Avoiding a payments lockdown

A paper presented to the Financial Conduct Authority and HM Treasury in the wake of the temporary shutdown of Wirecard Card Solutions Limited

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Introduction

The Emerging Payments Association is an industry association of payments professionals whose goals are to strengthen and expand the payments industry to benefit all stakeholders. Its membership includes participants from all parts of the payments ecosystem, from Tier 1 banks to innovative fintechs, and everything in between.[1]

We have created this paper in light of the recent regulatory intervention which caused a shutdown of the services of Wirecard Card Solutions Limited (**WDCS**) in late June. The circumstances surrounding the shutdown were in many ways extraordinary, in particular because of the investigation of such a very large level of fraud and the commencement of insolvency proceedings at the parent company in another jurisdiction. We fully understand that because of these circumstances, the FCA was faced with, and had to react quickly to, heightened concerns over the safety of safeguarded customer funds.

Whilst the WDCS shutdown is probably something of a case unto itself, its consequences during those few days can be seen as instructive both in terms of what the corollary effects of <u>any</u> shutdown are likely to be (whether instigated by the FCA or occurring through, for instance, insolvency), and in terms of other preparations that could be taken by industry and the regulator to lessen the effect of such a shutdown for industry and customers. Some of these may well complement the increase in 'wind-down planning' activity that the FCA has rightly encouraged.

In creating this paper we have drawn on the views of stakeholders from across the payments industry, including processors, e-money issuers, major banks, agency banks, programme managers, former regulators, specialist payments consultants, and legal advisers to the payments industry.[2] We are presenting this paper to the FCA and HM Treasury for two purposes:

- The first is, in order to set the scene, to provide a reference guide from the point of view of the payments industry, to the complex business models which underpin today's e-money and BIN sponsorship industry (Sections and 1 and 2).

- The second is, having analysed the effects and, from outside the situation, what we understand to be the causes of the shutdown, we offer our collective insights on various aspects surrounding the shutdown, namely:

  - how firms and regulators can avoid getting into a similar situation (Section 3);
  - alternative means of dealing with similar situations as they arise (Section 4);
  - the identification of the impact of regulatory intervention on different groups of customers (Section 5);
  - communication priorities and strategy (Section 6);
  - repatriation of funds (Section 7); and
  - areas of concern around safeguarding (Section 8).

[1] Please note that, whilst WDCS are a member of the EPA, they have not participated in the production of this paper.

[2] Whilst the views in this paper have been drawn from a number of industry participants, they may not be representative of the views of all EPA members.

We are highly motivated to achieve a payments industry that thrives and innovates, for the benefit of customers, and firmly believe that this can only be achieved through a level of cooperation and communication between industry and regulators that allows regulators to tailor their actions to the business models and practical realities of the industry as it continuously evolves. We therefore offer this paper, and the numerous suggestions in it, as a means of facilitating an increase in that communication and cooperation, and welcome further discussion on the topics addressed.

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1. Overview of UK e-money issuer and BIN sponsorship operating models

1.1 Introduction

a. It is important to appreciate the variety and complexity of e-money issuer operating models, which determine the types and ranges of third-party relationships e-money issuers hold. For example, some operating models may involve entities which are authorised to issue e-money also providing unregulated services, such as scheme settlement to other authorised entities. The parameters of the parties involved, and who amongst them is providing regulated services, have direct practical implications in dealing with e-money issuers and their responsibilities in distress or insolvency situations. This section attempts to provide a high-level overview of the operating models commonly used by e-money issuers.

1.2 Electronic Money Issuers

a. Electronic money (**e-money**) can be issued by persons authorised or registered to do so pursuant to national legislation implementing the Second Electronic Money Directive[3] (**EMD2**). In the UK, EMD2 is implemented in the UK by the Electronic Money Regulations 2011 (as amended). Typically, an e-money issuer is authorised or registered as an Electronic Money Institution (**EMI**), however, e-money can also be issued by other types of entities (such as the Post Office Limited or credit institutions with a Part 4A permission to issue e-money under the Financial Services and Markets Act 2000). At the time of writing, the register of the Financial Conduct Authority (**FCA**) shows 172 authorised EMIs and 24 registered small EMIs in the UK. EMIs are also permitted to provide payment services (for example, to issue payment cards) subject to the Payment Services Regulations 2017 in the UK. By comparison, a person authorised or registered as a payment institution (**PI**) under the legislation implementing the Second Payment Services Directive (the Payment Services Regulations 2017 in the UK) can only provide the specific payment services for which it holds permissions.

b. E-money has often been used as an alternative to more traditional bank accounts and products, and e-money issuers have enabled major innovations in the payment services industry and the fintech sector.

c. E-money issuers have developed various business models for bringing their e-money and payment services into the market. The collection of parameters for such e-money issuance and/or payment services, taking into account the intended use cases, customers and the method of delivery to the market, are often referred to as a 'programme' or a 'card programme'. The exact model for delivery and management of a programme depends on many factors, including: (i) the requirements for holding of appropriate regulatory permissions for the services involved and which of the parties involved holds such permissions; (ii) the membership with, or indirect access to, the card schemes (e.g. VISA or Mastercard) or other payment systems (e.g. Faster Payments, SEPA) to enable the making of payments; (iii) the cost of all the services required to manage and operate a programme and the opportunities for economies of scale when operating multiple programmes; and (iv) the knowledge or expertise in or ability to deliver to a particular market segment or customer base.

d. Very broadly and at the risk of over-simplification, e-money issuers can be categorised based on their model of operations, as set out in the table below. It is important to note that a single e-money issuer could fall under one or more of these categories, depending on the programmes it runs. The underlying principle, however, regardless of the model or category in question, is that the entity providing the e-money issuance and/or payment services has to be appropriately authorised to do so and bears the regulatory responsibility with respect to such services being provided (including for safeguarding of funds of its e-money holders/payment

[3] Directive 2009/110/EC of the European Parliament and of the Council of 16th September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions, amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

service users). This applies regardless of the involvement of any third party in the management and/or delivery of a programme.

	E-money issuer categories	
1.	**Direct e-money issuers**	• E-money issuer manages and delivers its own programme(s) • E-money issuer issues e-money and/or provides payment services to e-money holders/payment service users, and holds a direct contractual relationship with them • Programme is typically branded with the e-money issuer's brand and e-money issuer communicates directly with its customers (= the e-money holders/payment service users) • E-money issuer can operate own payment network ('closed loop'), be a direct member of a card scheme or a payment system, or contract with an existing scheme/system member for indirect access/sponsorship • E-money issuer typically outsources certain technical and operational services to third party providers (see 2.4 below)
2.	**Partner e-money issuers:** e-money issuers that issue e-money/provide payment services in partnership with third party partners	• E-money issuer manages and delivers various programme(s) in partnership with third party partners such as programme managers (**Programme Managers**) • Programme Managers can in turn contract with other partners, sometimes referred to as '**Programme Owners'** who may bring the customers for the programme and play a role in communications with such customers to deliver the programmes • E-money issuer issues e-money and/or provides payment services to e-money holders/payment service users and holds a direct contractual relationship with them with respect to those regulated activities; each Programme Manager (and Programme Owner, if applicable) may also have a direct contract with those customers (with respect to the unregulated services they provide) • Programme is typically branded with the brand of the Programme Manager or Programme Owner • E-money issuer can be a direct member of a card scheme or a payment system or contract with an existing scheme/system member for access/sponsorship • E-money issuer can have third party distributors or agents (which may include Programme Managers and Programme Owners, as applicable; see further 2.3b below) • E-money issuer typically outsources majority of technical and operational services to a Programme Manager who in turn sub-outsources some of those services to other third party providers (see 2.4 below) and/or Programme Owners
3.	**Settlement partners:** Entities which are authorised to issue e-money, providing access to settlement services to other authorised entities	• E-money issuer can be a direct member of a card scheme or a payment system or contract with a payment system member for access to the payment system • E-money issuer contracts with other authorised entities (such as an EMI or a PI) (**Authorised Customer**) to provide card scheme /payment system access (this is 'BIN sponsorship' - see further 1.3 below) and settlement services for Authorised Customers' programmes • E-money issuer's services to Authorised Customer may be limited to unregulated settlement-related services only or

		may also involve issuance of e-money and/or provision of payment services to an Authorised Customer • E-money issuer does not hold a direct contractual relationship with Authorised Customers' service users in relation to the issuance of e-money. Each Authorised Customer contracts with and is responsible for any regulated services it provides to its own customers • Authorised Customer can act as a direct e-money issuer or a partner e-money issuer (see above), or may be providing other regulated services that do not involve e-money at all, but do require access to payment schemes • E-money issuer can outsource certain technical and operational services to third party providers

We have provided diagrams illustrating each category in the **appendix** at the end of this paper.

