity at all times to absorb losses. For a payment or e-money firm which is a member of a group, the capital requirements are set at the level of the individual regulated entity, not the parent group. Under the conditions for authorisation or registration in regulation 6 of the PSRs and regulations 6 and 13 of the EMRs, APIs, AEMIs and SEMIs are required to operate effective procedures to identify, manage, monitor and report any risks to which they might be exposed. In our view, this includes any material risks as a result of the firm's relationship with other members of its group. One example of a relevant risk in this context is where a firm has a material exposure to the credit risk of one or more other group entities due to significant outstanding amounts receivable from those entities. For example, under intra-group loan arrangements.

4.10 A period of financial stress may affect the ability of other members of the firm's group to repay any amounts they owed to that firm. A firm's financial resilience and solvency may be at risk if it relies on other members of the group to repay intra-group receivables when the group is under pressure.

4.11 Our guidance clarifies that, as part of their stress testing and risk management procedures, we consider it best practice for firms to deduct any assets representing intra-group receivables from their own funds. Intra-group receivables include amounts owed to the firm by another member of its group, which are included as assets in the firm's balance sheet. However, if there are legally enforceable netting arrangements in place, a firm may deduct only the net amount receivable by the firm (ie after taking into account any intra-group amounts payable by the firm covered by those netting arrangements). An acceptable netting arrangement should set out the terms for netting of amounts owed under different agreements between the same parties, and be legally effective and enforceable in all relevant jurisdictions.

4.12 Where a firm chooses to apply this best practice, the deduction of intra-group receivables from own funds should also be reflected in the firm's reporting of its regulatory capital position to the FCA. The deducted amount should be included in the Capital resources section - field 'Deductions from CET1 items' in the FSA056 or FIN060a return, as applicable.

4.13 By stating that this is 'best practice', we mean that we consider this approach to be the most effective, but not the only, way of complying with the risk management requirements, and reducing the risk of a firm failing to meet its capital requirements in the future. For the avoidance of doubt, we do not consider that firms are legally bound to adopt this approach. However, if a firm does not apply this approach, it still needs to be able to demonstrate to us that it is adequately managing liquidity risk and group risk to comply with its conditions for authorisation or registration.

4.14 APIs, AEMIs and SEMIs should carry out capital adequacy assessments at least annually. They should also undertake them if there is a substantial change in their business model or circumstances, that would result in a material increase in capital required under the PSRs/EMRs.

Liquidity risk management

4.15 When firms are assessing whether they have adequate liquidity to ensure that they can meet their liabilities as they fall due, we consider it best practice to exclude any uncommitted intra-group liquidity facilities. This is to reduce exposure to intra-group risk. If a firm does not apply this approach, it still needs to be able to demonstrate to us that it is adequately managing liquidity risk and group risk to comply with its conditions for authorisation or registration.

4.16 Some respondents asked which firms this guidance applies to. We have clarified that our guidance on liquidity risk management applies to APIs, AEMIs, and SEMIs.

Governance and controls

4.17 Respondents generally supported our proposed guidance on firms' governance and controls. However, we have clarified that our guidance applies to APIs, AEMIs, and SEMIs.

Wind-down plans

5.1 In our consultation, we asked:

> **Q4. 'Do you agree with our proposed guidance on wind-down plans? If not, please explain why.'**

5.2 Most respondents supported our approach. Some raised questions about the proposed guidance. Questions reflected uncertainty about which types of firms should have wind-down plans and how frequently they should review these plans, whether wind-down plans should be proportionate to size and nature of firm and risks and for a firm which is a member of a group, whether a consolidated wind-down plan would be sufficient.

Our response

5.3 The conditions for authorisation or registration require a firm to satisfy us that they have effective procedures to manage any risks they might be exposed to. We are clarifying that, as part of satisfying us that they have such procedures, we require firms to have a wind-down plan to manage their liquidity, operational and resolution risks, and to quickly identify customer funds and return them as a priority. We expect firms' wind-down plans to be proportionate to the size and nature of the firm. Our guidance on wind-down plans applies to APIs, AEMIs, and SEMIs. Firms should review their wind-down plans at least annually, and when there is a change to a firm's operations which may materially change the way in which it can wind-down.

5.4 Firms which are members of a group should ensure that their wind-down plan considers how the regulated firm within the group would manage its liquidity, operational and resolution risks in a solvent and insolvent scenario, on a solo basis. The plan should take into account risks posed by the firm's membership of its group. These firms should also have a contingency plan to maintain key operational services which are provided by another member of their group in a group stressed scenario.