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Payments and e-money: UK FCA consults on two-stage reforms to safeguarding regime

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The FCA believes that there is a continuing problem with poor safeguarding practices across the industry due to poor implementation of the current regulatory framework under the Payment Services Regulations 2017 (PSRs) and the E-Money Regulations 2011 (EMRs). Whilst the proposals for the “interim” are largely a continuation of the current position with some tightening up, the proposals for the “end state” may prompt changes to firms' business models, given the challenges the proposals appear to create.

Of particular interest to: *Authorised payment institutions (PIs) and e-money institutions (EMIs), small EMIs, credit unions issuing e-money in the UK under the PSRs and EMRs, small PIs opting in to safeguarding requirements, EEA firms in supervised run-off under the financial services contracts regime (FSCR).*

What should firms be thinking about and how can Hogan Lovells help?

A lot of the changes being proposed bring the existing Approach Document guidance on safeguarding into the FCA Rulebook. Whilst this doesn’t shift the dial all that much in terms of FCA expectations (breach of the Approach Document might not have technically equated to a rule breach, but it represented a breach of the PSRs in the FCA’s interpretation), the FCA has taken the opportunity to introduce some changes that may impact firms’ day-to-day operations significantly. As with most legal developments, the devil is in the detail.

Regulatory burden and practicalities

With the interim changes, the FCA’s proposals seem based on the idea that there is insufficient focus on what is going on day-to-day within a firm’s safeguarding operations and that firms are not being rigorous enough in dealing with inconsistencies. Proposals are focused on:

- Improving the FCA’s ability to oversee firms operating in the payment space (with monthly and more detailed regulatory reports on safeguarding and the right of the FCA to receive a firm’s annual audit of its compliance with safeguarding requirements); and
- Greater discipline in connection with:

    - a change to, or renewal of, guarantees and insurance policies where a firm relies on this method to safeguard;
    - internal and external reconciliations for firms that rely on segregation – with both required at least once each business day and the need to top-up/remedy any inconsistency by the end of the business day on which the discrepancy is found (from other funds if necessary);
    - daily calculations of a firm's safeguarding requirement for those that safeguard via guarantee or insurance exclusively; and
    - a firm's choice of, and subsequent review of arrangements with, credit institutions, including:
        - additional criteria by which to assess that institution's appropriateness (e.g. creditworthiness of the bank holding the safeguarding account, creditworthiness of the issuer of the guarantee or insurance policy where a firm uses this form of safeguarding and the availability of FSCS protection (or an equivalent)); and
        - yearly reviews of acknowledgement letters to ensure they remain accurate (with firms required to secure an amended letter in the event of any change in parties' details (names, accounts, etc), including where the original details included a misspelling!)

This would essentially appear to be the FCA firming up its current approach, namely: a case of BAU (just more of it!).

However, the longer-term "end state" proposals represent a more significant departure from the current way of doing things and a divergence from the European requirements implemented to date.

These proposed changes suggest that the FCA's primary concern is that the safeguarding regime under the PSRs/EMRs is too relaxed, with the FCA seeking to fill in perceived cracks in the requirements to ensure firms always safeguard sufficient funds to meet claims in full. To that end, the FCA is proposing to:

- limit what a firm can do with the money it receives from customers in the first instance by:
    - requiring firms using the segregation method to receive relevant funds directly into a relevant funds bank account in the first instance, unless they are received by their acquirer on behalf of the safeguarding institution or received into an account the sole purpose of which is to enable participation in a payment system (in which cases such funds are still required to be included in reconciliation calculations and must be paid into the designated safeguarded account by the end of the next business day);
    - requiring firms who receive mixed remittances to pay funds that are not relevant funds out of the relevant funds bank account promptly and in any event before the end of the day on which they are received; and
    - applying the same requirements to funds received by agents and distributors unless firms want to estimate amounts they expect to receive through those channels based on historical data and place an equivalent amount of their own funds in a relevant funds bank account before the start of the next day.

- require firms that rely only on the insurance or guarantee method of safeguarding to have in place written policies and procedures for calculating foreseeable variations in the amount it might need to safeguard and the impact that has on headroom available under its insurance policies (although the drafting at this point makes it unclear if this will apply to all such institutions or only those that also carry out internal reconciliations); and
- require all relevant funds and amounts paid out under a guarantee or an insurance policy to be protected via a statutory trust.

The FCA is also seeking to expand the current position that applies to unclaimed e-money balances to other relevant funds by enabling firms to gift such balances held under the EMRs or PSRs to charity after 6 years if certain conditions are met (subject to any legal right of the consumer to demand the return of funds).

Firms will need to think through what these proposals mean for their approach to various aspects of their business model, depending on the approach used for safeguarding. For example, if a firm uses segregation (which the vast majority of firms do):

- if it currently receives fees in the form of “mixed remittances” that are split out prior to placing relevant funds in a safeguarded bank account, to what extent will it continue to be able to charge fees in this way:
  - when such apportionment must happen after the entire amount has been deposited in an account with a third-party bank specifically opened to hold funds subject to the statutory trust, and
  - given the need to carry out reconciliations at least once per day and remove non-relevant funds on the same day of receipt?
- what level of visibility must it have of funds that acquirers or payment systems may hold on its behalf to ensure that these can be included in the reconciliation process (and how often that data is refreshed)?
- where it receives funds via agents and distributors that cannot be received directly into a safeguarded bank account, to what extent can such firms accurately estimate what the flow of funds will be on a daily basis?
- while the proposal for unclaimed funds means a firm need no longer hold onto balances indefinitely:
  - where such amounts exceed £25 for consumers and £100 in other cases, they will become liabilities that it, or a group member, must undertake to owe indefinitely until successfully claimed. Firms will need to consider:
    - What will that do to the firm’s (or relevant group company’s) balance sheet?
    - And in the latter case – what must a group company do to enable it to make good on this undertaking?

    - firms that have sought to address this issue with the application of administration charges to erode the balance of such amounts will need to consider if this approach is still appropriate from a Consumer Duty perspective if this is offered as an alternative.

Firms might well want to explore whether it is better to adopt a hybrid model of safeguarding (segregation and insurance/guarantees) or rely purely on insurance / guarantees (although moving entirely to this form of safeguarding does require the firm to calculate whether its coverage is enough to cover any "foreseeable variations" whenever it carries out its internal reconciliations).

In addition to the above, accounts opened with credit institutions to hold relevant funds or receive the proceeds of an insurance policy will now need to be formally acknowledged as being subject to a statutory trust (which will require amended acknowledgement letters).

Trust issues

In addition to the safeguarding changes, the FCA is also focused on the circumstances in which the protection that safeguarding offers might need to be relied upon, proposing:

- "interim changes" that require firms to maintain and make available on 48 hours' notice a resolution pack; and
- "end state changes" that:
    - impose the concept of a statutory trust on relevant funds or funds realised under an insurance policy or a guarantee used for safeguarding purposes such that a shortfall can be dealt with via "the well-established principles of tracing, rather than relying on the novel approach in the ipagoo judgment"; and
    - enable firms to pay funds of their own into a relevant funds bank account if it is prudent to do so to prevent a shortfall in relevant funds on the occurrence of a "primary pooling event" (definition TBD), which is termed "Prudent Segregation".

From a consumer protection perspective, ipagoo clearly provides a more straightforward way to ensure that customers who are owed relevant funds are not left out of pocket. However, one can see how it creates uncertainty over the extent to which funds might remain available to creditors (such as suppliers rather than customers) in the event of an EMI/PI insolvency – such firms might be less inclined to lend to or do business with a company if funds that would ordinarily be available to creditors can be used by an administrator or other insolvency practitioner to "top up" or make good a shortfall in a safeguarded account.

To an extent, this is catered for in the special administration regime for EMIs and PIs, as the regime requires the administrators in a special administration to carry out a Day 1 reconciliation and use house funds to top up any shortfall. However, that process is not an on-going process and has to be done in the same way that reconciliations were done by the company prior to administration. The proposals under CASS would require "topping up" on a continual basis.

It also seems odd to labour the point about certainty in the case of topping up safeguarded amounts yet ignore this issue when it comes to Prudent Segregation. In the draft proposals, prudent segregation remains a voluntary action taken at the discretion of the EMI/PI. It is not a requirement. As such, while the mechanism helps ensure customer funds are replete, it reduces the level of general funds to which ordinary creditors would have recourse in the event of insolvency without providing senior managers with the argument that they were required to do this by regulation. It's easy to see how uncertainty in this scenario could lead to litigation and confusion amongst directors at the helm of a company running into difficulty as to where their responsibilities lie – should they voluntarily top up customer funds to the detriment of the ordinary creditors? Should the focus of their duties (owed to creditors once a certain point has been reached) be primarily on customers, even where that prejudices their ordinary creditors?

Admittedly, firms can only do this where it is "prudent", and the circumstances in which it is permitted are going to be subject to further consultation. Still, it will be interesting to see where the FCA believes the line should be drawn. (The current draft guidance suggests it might be prudent to act in this way in response to systems failures and exchange rate movements between the currency of the relevant funds bank account and the currency in which the safeguarding institution has liability to its clients, which could lead to a shortfall in relevant funds.)

Further, the insistence on having a statutory trust in place over the accounts into which relevant funds must be received by the EMI/PI poses additional practical concerns:

- What happens, for example, if mixed remittances aren't split before the end of the day (e.g. due to a systems failure)? Apart from being a regulatory breach – Do they become trust funds and no longer available to a firm to remove? Or does this lead to the commingling of funds?
- What happens if the EMI receives funds from a person subject to sanctions? Would the trust contain tainted funds?

Divergence

The approach proposed by the FCA marks a clear move away from the approach the rest of Europe is following, with safeguarding under PSD3 appearing to remain more or less "as is" (subject to the proposed requirement to mitigate concentration risk when it comes to safeguarded funds by (for example) diversifying one's choice of banks).

Should the FCA's proposals go through, firms subject to the UK regime that continue to be subject to EMD2 and PSD2 in Europe might no longer be able to adopt the same safeguarding approach across all their operations.

Separately, the added complexity and regulatory burden that the changes to the UK regime would introduce seem at odds with the direction the new Labour Government wants to adopt, with the announcement of plans to cut red tape and make the UK an attractive place for investment.

What's next?

The consultation closes on **17 December 2024**. The FCA plans to publish final interim rules with an accompanying policy statement within **the first six months of 2025,** followed by a six month implementation period. See 'Implementation' above for more on next steps.

Publication of final end-state rules (including new rules for when a payments or e-money firm fails or where a third-party used for safeguarding purposes fails) depends on HMT’s revocation of the safeguarding requirements in the EMRs and PSRs. Firms would be given another **12 months** to implement these additional changes following revocation.

The FCA does not intend to consult separately on the changes to the Approach Document mentioned above as they are consequential to the proposed rules.

The FCA will continue to work with HMT to review and consult on the rest of the current PSRs and EMRs regime, with a view to moving the firm-facing requirements into the Handbook.

In the meantime, if you would like to discuss how we can help you prepare your response to the Consultation and then to prepare for the changes, please reach out to any of the people listed in this article or your usual Hogan Lovells contact.

Authored by Julie Patient and Virginia Montgomery.