1.3 BIN sponsorship

a. BIN sponsorship is the provision of access to a card scheme (Visa, Mastercard, Union Pay, JCB, Discover) by a regulated principal member of the scheme, to a non-member, in order to issue card-based payment instruments. It enables companies to offer bespoke card products in a relatively fast and inexpensive way, with the support and experience of an existing member.

b. The term 'BIN sponsorship' should not be conflated with the provision of a payment account or other e-money or payment services, or the safeguarding of customer funds. BIN sponsorship instead describes the allocation of a Bank Identification Number (BIN) at a card scheme, to a specific programme/product by the sponsor, on behalf of their customer, the Programme Manager. BIN sponsorship services enable the issuance of cards and the settlement (via the card scheme) of transactions carried out using cards for a particular programme. Such cards are card-scheme based, but not necessarily plastic cards - they can also be virtual, digital or wearable - and the funds that are settled to a merchant via a card scheme may be e-money, but may also be from credit, debit or crypto asset accounts.

c. BIN sponsors do not tend to issue their own products, but instead issue multiple products or programmes in order to achieve economies of scale. As each product operates differently, operational activities are often undertaken by the BIN sponsor's client – typically referred to as a Programme Manager.

d. Whilst business models vary, frequently Programme Managers will decide which other third parties they will work with to provide the various services necessary to issue cards, negotiate commercial agreements and technically integrate, with the BIN sponsor remaining 'agnostic' as to the choice of third party service provider. However, where a BIN sponsor acts as an issuing partner and issues the e-money and/or provides payment services in conjunction with its BIN sponsorship services, the BIN sponsor retains appropriate oversight over services which are sub-outsourced to third parties by the Programme Manager.

e. BIN sponsors are not indispensable and it is possible to 'migrate' customers to another issuer by instigating a transfer of the BIN with the card scheme. This requires the consent of all parties (including the cardholders, where the migration results in a change of the legal issuer of e-money and/or payment instruments) and takes a significant amount of work, time and cost, so is not undertaken lightly – however the change is usually barely noticeable to the cardholder.

f. BIN sponsorship is not in itself recognised in regulation, but is self-regulated by the card schemes. Each scheme governs its members by publishing thousands of pages of guidance and rules with which its members must comply or face stiff penalties or suspension. The BIN sponsor remains responsible for settlement with the card schemes and compliance with scheme rules and will have set up the mechanisms to obtain funds from the Programme Manager or other relevant third party in time for settlement.

g. The issuance of payment instruments (such as cards) and other ancillary payment services, such as the operation of payment accounts from which the card transactions are made, are regulated and require the provider of those services to be appropriately authorised to do so. However, it is important to note that an e-money issuer that offers BIN sponsorship services can do so either as a partner e-money issuer where it issues e-money and provides payment services (including issuing payment instruments) to the e-money holders/payment service users; or as a settlement partner for other Authorised Customers in which case it is the Authorised Customer that issues e-money and/or provides the payment services to its customers. With respect to acting as a settlement partner, the BIN sponsor's services to the Authorised Customer may fall outside of e-money and payment services regulated activities.

h. If the Programme Manager is not regulated, the BIN sponsor will often provide the payment services required for operating a payment account, thereby undertaking full regulatory responsibility for the product and its customers. In other words, the BIN sponsor would also act as the 'partner e-money issuer' (see table above).

i. Where the Programme Manager is authorised to issue e-money (or other regulated activity involved in the provision of funds used for settlement of card transactions, such as credit) and/or to provide the ancillary payment services, it would typically act as an Authorised Customer and the BIN sponsor would usually act as a settlement partner only (see table above). There are variations where the BIN sponsor only issues the payment instruments, not the payment account, such payment account and/or the issuance of e-money (where relevant) being provided and operated by the Programme Manager.

j. The BIN sponsorship model arose following the first Payment Services Directive[4] and the ability of non-banks which were authorised to provide payment services to become members of card schemes. This led to the rapid expansion and innovation of prepaid services, predominantly by unregulated companies seeing opportunities that complemented their existing businesses - from closed loop gift cards to reloadable general spend and travel offerings.

k. A number of payment service providers (**PSPs**) now offer access to additional payment systems and offer Banking as a Service (BaaS) - IBAN sponsorship, digital wallets and access to instant payment systems such as Faster Payments and SEPA. This is often achieved using a similar relationship structure, through the sponsorship of a direct member of the relevant payment system, often referred to as indirect participation or agency banking.

l. This approach may be seen as a stepping stone, as many successful companies which start off as Programme Managers will eventually become regulated in their own right and subsequently obtain card scheme principal membership. However, the model continues to lower barriers to entry for new participants and drive innovation, enabling companies test out new products and start-ups to achieve scale, in line with the FCA's objectives. For instance, Monzo and Revolut both started out as distributors / Programme Managers of e-money issued by EMIs, before getting their own banking licences; and numerous other successful fintechs such as Curve, Monese, ANNA Money, Soldo and Pockit rely on similar structures.

[4] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC

2. Nature of the contractual relationships between the main actors in the market

2.1 Nature of contractual relationships/roles

a. The delivery and management of a programme often involves a complex network of third parties working together. The range of e-money issuers' third party relationships can be broken-down into: (i) customer relationships; (ii) customer-facing third party relationships; (iii) other outsourced service provider relationships; (iv) card scheme/payment system access relationships; and (v) safeguarding account relationships.

2.2 Customer relationships

a. E-money issuers have contractual relationships in place with their e-money holders and/or payment service users – broadly speaking their customers. The rights against the e-money issuer and the obligations of such customers are governed by the terms of their contract with the e-money issuer and the requirements of the relevant regulations.[5] This applies whether an e-money issuer provides its own programmes (as a 'direct e-money issuer') or in partnership with other third parties such as Programme Managers (as a 'partner e-money issuer'). Where an e-money issuer provides settlement services to other Authorised Customers (as a 'settlement partner'), it is typically such Authorised Customers that would hold the contractual relationships with their own e-money holders and/or payment service users. As part of its contractual relationship with an Authorised Customer, a settlement partner may also issue e-money and/or provide payment services to the Authorised Customer themselves.

