Finalised guidance

Coronavirus and safeguarding customers' funds: additional guidance for payment and e-money firms

9 July 2020

Introduction

- Guidance for firms on safeguarding and managing prudential risk is already available in our payment services approach document (Approach Document). However, in light of the impact of Covid-19 on firms' business models, we are providing this additional temporary guidance to the industry to strengthen firms' prudential risk management and arrangements for safeguarding customers' funds in this period of economic stress.
- We hope to conduct a full consultation later in 2020/21 on changes to our Approach Document. This is likely to propose incorporating this additional guidance on safeguarding and prudential risk management.

Safeguarding

Keeping records and accounts and making reconciliations

1.1 In our payment services approach document (paragraphs 10.14 to 10.17) we explain that the requirement to safeguard applies to 'relevant funds' in both the Electronic Money Regulations 2011 (EMRs) and the Payment Services Regulations (PSRs). Under the EMRs, these are funds that have been received in exchange for issued e-money. Under the PSRs, relevant funds are:

- sums received from, or for the benefit of, a payment service user for the execution of a payment transaction, and
- sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user.

1.2 A firm should keep records and accounts necessary to identify what relevant funds the firm holds, at any time and without delay (paragraph 10.59). These records should also enable the firm and any third party, such as an insolvency practitioner (IP) or the FCA, to distinguish relevant funds from the firms' own money, and relevant funds held for one customer against those held for another.

1.3 Some permitted forms of safeguarding create the potential for discrepancies that are difficult to avoid (paragraph 10.60). For example, where relevant funds are held in a currency that is different to the currency of the payment transaction. Where there is potential for discrepancies, firms should carry out reconciliations as often as is practicable. In no circumstances would it be acceptable to us for reconciliation to be carried out less than once during each business day.

1.4 For the avoidance of doubt, we are now clarifying that we expect firms to clearly document this reconciliation process and provide an accompanying rationale. This will help with the distribution of funds if the firm becomes insolvent.

1.5 Firms should notify us in writing without delay if, in any material respect, they have not or are unable to comply with the safeguarding requirements of the EMRs or PSRs (paragraph 10.66). They should also do this if they cannot resolve any reconciliation discrepancies in the way described in paragraph 10.65 of the Approach Document.

1.6 We are now clarifying that examples of the type of non-compliance we expect to be notified about in line with paragraph 10.66 are:

- not keeping up to date records of relevant funds and safeguarding accounts, and/or
- where a firm is unable to comply due to the decision by a safeguarding credit institution to close a safeguarding account.

Safeguarding accounts and acknowledgement letters

1.7 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). We are clarifying that this means the account name should include the word 'safeguarding', 'customer', or 'client'. If the credit institution 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.

1.8 As paragraph 10.40 of our Approach Document explains, only the firm, and no one else, may have any interest in or right over the relevant funds or assets in a safeguarding account, except as provided by regulation 21 of the EMRs or regulation 23 of the PSRs. These regulations implicitly give e-money holders and payment service users a beneficial interest in the funds or assets held by the firm in the safeguarding account. Accordingly, we consider that a firm holds these funds on trust for its customers.

1.9 Paragraph 10.40 of the Approach Document also explains that firms should have an acknowledgement, or otherwise be able to demonstrate, that the safeguarding credit institution or custodian, has no interest in (eg a charge), recourse against, or right (eg a right of set off) over the relevant funds or assets in the safeguarding account.

1.10 We are clarifying that the acknowledgement should be in the form of a letter (see Annex 1 for an example). It must make clear that the funds in the safeguarding account(s) are held for the benefit of the firm's customers. And it must 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 account (except as provided by regulation 21 of the EMRs or regulation 23 of the PSRs). Firms should clearly reference the safeguarding accounts in the letter.

1.11 Alternatively, where firms cannot get such an acknowledgement letter, as explained in paragraph 10.40, they should still be able to demonstrate that the safeguarding credit institution or custodian has no such 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 may ask firms for copies of their documentation referred to in this paragraph.

1.12 We also remind firms that, as paragraph 10.39 of the Approach Document sets out, only relevant funds should be held in the safeguarding account. It is important that the asset pool from which to pay the claims of e-money holders or payment service users in priority to other creditors in the event of insolvency is not improperly mixed with funds, assets or proceeds received or held for different purposes (paragraph 10.24). We are now clarifying that this is because mixing these assets may cause delays in returning funds to e-money holders or payment service users following an insolvency event of the firm.