2.3 Customer-facing third parties

a. An e-money issuer (whether acting, in relation to a particular programme, as a direct e-money issuer or as a partner e-money issuer) can partner with various third parties. Such relationships are typically forged due to the knowledge or access that such third parties have in a particular market or customer base, and therefore such third parties would often play an important role in communications and delivery of the e-money issuer's products to customers.

b. From a regulatory perspective, such customer-facing third parties can be (depending on the precise nature of their role and activities undertaken in relation to a programme):

i. **EMI EMD Agents.** EMIs and PIs can provide payment services through agents. In the case of an EMI's agents, such agents are referred to as 'EMD Agents'. A third party would be classed as an agent if its activities undertaken on behalf of an EMI constitute payment services.[6] UK EMIs and PIs cannot provide payment service through agents until such agents are registered with the FCA.[7] EMIs can also distribute or redeem e-money through such registered agents.[8] At the time of writing, the FCA's register shows 220 EMD Agents. Note EMD Agents may be registered by more than one EMI.

ii. **Distributors.** An EMI can distribute or redeem e-money through distributors.[9] Distributors do not have to be registered with the FCA, but an EMI may have to notify the FCA of changes in its distributors pursuant to their duty to notify significant changes in EMI's circumstances.[10] A third party would be classed as a distributor if its

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[5] Electronic Money Regulations 2011 and/or Payment Services Regulations 2017.
[6] See Schedule 1 (Payment Services) of the Payment Services Regulations 2017.
[7] Regulation 34(1) of the Electronic Money Regulations 2011 and Regulation 34(1) of the Payment Services Regulations 2017.
[8] Regulation 33(1) of the Electronic Money Regulations 2011.
[9] Regulation 33(2) of the Electronic Money Regulations 2011.
[10] Regulation 37 of the Electronic Money Regulations 2011.

activities undertaken on behalf of an EMI constitute distribution or redemption of e-money. EMIs cannot issue e-money or provide payment services through distributors.

iii. **Outsourced service providers.** An EMI can outsource certain operational functions in relation to a programme to third parties. In the context of customer-facing third parties, examples of operational functions that may be provided by them include the provision of customer services or a third-party branded website or app with access to the e-money and/or payments services (e.g. to display transaction information). EMIs only have to notify the FCA of their intention to enter into an outsourcing contract where they will be relying on a third party to provide an 'operational function relating to the issuance, distribution or redemption of e-money or the provision of payment services'.[11]

c. In each case, an EMI remains responsible for the actions or omissions of its agents, distributors or outsourced service providers in relation to its e-money and/or payment services.[12]

d. Programme Managers, depending on their activities in relation to a programme, could be EMD Agents, distributors or outsourced service providers. As stated above, when working with Programme Managers, an EMI acting as a 'partner e-money issuer' typically issues e-money and payment cards of a particular card scheme. The Programme Manager brands the product, provides the technology and undertakes a lot of the operational activities in relation to a programme. Such Programme Managers may in turn source the technology providers and enter into direct relationships with other third party service providers necessary for the delivery of the services/programme (payment processors, card manufacturers, website/app developers, data/cloud storage providers, identity verification providers for the purposes of customer due diligence, sanctions and PEP (politically exposed persons) screening, open-banking API providers etc).

e. As set out above, EMIs can also act as BIN sponsors for other Authorised Customers (as a 'settlement partner'). An Authorised Customer would typically not be considered either as an EMD Agent, a distributor or an outsourced service provider of a BIN-sponsoring EMI. This is because Authorised Customers would typically have their own regulatory permissions to provide payment services, including the issuance of payment instruments (cards). Therefore, such Authorised Customers would issue cards and provide other payment services and/or issue e-money to their own customers, and retain the regulatory responsibility for such services. The BIN sponsoring EMI's services to the Authorised Customer would consist of card scheme settlement services, enabling the Authorised Customer to offer card payment functionality. A BIN sponsoring EMI may, but does not necessarily, also issue e-money and/or provide payment services to its Authorised Customers as part of its services.

f. EMIs can also work with third parties on programmes which involve payment functionality other than card payments, for example, credit transfers which would require access to payment systems (such as Faster Payments or SEPA). Similarly to BIN sponsorship, in relation to programmes which involve access to such other payment systems, an EMI could work with Programme Managers (as a 'partner e-money issuer') or provide settlement services to other Authorised Customers (as a 'settlement partner').

2.4 Other outsourced service provider relationships

a. EMIs typically outsource certain operational and technical functions/services to specialist providers of such services. The contracts with such service providers would set out the nature of the services, any SLAs, security requirements, audit rights etc. As with other outsourced services, the EMIs bear the responsibility for the services carried out by such service providers. An EMI who works with a Programme Manager may outsource most or some of those services

[11] Regulation 2(1) of the Electronic Money Regulations 2011.
[12] Regulation 36(2) of the Electronic Money Regulations 2011.

to the Programme Manager and the Programme Manager may in turn enter into contractual arrangements with the outsourced service providers.

b. Examples of such specialist outsourced service providers include:

i. card processors providing technical card transaction processing services;

ii. card bureaus providing card manufacturing and delivery services; and

iii. identity verification, PEPs and sanctions screening and transaction monitoring service providers.

2.5 Card scheme and payment system relationships

a. EMIs have to be principal members of a card scheme (e.g. VISA or Mastercard) in order to issue card-scheme based cards, the transactions for which are settled via the relevant scheme. The EMI's contractual relationship with the card scheme would include: (i) a licence to issue scheme-branded cards and use their marks; (ii) rights and obligations with respect to settlement with the scheme for any transactions carried out via the scheme and any refunds; (iii) any scheme collateral requirements, such requirements intended to cover the EMI's settlement obligations. Where an e-money issuer works with third parties, whether as a 'partner e-money issuer' with Programme Managers or as a 'settlement partner' with Authorised Customers, it will have contractual and operational arrangements in place with such third parties to be placed in funds to ensure that it is able to meet its card scheme settlement obligations.

b. Other than card payments, some programmes may involve other types of payment functionality, such as credit transfers. Examples include payments effected through Faster Payments or SEPA systems. Enabling such functionality requires that an EMI is either a member of a payment system (which is relatively uncommon due to high costs and burdensome operational requirements) or is sponsored by an existing participant of the payment system, typically a bank. Such sponsored access to a payment system is often referred to as 'agency banking'. Where an EMI is a direct member of a payment system, it would have contractual relationships in place with the payment system and/or the central bank with which the accounts used for settlement are held. Such contractual relationships would, again, cover the rights and obligations with respect to settlement with the payment system participants for any transactions carried out via the system and any refunds or collateral requirements, with such requirements being intended to cover the EMI's settlement obligations via the payment system. Where, however, an EMI is sponsored for such system access by an existing participant of a system (agency banking), the EMI's contractual relationship would be with a sponsoring participant (typically, a bank) and the EMI would be required to place the sponsoring participant in funds, in order for such participant to meet their settlement obligations.

c. Similar to BIN sponsorship, EMIs may work with third parties such as Programme Managers or Authorised Customers in relation to a programme involving payments requiring access to the payment system. Where this is the case, an EMI will have contractual and operational arrangements in place with such third parties to be placed in funds to ensure that it is able to meet its settlement obligations to the payment system or the sponsoring payment system participant.

2.6 Safeguarding account relationships

a. EMIs are required to safeguard: (i) the funds received in exchange for e-money issued by them; and/or (ii) separately, where providing payment services not related to the issuance of e-money, the funds received for the execution of payment transactions.[13] The safeguarding

[13] Regulation 20 Electronic Money Regulations 2011.

requirements are that the relevant funds are segregated from any other funds and are, where held at the end of the business day after receipt, held in a safeguarding account with an authorised credit institution or the Bank of England (the latter applies only where an EMI is a participant of a designated payment system)[14]. Relevant funds could also be safeguarded by protecting the funds by an insurance policy or a comparable guarantee. However, due to the need for liquidity to move funds in and out as transactions are executed by an EMI, holding the funds in a safeguarding account with an authorised credit institution is by far the most common method of safeguarding.

b. EMIs must have contractual arrangements in place with the safeguarding credit institution with which the safeguarding account is held. The account must be designated by the credit institution so as to show it is used to hold customer funds in accordance with the applicable regulations. No person other than the EMI may have any interest or right in the relevant funds placed in the safeguarding account and the EMI will seek an acknowledgment from the safeguarding credit institution that it has no such rights over the funds in the safeguarding account.

c. Where a 'settlement partner' works with an Authorised Customer, it is the Authorised Customer's obligation to ensure that it safeguards the relevant funds with respect to e-money issued or payment services provided to its own customers.

d. There is further detail on safeguarding in section 8.