Selecting, appointing and reviewing third parties

1.13 Paragraph 10.59 of the Approach Document gives guidance on the steps a firm should take when appointing and periodically reviewing credit institutions, custodians and insurers. It states that firms should exercise due skill, care and diligence when carrying out this task, and gives examples of the factors that firms should take into account. We are clarifying that firms should carry out the periodic reviews of their providers as often as appropriate. This means they should be carried out at least annually, and whenever a firm might reasonably conclude that anything affecting the appointment decision has materially changed.

When the safeguarding obligation starts

1.14 As paragraph 10.57 of our Approach Document explains, firms must have organisational arrangements to minimise the risk of loss of customer funds through fraud, misuse, negligence or poor administration. Under the EMRs, funds received in the form of payment by payment instrument need not be safeguarded until they are credited to the electronic money institution's (EMI's) payment account, or are otherwise made available to the EMI, provided that such funds must be safeguarded by the end of five business days after the date on which the electronic money has been issued.

1.15 We are providing additional guidance in relation to EMIs that issue e-money, and allow customers to use that e-money to make payment transactions before the customer's funds are credited to the EMI's payment account, or are otherwise made available to it. The EMI should not treat relevant funds it is required to safeguard as being available to meet its commitments to a card scheme or another third party to settle these payment transactions.

Unallocated funds

1.16 In some cases, a firm may not be able to identify the customer entitled to the funds it has received. Despite this, the firm may still be able to identify that these unallocated funds have been received from a customer to execute a payment transaction or in exchange for e-money (as opposed to being unable to identify why the funds have been received). This could happen where funds are received with an incorrect unique identifier (eg account name/number). In our view, these funds are relevant funds and should be safeguarded accordingly. However, we expect firms to use reasonable endeavours to identify the customer to whom the funds relate. Pending allocation of the funds to an individual customer, firms should record these funds in their books and records as 'unallocated customer funds' and 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.

Annual audit of compliance with safeguarding requirements

1.17 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). This includes a breach of the safeguarding requirements or the organisational arrangements requirement (eg such as not keeping up-to-date records of relevant funds and safeguarding accounts, or where a firm is unable to comply due to the decision by a safeguarding credit institution to close a safeguarding account). For EMIs, this may be in relation to either or both the issuing of e-money and the provision of unrelated payment services.

1.18 In addition, the conditions of authorisation for authorised payment institutions (APIs) and EMIs require them to satisfy us that they have adequate internal control mechanisms, including sound administrative, risk management and accounting procedures, and that they have taken adequate measures to safeguard customer funds. We are now clarifying that, as part of satisfying us that a firm has such arrangements, we expect the firm to arrange specific annual audits of its compliance with the safeguarding requirements under the PSRs/EMRs, if it is required to arrange an audit of its annual accounts under the Companies Act 2006.

1.19 These should be carried out by an audit firm, 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. We expect firms to exercise due skill, care and diligence in selecting and appointing auditors for this purpose. 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.

1.20 We expect the auditor to provide an opinion addressed to the firm on:

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

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

1.22 As paragraph 10.66 of the Approach Document explains, firms should 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.

Small Payment Institutions

1.23 Small Payment Institutions (SPIs) are not required to safeguard relevant funds under the PSRs or EMRs, but they are subject to Principle 10 in our Principles for Businesses. Principle 10 requires all firms including SPIs, to arrange adequate protection for clients' assets when they are responsible for them. In our consultation on extending the principles to PIs and EMIs (CP18/21) we made clear that we were not proposing to extend the safeguarding requirements to SPIs, but that they must consider what protections are adequate for the business they are conducting. We are now adding that, when complying with Principle 10, all firms including SPIs, should keep a record of the customer funds that they hold.

1.24 SPIs can choose to opt in to the safeguarding regulations in the PSRs. We encourage SPIs to consider safeguarding their customers' money voluntarily. This guidance also applies to small EMIs in respect of payment services unrelated to issuing e-money. 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.