[14] Regulation 21(2) Electronic Money Regulations 2011

3. Activities or structures that might prevent a firm from getting into this type of situation

In order to properly respond we must first define 'type of situation'.

In our view the situation surrounding WDCS is a 'black swan' event coming out of a group of businesses which have been created across a number of territories, of which one entity is a regulated PI or EMI. The 'event' is one in which the parent (or sister) business has an incident, be it fraud, insolvency or otherwise which leads to a run on or damage to its underlying regulated firm.

3.1 This being the case what 'activities' could be done to pre-empt it?

Speak to the Regulator

a. In terms of activities, first and foremost is for a firm to take immediate action as soon as there is any real question over a related company, and to meet up with the national regulator to talk though the potential consequences. In this way, the regulator can see that the firm is being proactive and can work with the firm to resolve any potential issues. If the firm waits too long to approach the regulator, either the regulator may approach to the firm directly, or when it is invited in, it may have limited time to act - hence the need to bring in the regulator as early as possible. Firms should be made aware of the importance of being as transparent and helpful as possible, looking at the situation through the regulator's eyes and helping to come up with ways forward which will cause the least damage to the firm and its end users.

b. In the latest temporary guidance from the FCA (*Coronavirus and Safeguarding Customers' Funds: Additional Guidance for Payment and E-money Firms dated 9 July 2020*[15]), the FCA is, inter alia, clarifying its expectation that firms stress test their liquidity and capital position and have wind-down plans that cover solvent and insolvent scenarios. We think this is an excellent idea because, in situations like this, clarity over the safeguarding of end user funds is paramount, as is the firm's capital adequacy, and if the situation has been properly modelled, a better outcome can be implemented. The guidance states that:

   '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.'

c. Indeed, there is certainly a case that, for the larger multinational, multi-programme firms like WDCS, their supervision should be closer to that for banks than the smaller, single-programme firms that are unlikely to get into this type of situation. The greater the complexity and size (both in terms of daily transaction volumes as well as e-money held), the greater the level of supervision required. It is so important that the fintech industry is allowed to thrive with good regulation and good regulators and creating a proportionate regulatory regime is to key to this.

d. As the FCA pointed out in their recent '*Dear CEO*' Portfolio strategy letter for payment services firms and e-money issuers dated 9 July 2020[16]:

[15] Available at https://www.fca.org.uk/publication/finalised-guidance/coronavirus-safeguarding-customers-funds-additional-guidance-payment-e-money-firms.pdf

[16] Available at https://www.fca.org.uk/publication/correspondence/payment-services-firms-e-money-issuers-portfolio-letter.pdf

‘many firms do not review their regulated processes sufficiently frequently to ensure that they remain compliant as the business changes or grows.’

e. The key phrase here is ‘as the business……grows’. It is at these times, especially, that in our view the regulator’s approach should also change and, based on the size and speed of growth, monitored accordingly. Too often, firms grow quicker than their internal resources, needed to deal with such growth, can cope with and the business is thereafter always in catch-up mode until something happens. A proper acceptance by firms that this needs to be done ahead rather than behind the curve is necessary to avoid these situations in future. How can a regulator assist here? Through education and leadership. The FCA has always been progressive and proactive in listening to the industry and creating good guidance. This must continue but must also reflect the stage the firm is at in its growth, from start-up to mature business. Regulators can only ever interpret and follow the law, not change it, and this must be accepted by the industry, such that if the regulation doesn’t fit perfectly then the regulator can only give the best guidance and interpretation of it for the industry until it is changed though the legislative process.

Actively deal with PR

f. In a situation like WDCS it is key for a firm to highlight the independence, if applicable, of the subsidiary as quickly as possible and not hide away. When a subsidiary shares a name and brand with a parent ‘in trouble’ then there is a natural assumption that it is the same business, even if it is a separately regulated company. As such, the media messaging is crucial. In addition, the messaging of an EMI or BIN sponsor to its Programme Managers and their end customers, needs to be coordinated like a military operation (there is further detail on communications strategy in section 6). In such situations, although unusual, we wonder if the subsidiary should change its name and even split from its parent to achieve greater distance. These are difficult questions but ones that should be built into contingency planning for events like this.

3.2 This being the case what ‘structure’ could enable a better outcome?

a. The group structure of WDCS, with the UK entity being a separate company and having its own authorisation from the FCA, with its own capital requirements being met as well as the FCA accepting it was governed and run in the UK, should have been enough. But, could there have been a way to give it even greater separation? Could its ownership have been separated more? Could it have operated with a different name? Should it have avoided entering into joint contracts for its customers with other group companies? All of the above would take away from the benefits of running groups of companies: the use of the same name, the ability to leverage associated companies in the group and the cross-funding opportunities to ensure any new business is already backed by the size and experience of the group, are fundamental to having a group structure.

b. We wonder whether, in line with the FCA’s current thinking in relation to wind-down planning, the solutions to these issues lie in exit and recovery planning and having a structure that can quickly and easily separate, like deploying the ejector seat in a fighter jet about to crash.

3.3 Conclusion

We can only hypothesise over what could have been done better in future, but we can take some of the steps above and work with regulators to see how we could create a better outcome in a similar situation. Above all, the industry must always learn and not be afraid to ask for help.

4. Alternative means of dealing with situations as they arise

4.1 What are the FCA's powers?

a. The FCA has the power to cancel, vary or place requirements on an EMI's authorisation in accordance with the Electronic Money Regulations 2011/99 (**EMRs**).

b. Regulation 11 of the EMRs gives the FCA the power to vary an EMI's authorisation on the FCA's own initiative, that is, as opposed to a variation on the EMI's own initiative. This includes the power for the FCA to impose a requirement on an EMI's authorisation. The FCA may exercise this power if it appears to it that certain prescribed conditions are met, including, for example, where the variation is desirable in order to protect the interests of consumers (regulation 11(1)(d)).

c. A requirement may be imposed for an indefinite period and in accordance with regulation 7 of the EMRs. A requirement may, in particular, be imposed so as to require the EMI to: (a) take a specified action; or (b) refrain from taking a specified action. Also, a requirement may be imposed by reference to the EMI's relationship with its group or other members of its group. Beyond these limitations, the FCA has a very broad discretion as to what to include in the terms of a requirement imposed pursuant to regulation 11.

d. The FCA has an additional power under regulation 52 of the EMRs that allows it to suspend an EMI's authorisation or impose limitations or other restrictions on its payment services or e-money business activities for a maximum of 12 months as it considers appropriate, where an EMI has contravened a requirement under the EMRs. Again, the FCA has very broad discretion as to what to include in the terms of a limitation or a restriction on an EMI's activities.

e. The main differences between the FCA's powers under regulations 11 and 52 appear to be that, under regulation 11 requirements can be imposed indefinitely and do not require there to be contravention of the EMRs (for example, the FCA could impose a requirement in order to protect the interests of consumers), whereas under regulation 52, there needs to be a contravention of the EMRs and the FCA can only suspend an EMI's authorisation and/or impose limitations/restrictions for up to 12 months (although the imposition of a requirement under regulation 11, for example, to cease providing payment services or issuing e-money could have a similar effect to a regulation 52 suspension).

4.2 Action taken by the FCA in relation to WDCS

a. The FCA imposed various requirements on WDCS on 26 June 2020, including that it must not dispose of any assets or funds, that it must not carry on any regulated activities and that it must set out a statement on its website that it is no longer permitted to conduct any regulated activities.

b. These requirements were lifted as of 00:01 on 30 June 2020, although certain requirements continue to apply as set out in the FCA's Financial Services Register.

c. The FCA has not stated which powers it used in applying these requirements to WDCS (for example, under regulation 11 or 52 of the EMRs). The statements that the FCA published on its website (including in the Financial Services Register) in relation to WDCS used the term 'requirement' (as opposed to a 'limitation' or 'restriction'); were not time-limited; referred to its objective of protecting the e-money funds of consumers in safeguarded accounts; and did not refer to any contravention of the EMRs. We can probably assume, therefore, that the power exercised was pursuant to regulation 11 rather than regulation 52, but it is not totally clear.

EPA

4.3 What else could the FCA have done?

a. Given the broad discretions granted to the FCA under EMRs, the FCA could have taken action other than prohibiting WDCS from carrying on any type of regulated activities, albeit temporarily. For example, the FCA has the power, under the EMRs, to require an EMI to cease carrying on certain aspects of its business (for example, accepting new customers), whilst allowing it to continue to carry on with other aspects of its business (for example, executing customers' payment orders and issuing e-money in relation to funds received into customers' accounts).

b. Where WDCS acted only as a 'settlement partner' in relation to a card programme (and not as the regulated party that has the direct relationship with the end customer/card user, i.e. as a 'direct e-money issuer' or a 'partner e-money issuer'), and thus did not hold customers' monies as safeguarded funds under the EMRs, the FCA could have allowed those programmes to continue on the basis that there would have been no WDCS-related risk to customers' monies (as they were not held by WDCS).

c. Where WDCS was providing e-money services to customers and held funds in appropriately safeguarded designated accounts, the FCA would have been acting within its powers in allowing WDCS to continue operating those programmes without interruption.

d. The FCA's powers would have allowed it to enable customers to spend on their cards but to prohibit new loading of money into WDCS's e-money accounts, as ultimately the card schemes hold the liability, so merchants and consumers would always have received their funds. One of the arguments against this approach is that allowing spending of this type may have had the effect of creating an imbalance in the availability of funds as between those customers that were quick to react and those that were slower, meaning that the quicker customers would have drained the available safeguarded funds, leaving the slower customers with no ability to redeem their e-money. However, given that the safeguarded funds of the UK subsidiary were held in a tier 1 bank, this risk of consumer harm was perhaps lower than the harm that would naturally arise from consumers not being able to access their money at all, particularly where some products were used as a primary banking service.

e. We believe the FCA would have been better able to enact a more granular approach (as opposed to the blanket approach of prohibiting an EMI from carrying out any type of regulated activities) if the FCA had had a greater understanding of the variety different structures that are available in the payments industry. This understanding could be improved, for example, through greater engagement with the payments trade associations, including the EPA.

f. In situations such as with WDCS, the FCA would be better able to assess the actual risk position in relation to an EMI, customers and the market by reaching out to payments trade associations, including the EPA and other parts of ecosystem (including other firms directly connected with the relevant EMI; e.g. card Programme Managers, EMD Agents and e-money distributors). This understanding of the risk picture would have the benefit of enabling the FCA to take a more targeted approach to managing the situation. However, we acknowledge that there may have been aspects of the WDCS situation, especially in relation to the fraud allegations against the parent company, that may have prohibited such an approach.

g. In order to enable the FCA to engage with other payments market participants that are directly connected with an EMI, the FCA essentially would need a list of such participants (the FCA, of course, maintains records of EMD Agents in the Financial Services Register and holds information provided to it in relation to outsourcings notified to it pursuant to the EMRs, but this would not necessarily show all of the relevant relationships, as outlined in sections 1 and 2 above). The FCA could access such lists through, for example, requiring each EMI produce or have available an up to date register of all parties with whom it has, for example, an EMD agency, a distribution and/or a BIN sponsorship relationship. Potentially the FCA could approach this by way of publishing an updated version of its Payment Services and Electronic Money Approach Document.

5. How the FCA might better identify the impact that any intervention will have on different groups of customers

5.1 The European Environment

a. Europe is a world leader when it comes to technology development. With such creative and talented technology innovators in the market and a regulatory framework designed to increase competition and innovation, Europe has become home to a multitude of innovative fintech companies looking to solve payment processing problems for consumers and businesses alike. The fintech community's technology-led approach to financial services means that fintechs invest heavily in their technology and often have newer technology platforms and better customer journeys than traditional financial services providers. Over the last few years there has been an increasing trend for fintechs to partner with other fintechs rather than traditional banks. This is partly out of a desire to work with likeminded technology-led companies to achieve the ultimate customer experience, and partly out of necessity due to de-risking undertaken by, and the difficulty of contracting with, the mainstream, traditional, well-understood banks. All of this has led to the creation of some complex legal, regulatory and technical business models (see Sections 1 and 2 for more detail).

5.2 Understanding various business models

a. To regulate the industry effectively, regulators need to understand these business models, the technology that underpins them and why a management team has chosen a particular business model. It would be a mistake to assume that all payment service providers offering similar products operate their business in the same way. Not all PSPs are unprofitable, not all of them target the consumer market, not all of them offer prepaid cards and, for most of them, quality UK banking relationships are a distant dream (see section 7). Understanding how different firms operate and why will certainly help regulators to understand the risks each firm poses to its customers, its customers' customers, and the stability of the market. This in turn will mean that regulators can take a tailored and proportionate approach to intervention.

b. The FCA has acknowledged over the last year that EMIs and PIs have become extremely successful, but that, because of the scale of this success, they now represent a significant potential risk to consumers and the stability of the UK market. This led to the FCA taking steps to increase its regulatory oversight and focus over these firms, holding them to higher regulatory standards as detailed in the 2019/20 FCA Business Plan[17]:

<u>*Ensuring reliable payments services for all users*</u>

The payments sector is vital to the smooth functioning of the economy, and is complex and heavily interdependent with other sectors. We aim to ensure that payments services are accessible, safe, reliable, resilient, value for money and innovative, all while functioning well for consumers and other users. Firms in this sector will need to have high standards of conduct to deliver this, which we will support through:

- *extending the Principles for Businesses to payments services and e-money firms*
- *ensuring that business models are fit for purpose through our re-authorisation programme*
- *engaging with other regulators and industry to anticipate and shape the development of the banking and payments sector business models*

Making payments safe and accessible is also a key priority in the 2020/21 FCA Business Plan[18]

[17] https://www.fca.org.uk/publication/business-plans/business-plan-2019-20.pdf
[18] https://www.fca.org.uk/publication/business-plans/business-plan-2020-21.pdf

5.3 How to achieve understanding

Regulators and industry need to work together to ensure that they both have a sufficient degree of understanding of the regulatory landscape, technology and industry trends. This will enable regulators to intervene quickly in an effective and proportionate manner without causing unnecessary harm to a firm's customers. To achieve this:

a. Industry and regulators must communicate regularly to make sure that regulators are fully up to speed with how the industry is evolving, including as to new technologies and business models.

b. Firms need to make sure their business model is clearly set out in their regulatory business plan filed with their regulator, and they must be open and transparent with the regulator over new developments to their business plan.

c. Regulators need to dedicate sufficient resource to understand fintechs' business plans and strategies and implement guidance that is effective and specific to these firms, rather than imposing guidance on PSPs that was designed for banks.

d. Regulators need to bear in mind when drafting guidance that not all PSPs are unprofitable, focused on consumers or operating card programmes. This will ensure firms (or parts of their operations) that do not pose a material risk to consumers or the market in certain situations are not caught in the crossfire.

e. Regulators generally focus their attention on PSPs that are large enough to pose a threat to the stability of the market. However, if they engage with firms earlier, they can have more influence on how firms grow and develop and keep in tune with developments in the industry.

6. Communication priorities and strategy between the regulator and different stakeholders

6.1 Introduction

a. One of the difficulties arising out of the suddenness of the WDCS shutdown, as reported by the industry and in the press, was that communication with customers and other industry stakeholders was last-minute and in many cases poor. To a large extent this was a necessary by-product of the circumstances of the alleged fraud: it was necessary for the FCA to act swiftly and without warning because of the risk of funds being moved improperly, and the suddenness itself precluded effective preparations by WDCS of its communications to customers. However, we also feel that there are perhaps additional steps that might be taken in future should similar circumstances arise, which could help to smooth the effects of any shutdown on the many parties that interact with entities of this type, and ultimately on customers.

6.2 What did the WDCS shutdown reveal about communications strategies?

a. As we have outlined in sections 1 and 2 of this paper, the number of participants involved in the e-money ecosystem – as with any payments system – is high, as are the interdependencies between them. Some, but not all, of those participants are regulated by the FCA. The FCA's primary communication channel will of course be directly with the regulated entity which is the subject of the shutdown or other enforcement action. The expectation would normally be that that regulated entity would be responsible for communicating with its customers (who could be, for instance, Programme Managers or other EMIs) and other ecosystem participants about the shutdown. However, what we saw with the WDCS shutdown was that, for obvious and understandable reasons, WDCS was taken by surprise, did not have a full communications strategy in place, and in those first few hours and even days was, we assume, having to focus on numerous other issues relating to the shutdown and simply did not have the time or capacity to think through and deal with all the communications it would ideally have liked to make.

b. The result was that for both ecosystem participants (such as Programme Managers, EMIs and processors) and for customers, there was in practice very little communication coming out of either the regulated entity or the schemes about what was happening, or when the issues might be resolved. The speed at which the shutdown was effected also meant that the regulated entity did not have time to think through or communicate many of the nuances of how the shutdown might take effect. This had a number of knock-on effects, including that:

   i. it was not clear to processors, agency banks or Programme Managers which in-flight payment runs they could complete, meaning that in some cases payments were not completed but could also not be returned to customers' accounts;

   ii. the fact of non-completion of those payment runs effectively made it far more difficult and slower to recommence services once the FCA had lifted the restrictions;

   iii. those EMI customers of WDCS that were using WDCS only for BIN sponsorship and settlement (i.e. as a 'settlement partner') were caught up in the shutdown, despite the fact that WDCS was not holding any safeguarded funds for them, and even when questioned WDCS maintained that it could not recommence services in respect of those customers;

   iv. a number of ecosystem participants had questions about how to proceed on a range of issues, and how they could best protect their customers, but found it difficult to get answers either from WDCS or from the FCA.

6.3 How could communication be improved?

a. A few ideas have emerged from discussions with participants that may be useful for the FCA to consider for future situations where some form of shutdown of a payments firm is at hand. We offer these only as thoughts for further development, very much recognising that each situation is different and will need to be treated according to its individual circumstances. Equally, we recognise that we do not know all the facts surrounding the WDCS shutdown or how it was in fact handled by the FCA, and so it may well be that some of the thoughts shown here have in fact already been put into action. The thoughts are as follows:

  i. We would not expect the FCA to have answers to all the many questions that other ecosystem participants will naturally have in a shutdown scenario, or necessarily to communicate with them directly, but some participants have expressed that a resolution on many issues may have been reached more quickly if WDCS had been able to refer such questions to an expert within the FCA's team, to check whether their proposed answers were acceptable to the FCA (for instance on the recommencement of services for the BIN sponsorship-only Authorised Customers).

  ii. There are participants in the payments chain that, because of the highly interconnected nature of the payments ecosystem, may be able to provide to the FCA corroboration of evidence that has been provided to the FCA by the entity in shutdown. This corroboration may in turn help to speed up the FCA's resolution of issues, or to give it comfort as to risk levels on certain aspects of the shutdown entity's business.

  iii. Given the wide-ranging effects that such a payments company's shutdown may have on other businesses and customers, we wonder whether a specific task of the FCA's team in the event of regulatory intervention should be to oversee effective communication with all those entities, to ensure that customers in particular are kept informed. Given that the WDCS shutdown occurred on a payday and affected a large number of vulnerable customers, communication with those customers – whether directly or through Programme Managers - would ideally have been a priority.

  iv. We can envisage circumstances where certain participants, even if not regulated, would be willing to cooperate with the FCA in facilitating an orderly process for any shutdown. The WDCS incident has shown that expecting to rely on the affected entity itself to communicate quickly and effectively, across all participants and through the many nuances of the complex services they provide, is not realistic, and is likely lead to a lack of communication and a host of unintended consequences. Working with other participants in advance of a shutdown, under strict conditions of confidentiality, may help to increase the speed and effectiveness of communication with all participants and customers once the shutdown does occur.

  v. It could also well be the case that conversations with participants that interact directly with the entity in shutdown would – because of those participants' detailed knowledge of the operations of the entity - help the regulator to assess exactly where the risks lie, which parts of the entity's operations do not pose any risk, and therefore the level of enforcement action that would address the relevant issues proportionately without creating undue disruption. Whilst wind-down activity planning would help with some of this assessment process, and would presumably help the FCA to identify any such participants, such conversations may well be more fruitful in addressing the detail of the situation at hand.

vi. The FCA's suspension notice included reference to the fact that they could not guarantee that cardholder funds were safe, which in combination with the intense media attention and reports about the missing €2bn understandably created, during the weekend of suspension, something of a wave of panic amongst consumers that their funds were potentially lost forever. Programme Managers were not permitted to provide any reassurances. However, we presume that by Saturday the FCA had reassurance that the funds did exist, and by Sunday had a view that the repatriation was underway such that the accounts would be unfrozen. We therefore wonder whether it may have been possible to issue updates along these lines – even if suitably caveated – as this would have greatly helped manage the consumer distress caused, particularly for the most vulnerable.

We offer these ideas as food for thought and are very much open to further discussion on the topic.

7. Repatriation of funds to the UK for those companies that don't have access to UK bank accounts

7.1 Introduction

a. We understand that one of the features of the WDCS shutdown was that the FCA required safeguarded funds to be moved from a Tier 1 bank in Germany, back to a UK bank, before the shutdown would be lifted. This raises a number of important questions for the industry, in particular because of the fact that very few of the UK's e-money issuers hold safeguarded accounts in the UK. This is not out of choice: all of the UK-based EMIs we spoke to would prefer to hold the money onshore, but they do not feel that the Regulation 105 (Payment Services Regulations 2017) POND requirements have been effective in opening up access to such accounts in the UK for this part of the market. As such, the vast majority of EMIs hold safeguarding accounts with non-UK banks.

b. The stipulation that safeguarded funds had to be repatriated in this case therefore raises significant concerns for the industry: WDCS happened to be one of the few EMIs with a UK bank account and so was in a position to repatriate the funds, but if another EMI were in a shutdown situation that facility would simply not be available. In accordance with the Electronic Money Regulations 2011, safeguarded funds can be held in a bank in any EEA, or, after the Brexit transition period, OECD country. A number of market participants have therefore expressed surprise and concern that repatriation was felt to be a necessary step even where the funds were held by a bank in an EU Member State, and a Tier 1 bank at that.

7.2 Relevant factors

a. From the outside, there appear to be two significant factors at play in this instance. The first is the alleged fraud by the German parent company, and therefore the fear that safeguarded funds might be moved improperly. (It is worth noting that the WDCS operations in relation to e-money, BIN sponsorship and related services are not to our knowledge involved in any of the allegations of fraud.) The second is the insolvency proceedings in relation to the parent company, and the fear that the insolvency process may result in a freezing of the safeguarded funds, which would in itself prevent their capacity to be redeemed for the benefit of customers.

b. On the first factor, the scale of the fraud and the funds held is unusual. However, we question whether repatriation was (absent the second factor) necessary, and whether cooperation with the regulator in the local jurisdiction of the safeguarding bank could have achieved the same comfort by seeking to impose lockdown requirements on the local bank, even if informally.

c. On the second factor, Regulation 24(1) of the Electronic Money Regulations 2011 and Regulation 23(14) of the Payment Services Regulations 2017 are clear that the claims of payment service users take priority over all other claims in the case of an insolvency. These derive from Article 10(1)(a) of PSD2, which, being a maximum harmonisation directive, should therefore have been implemented in a very similar way across all EU Member States. As such, we therefore again question whether repatriation of safeguarded funds held in a credit institution in an EU Member State would be necessary to protect those funds from the effects of an insolvency process.

7.3 Next steps

a. We would welcome clarification on the approach that the FCA is likely to take in future, on the second factor in particular. If the FCA is uncomfortable with the insolvency processes in a particular jurisdiction (or the implementation of PSD2 in relation to the effects of insolvency processes on safeguarded funds), the industry needs to know so that affected participants can attempt to re-work their banking arrangements accordingly. However, the FCA should be cognisant of the difficulties already faced by EMIs in obtaining banking services in practice,

sometimes requiring dedicated teams to obtain and maintain such account access. A wholesale move out of a jurisdiction would therefore cause significant difficulties to the industry, and may as a result hamper much of the innovation that relies upon it.

b. Two possible alternatives would be:

i. for the FCA to control, or to establish an independent trustee to control, a UK-based account which could be used as a temporary repository for the repatriation of safeguarded funds in the event of an insolvency. This would help to ensure that safeguarded funds are made available quickly, but such an approach is likely to be fraught with operational complexities in practice, and would be likely to require new legislation; or

ii. for the FCA to work with the insurance industry to establish workable policies to cover the safeguarding requirements.

We are very much open to further discussion on these issues, as they are of great importance to the future of the industry.

EPA

8. Safeguarding: what are potential areas of concern that industry and regulators can work together to resolve, to create a better and more reliable methodology for all?

8.1 Introduction

a. Safeguarding is important. The aim of safeguarding is to protect customers' money and it is imperative for the industry, consumers and regulators that safeguarding is well managed and does not fail.

b. While it is understood and appreciated that the FCA has worked with industry to both review safeguarding processes undertaken in firms (the thematic review and CEO attestation in 2019), and also more recently to enhance the safeguarding requirements (the FCA temporary guidance issued in July 2020), there still remains a concern that there are aspects of the safeguarding regime that can still cause undesirable consequences or may not truly achieve its aim when it really matters.

c. In an attempt for industry and regulators to work together, here we outline six areas of concern. The EPA would welcome working jointly with other industry partners and regulators to resolve these for the benefit of all involved.

8.2 Areas for further action

a. **Concern 1: A better understanding of business models**

There is a currently 'one size fits all' approach to safeguarding. This causes difficulties from an understanding and application perspective, and we assume also from a supervision perspective too. The application of the same rules differs greatly in practice between different business models. For instance, if we are to look at the flow of funds for card schemes, this is very different to e-money, which is different to PIs' 'payment accounts', which is different to remittance flow, which is different to a firm that supplies services to a number of differing underlying business models – like servicing both directly regulated Authorised Customers and unregulated Programme Managers, as WDCS did. There are many different models to which the same safeguarding principles are applied, and while the FCA approach document does provide some guidance, further detailed scenario-based guidance would be welcomed by all.

b. **Concern 2: FSCS cover**

A related but slightly different issue to concern 1, is the difference in the sizes of the institutions implementing this regime. Originally, PI and EMI permissions / licences were considered entry points to the financial services payments market. Now, some of these firms will have a level of funds flowing through them or electronic value stored with them, that outweighs some of the smaller banks in the industry, yet do not have the same regulatory requirements upon them that a bank does. Perhaps more consideration should be given to the 'size' of the institution (based on a number of variable such as numbers of customers and the value of funds processed, as examples), and for there to be not a one-size-fits-all, but a tiered approach, potentially with some firms being permitted to join the Financial Services Compensation Scheme should they wish.

c. **Concern 3: The challenges of safeguarding**

There is an argument from the industry's perspective that the current safeguarding regime may be 'too nebulous' and, as a result, this results in it being considered too difficult for firms to always apply all the intricacies properly. This is compounded by the fact that a safeguarding calculation takes place at a specific point in time, whereas the reality is that customers funds are still continually moving and out of the accounts the firm uses. This comes down to principle

versus practice: in principle many of the aspects do logically fit together; however, in practice they are not so easy to apply.

d. **Concern 4: What constitutes 'relevant funds'**

There is no comprehensive standardisation on how firms detail what is relevant versus non-relevant funds, and the instances whereby funds are placed in a 'payment account' versus when they are deemed to simply be 'remittance' flow (the latter being more relevant to PIs).

This differing application of how firms regard the definition of relevant funds causes inconsistency in the market, with none of them being technically wrong. This further means that some consumers are not aware of when funds are safeguarded, versus when they are not – for example some consumers will be unaware that 1st party to 1st party payments outside a payment account are <u>not</u> safeguarded (an instance of this being a foreign exchange transaction as noted in 10.20 of the FCA Approach document).

e. **Concern 5: When does safeguarding end?**

Firms have no clarity on when the safeguarding obligation ends. The FCA's approach document states that the obligation remains in place until the funds are 'paid out' to the payee or the payee's PSP. However, the firm has no knowledge of when the funds are actually received by the payee or the payee's PSP and 'paid out' is not further defined, which creates difficulties when the PI or EMI wants to use a correspondent to move the funds for them. This results in double or triple safeguarding of the same money, which in turn means increased costs for firms.

f. **Concern 6: The reliability of safeguarding calculations when it matters**

If a firm is starting to recognise that it is failing, for instance in the last days before insolvency when safeguarding really matters, will employees be motivated to do the calculations correctly? A firm might do everything correctly for years, but in practice, there is still always the human element to consider and there needs to be an appreciation that when a firm does head towards insolvency, the employees may not be as diligent as they once were when faced with the stresses of potential unemployment.

8.3 Proposed enhancements

To address the concerns noted above, we propose the following aspects should be considered:

a. Regulators should work closely with the industry to get a better understanding of all the elements that do not work in practice, and to provide more industry guidance and an enhanced framework that is easier for everyone to understand. This guidance should contain more specific scenarios that reflect the industry in practice, and better balance the legal requirements with the reality of safeguarding. It would also be useful to have more standardisation requirements on the timing of safeguarding calculations, and more examples of what is required to be considered as relevant vs non-relevant funds.

b. If regulatory intervention is required, a standardised pre-documented and publicised approach will have great value. While it is appreciated that there will need to be controls implemented when a regulator does intervene, a balance needs to be achieved regarding what funds can leave a firm's accounts, and still allowing underlying consumers to still spend the money they have with the firm in question. It is understood that allowing some people to transact may create 'an unfair playing field' meaning some would take their money out earlier than others, however, there may not be significant detriment because this is not the same scenario as a 'run on a bank'. In addition, implementing requirements for a more structured 'wind-down' in the event of a PI or EMI becoming insolvent, will be of great benefit for the industry. We believe the FCA is currently looking at this, as the 'Dear CEO' letter of 9 July 2020 details 'Prudential risk management' as a key area where non-compliance harms consumers.

EPA

9. Conclusion

We hope this paper is informative. If you would like to discuss any aspect of it, please let us know and we will be happy to run through any of the points in more detail.

This paper was produced by a team of enthusiastic members of EPA's Project Regulator Team within three weeks. The editor was Chris Hill, Partner and Head of Fintech at Kemp Little LLP. The Projects Manager was Tom Brewin from the EPA. The contributors were:

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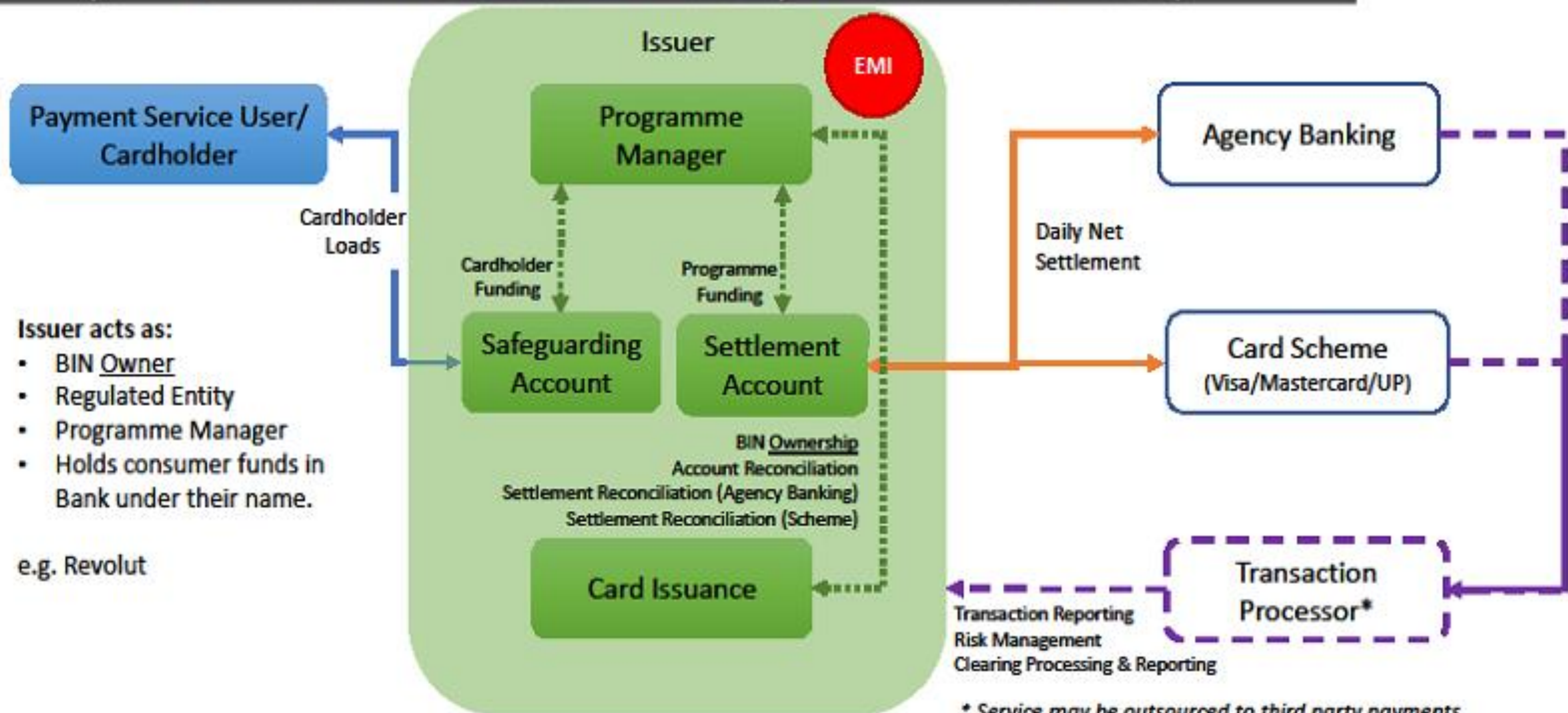
The UK payments community is indebted to them for their willingness to assemble immediately and collaborate proactively, as volunteers working remotely in what is, for many, a challenging economic environment.

Note:

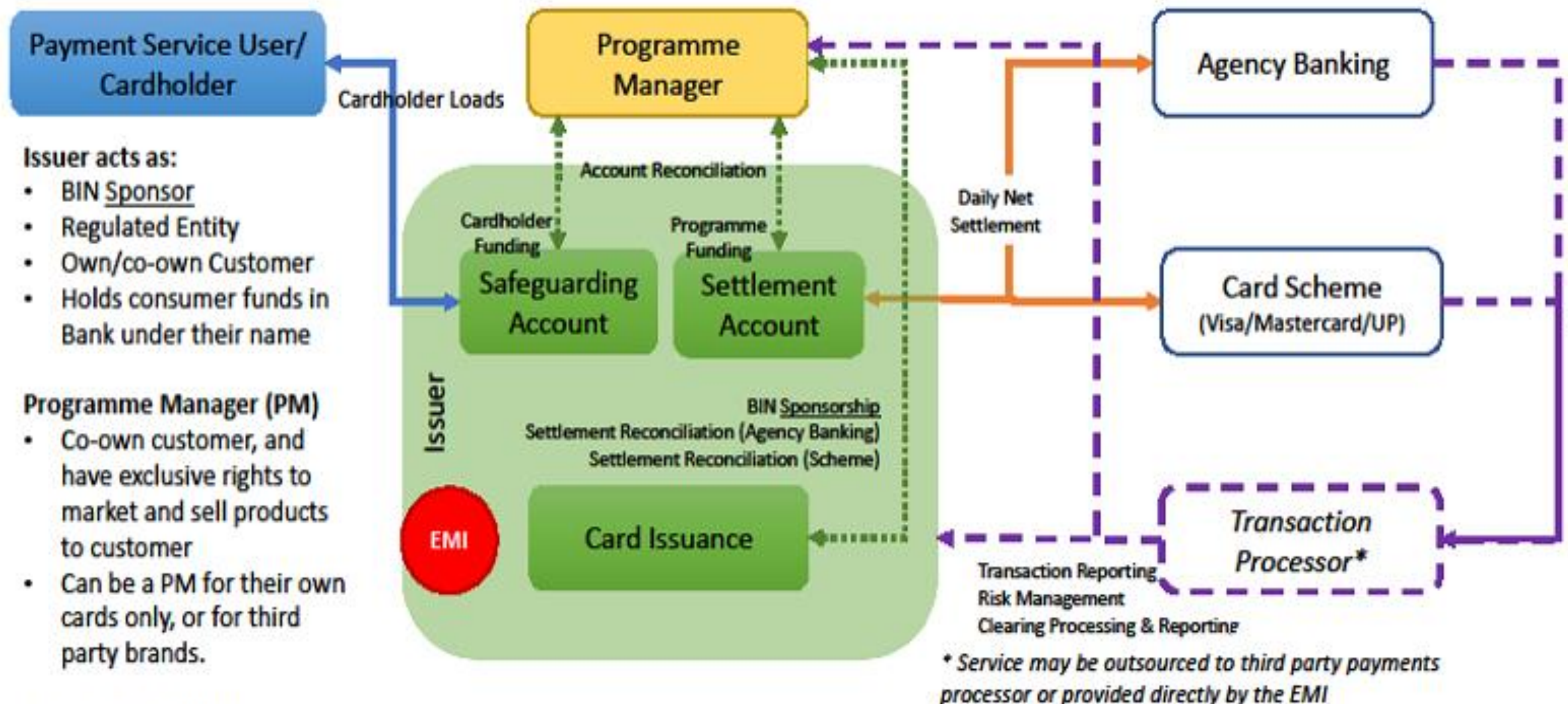
This paper does not necessarily represent the views of all EPA members. For more information or access to the editor or authors, please contact Tom Brewin, Projects Manager at the EPA, tom.brewin@emergingpayments.org.

Appendix - Principal categories of e-money issuer business model



2. PARTNER E-MONEY ISSUER

(EMI IS BIN SPONSOR AND REGULATORY SPONSOR, PROGRAMME MANAGER MAY BE UNREGULATED)



3. SETTLEMENT PARTNER
(ISSUER IS ONLY BIN SPONSOR)