Disclosing information on treatment of funds on insolvency to customers

1.25 We are giving additional guidance in relation to the information firms give customers. In particular, firms will need to be careful to avoid giving customers misleading impressions about how much protection they will get from safeguarding requirements. Examples include firms implying that customer protections arising from safeguarding extend to a firm's non-regulated business, or implying that on the firm's insolvency, the customers' claims for repayment of their funds would be paid in priority to an insolvency practitioner's costs of distributing the safeguarded funds. We believe this is necessary for firms to comply with the Consumer Protection for Unfair Trading Regulations 2008.

1.26 Payment and e-money firms should also avoid suggesting to customers that the relevant funds they hold for them are protected by the Financial Services Compensation Scheme.

Prudential risk

2.1 The following guidance is in addition to the guidance on the conditions for authorisation or registration in the Approach Document.

Governance and controls

2.2 Authorised payment institutions (APIs), authorised e-money institutions (AEMIs), and small e-money institutions (SEMIs) should ensure they have robust governance arrangements, and effective procedures to identify, manage and monitor risks, in accordance with their conditions of authorisation or registration. A firm's senior management should ensure that the firm regularly reviews its systems and controls, including its governance arrangements. It should also ensure that the firm's governance functions, procedures and controls appropriately reflect the firm's business model, its growth and relevant risks.

Liquidity and capital stress testing

2.3 APIs, AEMIs and SEMIs should carry out stress testing to analyse their 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, and assess their potential impact, using internal and/or external data and scenario analysis. Firms should use the results of these tests 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 around adequate liquidity and capital resources, as well as identifying any changes and improvements to required systems and controls.

2.4 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 should be understood as 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. Examples 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 terminate their contracts, or when the firm's existing investors are unwilling to provide new capital to continue operating its existing business. Such a point may be reached well before the firm's financial resources are exhausted.

2.5 A firm's senior management or governing body should document, review and approve – at least annually – the design and results of a firm's stress testing. 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.

2.6 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.

Risk-management arrangements

2.7 As part of their liquidity risk-management procedures, we expect firms to consider their own liquid resources and available funding options to meet their liabilities as they fall due, and whether they need access to committed credit lines to manage their exposures.

2.8 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 for APIs, AEMIs, and SEMIs 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.

Capital adequacy

2.9 It is essential that firms accurately calculate their capital requirements and resources on an ongoing basis, and report these correctly to us as required in regulatory returns, as well as on request from us. A firm's senior management should ensure that its capital resources are reviewed regularly. Under their conditions for authorisation or registration, APIs, AEMIs and SEMIs are required to operate effective procedures to identify, manage, monitor and report any risks to which they might be exposed.

2.10 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, to reduce exposure to intra-group risk. 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.

2.11 If there are legally enforceable netting arrangements in place, a firm may deduct only the net amount receivable by the firm (i.e. 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 enforceable in all relevant jurisdictions.

2.12 In addition, where a firm chooses to apply this best practice, the deduction of intra-group receivables from own funds should 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).

2.13 This is designed to ensure an adequate level of financial resources within each individual regulated entity at all times to absorb losses. It also reflects the risk that a period of financial stress may affect the ability of other members of the firm's group to repay any amounts owed.

2.14 By 'best practice', we mean that we consider this approach to be the most effective way, 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, firms are not legally bound to adopt this approach. But 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.

2.15 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.

Wind-down plans

3.1 The conditions for authorisation or registration require a firm to satisfy us that they have effective procedures to manage any risks to which they might be exposed. We are clarifying that, as part of satisfying us that they have such procedures, we require APIs, AEMIs, and SEMIs, to have a wind-down plan to manage their liquidity, operational and resolution risks. The wind-down plan should consider the winding-down of the firm's business under different scenarios, including a solvent and insolvent scenario. In particular, the wind-down plan should include/address the following:

- information which would help an administrator or liquidator to quickly identify customer funds and return them as a priority
- funding to cover the solvent wind-down of the firm, including the return of all customer funds
- realistic triggers to start a solvent wind-down
- the need for any counterparties (eg merchants) to find alternative providers, and
- realistic triggers to seek advice on entering an insolvency process

3.2 We expect the complexity of firms' wind-down plans to be proportionate to the size and nature of the firm. 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.

3.3 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 the group in a group stressed scenario.

Annex - Acknowledgement Letter

Safeguarding Bank/Custodian Acknowledgment Letter

We refer to the following [account[s]] which [*name of firm*], regulated by the Financial Conduct Authority (Firm Reference Number [*FRN*]), ('us', 'we' or 'our') [has opened or will open] [and/or] [has deposited or will deposit] with [*name of bank*] ('you' or 'your'):

[*insert the account title[s], the account unique identifier[s] (eg sort code and account number, deposit number or reference code) and (if applicable) any abbreviated name of the account[s] as reflected in the bank's systems*]

([collectively,] the 'Safeguarding Account[s]').

For [each of] the Safeguarding Account[s] identified above you acknowledge that we have notified you that:

1. we are under an obligation to keep [money/assets] we hold belonging to our customers separate from our own [money/assets]

2. we have opened, or will open, the Safeguarding Account for the purpose of depositing [money/assets] with you on behalf of our customers, and

3. we hold all [money/assets] standing to the credit of the Safeguarding Account in our capacity as trustee under the laws applicable to us

For [each of] the Safeguarding Account[s] above you agree that:

4. You do not have any interest in, or recourse or right against, [money/assets] in the Safeguarding Account for any sum owed to you, or owed to any third party, on any other account (including any account we use for our own [money/assets]), except as permitted by [regulation 23(14) of the Payment Services Regulations / regulation 24(1) of the Electronic Money Regulations 2011]. This means, for example, that you do not have any right to combine the Safeguarding Account[s] with any other account and any right of set-off or counterclaim against [money/assets] in the Safeguarding Account, except following an insolvency event (as defined in regulation [23 of the Payment Services Regulations 2017 / Regulation 22 of the Electronic Money Regulations 2011]), and:

(a) to the extent that the right of set-off or counterclaim relates to your fees and expenses in relation to operating the Safeguarding Account, or
(b) if all the claims of our customers have been paid.

5. You will title, or have titled, the Safeguarding Account as stated above and that this title is different from that of any other account containing [money/assets] belonging to us or to any third party.

6. You are required to release on demand all [money/assets] standing to the credit of the Safeguarding Account on proper notice and instruction from us or a liquidator, receiver, administrator, or trustee (or similar person) appointed for us in bankruptcy (or similar procedure), in any relevant jurisdiction, except:

(a) to the extent that you are exercising a right of set-off or security right as permitted by [regulation 23(14) of the Payment Services Regulations / regulation 24(1) of the Electronic Money Regulations 2011], or
(b) until the fixed term expires, any amounts currently held under a fixed term deposit arrangement which cannot be terminated before the expiry of the fixed term,

provided that you have a contractual right to retain such [money/assets] under (a) or (b) and that this right is notwithstanding paragraphs 1 to 3 above and without breach of your agreement to paragraph 4 above.

We acknowledge that:

7. you are not responsible for ensuring our compliance with our own obligations, including as trustee, for of the Safeguarding Account[s].

You and we agree that:

8. the terms of this letter shall remain binding upon the parties, their successors and assigns, and, for clarity, regardless of any change in any of the parties' names

9. this letter supersedes and replaces any previous agreement between the parties involving the Safeguarding Account[s], to the extent that such previous agreement is inconsistent with this letter

10. if there is any conflict between this letter and any other agreement between the parties over the Safeguarding Account[s], this letter agreement shall prevail

11. no variation to the terms of this letter shall be effective unless it is in writing, and signed by the parties

12. this letter is governed by the laws of [*insert appropriate jurisdiction*] [*firms may use this space to insert additional wording to record an intention to exclude any rules of private international law that could lead to the application of the substantive law of another jurisdiction*], and

13. the courts of [*insert same jurisdiction as previous*] have non-exclusive jurisdiction to settle any dispute or claim from or in connection with this letter or its subject matter or formation (including non-contractual disputes or claims)

Please sign and return the enclosed copy of this letter as soon as possible.

For and on behalf of [*name of firm*]

x___________________________

Authorised signatory

Print name:

Title:

ACKNOWLEDGED AND AGREED:

For and on behalf of [*name of bank/custodian*]

x___________________________

Authorised signatory

Print name:

Title:

Contact information: [*insert signatory's phone number and email address*]

Date: