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17 December 2024

Dear Jane,

**Re: EMA response to CP24/20 on changes to the safeguarding regime for payments and e-money firms**

The EMA is the European trade body representing electronic money issuers and alternative payment service providers. Our members include leading payments and e-commerce businesses worldwide, providing online payments, card-based products, electronic vouchers, mobile payment instruments and cryptoasset services. A list of current EMA members is available on our website: https://e-ma.org/our-members.

Please find below our response to the above consultation. I am grateful for your consideration of our comments and proposals.

Yours sincerely,

Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

## **EMA response**

I – General comments and summary of our views

We welcome the FCA's objectives of minimising poor safeguarding practices, ensuring safeguarded funds are available to users in the event of the failure of a firm, and making them available in the shortest possible time. It is in the interests of industry as well as their customers and the FCA to ensure that in the event of insolvency, funds are returned to customers as quickly and as fully as possible. EMA members stand ready to make all efforts to minimise the risk of customers losing their funds in the event of insolvency of an EMI or PI.

However, we fundamentally disagree with the approach taken by the FCA in trying to achieve these aims. We do not believe that the proposed changes are effective in addressing the problems that the FCA has identified, that the solutions are suitable to the payments sector or that they achieve an appropriate balance between competing interests.

The proposals do not address the issues identified: Based on evidence collected from insolvency practitioners that were involved in a number of recent insolvencies of payment firms, it seems that in many cases shortfalls in safeguarded funds – and in some cases delays in returning funds to customers - were due to a firm's failure to follow existing rules, i.e., failures in compliance, which can be remedied with closer supervision and enforcement. There is little evidence that suggests a need for a wholesale change in the legal requirements of the safeguarding regime, let alone the imposition of a significantly more complex and demanding one.

Therefore, while we recognise the need for some of the increased 'checks and balances' envisaged by the interim rules that will help businesses comply with the existing law and help the FCA in its supervision and enforcement efforts, we do not agree with the proposed end-state rules, which go significantly beyond what is reasonable to expect of payment firms.

The proposals are unsuited to the payments industry: We think that the FCA's approach to read across provisions applying to investment firms, general insurance intermediaries, debt management firms and claims management companies subject to CASS is poorly conceived. Not only are the business characteristics of payment firms distinct from those of investment and insurance firms, but the circumstances under which payment firms hold funds are also distinct – with these being mostly in-flight, moving through different payment schemes to meet payment obligations in real time. Indeed, CASS 7.11 contemplates a 1-day exemption from client money requirements precisely for payment/settlement purposes (the DvP exemption), which we observe has not been carried over to payments. The proposed application of CASS to payment firms forces the sector into alignment with a regime ill-suited to the fast flow of payments and the evolving payment landscape in the UK that emphasises innovation alongside consumer protection.

The proposals undermine the ability of firms to meet customer expectations: In this respect, the proposals insufficiently reflect the fact that the function of safeguarding is not only consumer protection on insolvency but also ensuring that a firm has sufficient funds available to meet customer demands for redemption/payment on an ongoing basis, and in the absence of the onerous prudential requirements applying to credit institutions. Insolvency is, and should be viewed as, the ultimate exception. The arrangements for holding, disbursing and

receiving funds should not be designed to cater for exceptional events, at the cost of failing to meet the needs of dynamic and fully functional payment businesses. As such, the objective of safeguarding should be to support ongoing businesses, while simultaneously ensuring that a firm's failure is provided for. The arrangements should not unduly restrict innovative business models designed to compete with those of banks (which are not subject to safeguarding requirements).

The proposals and cost benefit analysis provided alongside the consultation do not adequately represent the needs of the different business models of payment firms, the complexity that is introduced by payment schemes, by international payments and by ancillary functions such as FX conversion.

The proposals will cost far more than estimated: As we elaborate in our responses to the questions below, the proposals will make it more restrictive and costly to conduct business under these models, thereby negatively impacting innovation and competitiveness of the UK payments sector. Some of our members have informed us that, if fully implemented, the end-state rules will result in their prioritising of investment in other jurisdictions over the UK, while others will seriously consider the closure of their UK operations altogether.

The proposals will place the UK regime as an outlier: At the very least, adopting a statutory trust model will put the UK's safeguarding regime at odds with that adopted in the EU, adding costs and operational friction for firms operating across both regions. The cost-benefit analysis does not capture these costs to the UK economy. It is our view that the proposals will therefore not achieve the FCA's secondary objective of advancing competitiveness and growth in the UK financial sector.

The proposals have not sufficiently considered other options: For these reasons, we would urge the FCA to pause and take account of the sector's representations before proceeding with the proposed changes. As a public body, the FCA should carefully consider the responses that it receives in respect of its consultations, and it should act rationally, reasonably and proportionately when it makes its decision. The EMA, other trade associations and their members have raised the same concerns multiple times already before the consultation was issued, and yet these appear not to have been taken into account in drafting the proposals. In this respect, we would like to remind the FCA that the courts, in *HA v University of Wolverhampton* [2018] EWHC 144 (Admin), confirmed that not taking relevant information into account when arriving at a decision will fall within the scope of Wednesbury unreasonableness.

Furthermore, it has become clear from the FCA's recent public engagements on the consultation that there is no willingness to even consider alternatives to the statutory trust that could be implemented to strengthen the safeguarding regime for payment firms (as stated, for example, at the webinar on 5 December).

In this respect, the case has repeatedly been made for the application of the FSCS to e-money and payments, which would achieve higher consumer protection at a much lower cost to the UK economy, to payment service users and to industry. Additionally, the provision of safeguarding accounts at the bank of England would address investment and credit risks.

A fuller assessment of the options and potential impact should be conducted before moving forward with the end-state rules. A good case could also be made for the pausing of the implementation of end-state rules until the effects of the interim rules have been ascertained and the need for further rules assessed, as we believe that compliance with the interim rules will address most (if not all) of the issues the FCA seeks to address. If at that point there is a continued need for further rules, it would be prudent to conduct a separate consultation that focuses on areas of continued concern. The current approach to consult on incompletely drafted end-state rules without the benefit of knowing the effects of the interim-state rules (or the outcomes of the Independent review of the Payment and Electronic Money Institution Insolvency Regulations 2021) is not a business-sensitive way of proceeding, particularly given the significant costs of these rules to industry. In light of the difficulties that the proposals in this consultation will raise, there is a need to revisit all of these options.

II - Consultation questions

1. **Do you agree with our proposed rules and guidance on record-keeping, reconciliation of relevant funds and the resolution pack in both the interim and end state? If not, please explain why.**

   **Record-keeping**
   We support the proposed requirements for improved record-keeping, as these will help ensure ongoing safeguarding compliance and contribute to reducing distribution time on firm failure.

   **Reconciliation - definition of 'business day'**
   The FCA's interpretation of a 'business day' (provided during the webinar on 5 December) as any day on which the firm processes payment transactions is problematic, as this would require many firms to move to a 7-day week for operational teams, significantly increasing costs. Many services of technology-focused payment firms are available 24/7/365 but see significantly reduced traffic on the weekends, in particular from corporate customers. The residual payments traffic would result in a negligible risk from a safeguarding shortfall perspective, for which the cost to manage would be disproportionately high (please see our answer to question 2 below). We would therefore strongly suggest that the definition of a business day should be left to individual firms to define in accordance with safeguarding risk.

   Furthermore, the vast majority of the global payment rails indirectly accessed do not settle on non-business days (weekends and public holidays); bank statements will not be available for the purpose of external reconciliation, and bank balances cannot be adjusted on non-business days.

   An alternative solution to address any safeguarding risks during weekends and bank holidays would be to require firms to pre-fund safeguarding accounts in line with business expectations for these days. This is already good practice amongst our membership, although further guidance on the required processes and calculations would be welcome.

   **Internal vs. external sources of data**
   Further guidance and clarity should be provided on the sources of data firms can use for their internal records (CASS 7.15.12.5G) and internal reconciliations (CASS 15.1210R). In particular, a firm that processes/executes significant volumes of transactions (e.g., a card issuer) and relies on third-party data as its source of truth to calculate customer balances (e.g., bank statements and card scheme data) must be able to incorporate this data into its internal records and use it for its internal reconciliations, as this is the most up-to-date data available to the firm. To do so would not prevent the firm from also carrying out an external reconciliation with the balance in the safeguarding account.

**Terminology**

The terminology used for the definitions uses quite similar defined terms, many of which are not generally used widely in the industry. These may be confusing for firms and may lead to non-compliance due to mis-interpretation.

**Resolution packs**

We support the requirement of a resolution pack, which will aid insolvency practitioners in their work. However, we note the significantly higher costs of this requirement than estimated in the CBA. The assumption stated in paras 136-138 of staff time needed for the collation of resolution packs significantly underestimates the complexity of this task. For global businesses, resolution packs require data from many different sources as well as regular review and ongoing maintenance. Further costs are added if resolution packs need to be signed off by auditors.

2. **To what extent will firms incur operational costs relating to record keeping, reconciliation and resolution packs when moving from the interim to end state?**

The interim state will likely require one additional permanent FTE member of staff to cover increased requirements around record keeping, reconciliation and resolution packs if 'business day' is defined as excluding weekends and public holidays. However, if 'business day' were to be defined as any day on which payment transactions are processed, this would have a significant impact on operational costs already in the interim state, requiring the employment of further additional treasury operations staff, as well as management and oversight resources to cover weekends and bank holidays. These costs would be disproportionate to the intended benefits (please see our response to question 1 above).

In moving to the end state rules, firms will incur significant operational costs. The rules will require an entire re-design of funds flows and related technological infrastructure, as well as of operational policies and procedures. New investments/custody permissions may need to be sought. There will be liquidity costs, as current banking partners will no longer be available for safeguarding, while new banking partners will be subject to more stringent requirements. The safeguarding obligation itself will also be extended to a longer time period, tying up liquidity. Ongoing compliance costs will dramatically increase to meet the new requirements, including those relating to the management, periodic review and interactions with safeguarding account providers. Furthermore, the implementation of the new rules will need to be evidenced to auditors, requiring substantial additional record keeping in addition to the FCA-required records. It is difficult to estimate the additional costs that these proposals will entail at this point, but our members currently regard them as a significant business risk.

3. **Do you agree with our proposals for requiring external safeguarding audits to be carried out in both the interim and end state? If not, why not?**

**Costs, timing and quality of audits**

We agree that there is a need for strong and consistent audits/compliance assessments and that the output of these exercises should be shared with the FCA.

However, we anticipate that the costs that firms will have to budget for will significantly increase (in practice, firms are likely to spend three to four times the amount of their current audit expenditure), while the assurance that will be provided by these exercises is likely to be variable:

- There will be an increased demand for audit services as a result of these proposals.
- The frequency currently envisaged would require audits to be prepared much more rapidly and submitted by the entire industry at the same time. Currently audits may take 7-8 months to prepare, with scheduling of audits sometimes needing to take place several years in advance.
- The need to engage auditors who are eligible for statutory appointment, experienced in auditing firms subject to safeguarding/CASS and familiar with the new standard for payment firms will restrict choice amongst auditors.
- The more detailed rules on reconciliation will increase the costs of audits.
- The new audit standard will effectively constitute an additional rulebook, requiring firms to evidence further aspects of its compliance.
- The fact that the proposed audits include no adequate thresholds of materiality means that auditors may over-interpret their responsibility to investigate, and include even the most minor breaches in their reports. This may significantly lengthen the audit process and raise its costs. This is particularly concerning given the prevalence in payments of small inconsistencies in complex flows of funds, which are normally resolved in reconciliation during the following day.

We therefore recommend that the statutory eligibility requirement in SUP 3A.4.2R be removed. This will allow firms to engage auditors who, while non-statutory, have significant experience auditing businesses in the sector, rather than having to rely on junior staff in statutory auditors, at a disproportionate cost. This would allow the FCA to achieve its objectives in a more cost-effective manner for firms.

Audits and the new audit standard for payment firms should reflect the nature of payments business, which involves the processing of a high number of non-transactionally linked transfers at rapid speed rather than an emphasis on the holding of funds.

We also recommend that the frequency of audits be reconsidered, with perhaps more frequent audits only when material failings have been identified. We have been made aware (during the webinar on 5 December) that the FCA are not intending to commit further resources to safeguarding supervision and enforcement, despite the fact that

the FCA will receive a large amount of additional safeguarding data - both through direct reporting and through audits - under the new rules. In light of this, we do not think the proposed frequency of audits is warranted, as the data will not be acted upon.

Furthermore, firms should be permitted to schedule audits at a time during the year that is convenient for them, avoiding periods of high demand on auditors. Audits could cover a one-year period and audit reports could be required to be submitted to the FCA within six months of their preparation.

4. **Do you agree with our proposals to require that safeguarding audits are submitted to the FCA? If not, why not?**

   We agree with the proposal to require firms to submit safeguarding audits to the FCA, as this will act as an incentive for firms to understand and implement their safeguarding obligations appropriately.

5. **Do you agree that small EMI's should be required to arrange an annual safeguarding audit? If not, why not?**

   **Small EMIs**
   Our general view is that small EMIs should be subject to an appropriate and proportionate regime that ensures the safety of safeguarded funds. This need not be as onerous as fully authorised firms, but in the absence of any obligations, the likelihood of failings will increase, and these may be indistinguishable by users from those of authorised firms.

6. **Do you agree with our proposals for safeguarding returns to be submitted to the FCA and the frequency of reporting, in both the interim and end state? If not, please explain why.**

   **Safeguarding returns**
   While we support increased reporting requirements on safeguarding in principle, the extent and form of information sought as part of the monthly returns places an undue additional burden particularly on smaller firms. For these firms, reporting is unlikely to be automated and will require the collation of data and information from various sources internal and external to the firm, tying up resources that could otherwise be used for customer support or innovation.

   We believe reporting on a quarterly, rather than monthly basis would be more proportionate and in line with existing reporting cycles. As mentioned in our response to question 3, given the fact that the FCA has not set aside any additional resource to review or act on this data, it does not seem to be prudent to have such a frequent data collection.

   Combining the required reports into one rather than a series of linked forms may also reduce the operational burden.

Care should also be taken not to include data points that are already submitted to the FCA (e.g. FIN 073 quarterly Financial Resilience report, REP018 quarterly Operational Resilience and Security report, REP017 six-monthly Payments Fraud data report, or REP-CRIM Financial Crime report), so as not to duplicate work for the industry and ensure that additional costs remain limited. Alternatively, existing regulatory reports could be shortened to omit information required by safeguarding returns.

7. **Do you agree with the proposed data items to be included in the report? If not, please explain why.**

- Many firms operate different models that operate independently of each other, and safeguard in multiple currencies. This is not reflected in the template report. Further guidance should be provided on how firms should complete the report in those circumstances and/or the form should be amended accordingly.
- The report requires firms to declare where there is an excess/shortfall in the amount they are required to safeguard and the amount actually safeguarded. However, the form does not allow firms to provide an explanation for any variance. For example, many firms will have variances that can be explained due to timing differences (e.g., due to when various sources are validated or processed as part of the reconciliation). Without an option to provide an explanation, firms will appear to be in breach of their safeguarding obligations.
- Question 14: Please note that guarantees are often provided by a consortium of creditors, rather than a single provider. The report will therefore need to allow for this possibility.
- Question 20: It is important to note that firms run reconciliations at the end of each day and transfer funds between accounts as appropriate to comply with the safeguarding regulatory requirements. Therefore, providing the answer to funds transferred on the last day of the reporting period during the reconciliation may not provide the most meaningful information to the FCA. We believe it would be more useful to ask how much firms were unable to reconcile.
- Questions 26 and 27: This question envisages firms conducting static reconciliations at certain points during the day. However, firms' treasury systems are often more fluid than this. A firm may conduct a reconciliation at the end of each day to comply with its UK regulatory requirements, so its answer to this question would be 'once'. However, its treasury system constantly monitors accounts, assets and liabilities and sends alerts to treasury operations throughout the day to move money as required. This would not be captured in the answer to this question and may suggest firms are not moving money as often as they could.
- Question 29: This question is reliant on firms' interpretation of 'material' under CASS 15.12.59R. To ensure consistency amongst firms and accurate reporting, we believe it would be appropriate for the FCA to provide guidance on what continues 'material'.

8. **Do you agree with our proposals to make prescriptive rules on the segregation of relevant funds in both the interim and end state? If not, please explain why.**

**Acknowledgment letter**

The prescriptive nature of the acknowledgment letter in both the interim and end-state, requiring the precise prescribed wording, may pose problems for firms seeking to safeguard funds with banks outside of the UK. Issues may include not being able to obtain an acknowledgement letter in English (e.g., in Thailand), banks being cautious of wording around the trust that may have a different meaning in their jurisdiction (e.g. in the US) or may not be recognised in their jurisdiction (e.g., in Italy), banks not being permitted to sign letters required by foreign regulators (e.g., in France) or the reluctance to commit to the governing law of another jurisdiction.

These issues are likely to affect firms with international business models and those who rely on safeguarding accounts in other jurisdictions most. This represents a significant proportion of affected firms. These issues will increase the costs of running those business models by requiring the use of the already expensive safeguarding insurance or corporate funds to cover balances held out of safeguarding accounts, or switching to UK safeguarding accounts that are ill-suited to their business model, thus reducing the scope of innovative global services payment firms can provide.

For firms carrying out business only in the UK, these issues mean that safeguarding accounts abroad will be more difficult to obtain, leading to increased pressure on the already limited availability of safeguarding accounts in the UK and limiting firms' ability to manage their concentration risk.

We suggest the adoption of a flexible approach as currently adopted under para. 10.47 of the FCA's Approach Document on Payment Services and Electronic Money, which states:

> "Alternatively, where institutions cannot get such an acknowledgement letter, as explained in paragraph 10.47, they should still be able to demonstrate that the authorised credit institution or custodian has no interest in, recourse against, or right over the relevant funds or assets in the safeguarding account, and is aware that the funds are held by the institution to meet claims of customers. 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 institutions for copies of their documentation referred to in this paragraph."

**Group multiple entity business models**

The existing proposals, including the acknowledgment letter, do not cater well for firms with group entities that are regulated in other jurisdictions. Such business models allow for low cost and value-added payment services (both pay-ins and pay-outs) into other jurisdictions, while ensuring the firm adheres to all local licence requirements.

Under current operating models, non-UK group entities receive and hold client related funds on behalf of other group entities and safeguard those funds in line with their local requirements. However, under the proposed changes, the UK e-money firm would not be able to consider those accounts as safeguarded, as they are not in its own name and would therefore not be able to receive funding into those accounts. This would restrict the firm's ability to operate a competitive international business model.

The requirements also create a situation of double safeguarding within the group. For example, in a scenario where a Dutch regulated Payment Institution is holding funds for the purpose of executing pay-outs on behalf of the UK regulated e-money firm within the same group, the Dutch firm safeguards the funds in a separate safeguarding account in line with Dutch safeguarding requirements. However, the UK e-money firm is unable to consider them as safeguarded because it cannot obtain an acknowledgment letter from the Dutch bank as the safeguarding accounts are held in the name of the Dutch firm. The UK firm would then need to additionally safeguard those funds via insurance or other methods, creating an absurd position of double safeguarding within a group entity where both firms have full visibility, oversight, and control of the funds, and not adding any additional protection for customers' funds.

**9. Do you agree with our proposals to require relevant funds to be received directly into a designated safeguarding account subject to specified exceptions? If not, please explain why.**

**International models**

Many business models of payment firms include an international element, whereby funds are received into foreign currency accounts held by a group company outside of the UK. These business models are customer-friendly, as they offer local transfers to the payment firm at a low cost, which constitutes a competitive advantage over comparable services offered by banks.

The current practice is for a firm that receives deposits in multiple currencies to receive these into transactional accounts but to safeguard them in single currency (e.g., GBP) or multiple currency accounts held by the UK firm. Under the proposals, such transactional accounts (often numbering in the hundreds) would need to be acknowledged safeguarding accounts held by the payment firm itself in multiple jurisdictions. This would add additional cost and difficulty (see our responses to question 8 above) and impact existing funds flows.

Where the preference is to retain single-currency safeguarding, incoming funds would need to be auto-converted before reaching the safeguarding account, which would add significant FX cost to payments made by customers each time. Alternatively, a mix of the insurance and segregation methods of safeguarding would need to be adopted in order to cover funds until they reached the safeguarding account. In all

cases, the overall result would be a direct negative impact on the competitiveness and viability of existing international business models.

To address these issues, we strongly recommend extending the D+1 exemption to accounts held in another jurisdiction.

**Acquiring models**

Acquiring payment firms process a large number of small transactions each day over short periods of time. The flow of funds relating to these transactions is complex, as they do not proceed from receipt to holding to settlement in a linear fashion. Settlement to the merchants is often undertaken before funds have been received from the card scheme and in an aggregate manner, relating to multiple means of payment, with liability calculated at portfolio rather than at transaction level. Fees for various actors within the network (e.g., schemes, interchange, etc.) are deducted at different points in the transaction flow. To make this complexity work, acquiring business models currently depend on the ability to receive funds into a central transactional account, out of which they are swept into settlement, safeguarding or the firm's own accounts, as appropriate.

The proposed receipt of all relevant funds into a safeguarding account would significantly and permanently reduce the operational flexibility needed for acquiring models, thereby impacting the competitiveness of UK payment firms both vis-à-vis bank acquirers and international payment firms. The proposals would also necessitate the re-design of payment flows at a much greater one-off operational cost than that detailed in the cost benefit analysis (please see our response to question 22 below), and at an ongoing capital funding cost to create additional liquidity for no other reason than this new day 1 safeguarding provision.

It is disappointing to see that no exemption to the proposed requirement to receive funds directly into a safeguarding account is provided for acquirers. The exemption provided for in CASS 15.5.5 R (1) only applies to payment firms acting as either merchants in the payment chain (i.e., an EMI receiving funding from customers via card payments) or operating a payment facilitator model, and not to acquirers themselves.

If this CASS approach is adopted, we cannot see how the competitiveness of the non-banking sector could be sustained without such an exemption. We strongly recommend extending the exemption in CASS 15.5.5 R to acquirers, or, more reasonably, simply retain the D+1 rule for all payment firms. In this respect, it is notable that no alternative approach to receiving funds directly into a safeguarding account like that set out in CASS 7.13.54 G to CASS 7.13.69 G appears to have been envisaged for payment firms.

**B2B business models**

The requirement to receive relevant funds directly into a designated safeguarding account should not apply to firms that operate exclusively on a B2B basis, i.e., do not transact with consumers, micro-enterprises or charities. The customers of such firms have a deeper understanding and acceptance of insolvency risks than consumers. We therefore recommend extending the D+1 exemption to such business models.

**Liquidity**
It is common practice for acquiring payment firms to use transactional accounts to raise liquidity that allows them to settle with merchants before the receipt of relevant funds from the card schemes. Under such models, liquidity providers have a security interest over the transactional accounts. While most of the funds in transactional accounts are not subject to safeguarding obligations, funds held by the acquirer (and not yet settled to the merchant) for fraud prevention purposes are subject to safeguarding obligations. Card schemes cannot separate these potentially fraudulent funds from other funds when settling with the acquirer, which means all the funds have to go into the same transactional account before the acquirer then separates the potentially fraudulent funds and safeguards these in a safeguarding account.

However, if all funds are to be received directly into a safeguarding account, a bank could not acquire a security interest over such an account and this business model would no longer be operative. This directly affects the competitiveness of acquirers that are payment firms and are unable to pre-settle with merchants vis-à-vis those that are banks.

**Organisational arrangements**
The Guidance provided for in CASS 15.2.13G addressing payment flows and settlement processes does not reflect business practice. As stated above, payments and settlements are often not transactionally linked in a linear way. While firms should mitigate the risk of misuse of safeguarded funds, the examples in the proposed text for CASS 15.2.13G do not present such misuse. For example, they contradict the 5-day allowance in CASS 15.5.11R, under which the safeguarding balance may fall below the balance of issued e-money. Given that funds in the safeguarding account are not in themselves linked to particular customers, a spend and redemption of such e-money within the five days, and associated withdrawal of funds from the safeguarding account, should not give rise to concerns, particularly if the risk arising from the resulting exposure is adequately managed by firms.

**Transactional accounts held with other payment firms**
For the reasons stated above (international business models, acquiring, etc.), payment firms need transactional accounts to process transactions before or after funds have been safeguarded. This need is unlikely to change under the current proposals, as it is linked to business models and competition with the traditional banking sector rather than regulatory requirements. If payment firms are required to receive funds directly into a safeguarding account, they have two options for compliance, while at the same time continuing to use transactional accounts: (i) fund

the safeguarding account with their own funds or borrow funds to do so. This option is expensive and will negatively impact their products' competitiveness; (ii) obtain insurance to cover the periods in which funds should be, but are not, in the safeguarding account.

The second option (insurance) is the more likely choice for payment firms to make. But it should be noted that insurance is not only a costly method of safeguarding but that it also does not mitigate the risk of contagion that the FCA describes in para. 6.4 of the consultation. This is because firm A may in practice rely on a transactional account with firm B that is not subject to the safeguarding regime (i.e., located abroad) to transfer funds to the payee. Should firm B fail and a shortfall arise, firm A remains liable to its customers without recourse to the insurance, which only pays out on the insolvency of A. The shortfall may put firm A under financial strain, which may in turn bring about firm A's failure. While the insurance thus provides a safety net of last resort for A's customers, it does little to protect firm A from failure in the first place.

In comparison, firm A holding a transactional account with firm B in the UK presents a much smaller risk of contagion. In such a scenario, one EMI (firm A) may hold a transactional account with another EMI (firm B) that issues e-money to firm A in relation to funds it receives from that firm. While on Day 1, these funds will be segregated from firm B's own funds but not safeguarded by firm B, it is the e-money which is in fact the relevant asset in the transactional account. This e-money is held in an e-money account in firm A's name, where it is both segregated from all other e-money firm B issues and subject to a redemption right against firm B. It would be confusing to require such e-money accounts to be designated as 'safeguarding' accounts, as suggested under para. 6.5, and obtain acknowledgement letters for them.

- On the failure of firm A, this redemption right will be exercised by the insolvency practitioner acting for firm A in the same way in which any other customer of firm B may exercise their redemption right. Unless firm B is also failing, there is no reason to presume that this should give rise to any difficulties.
- On the failure of firm B, firm A will have a right to distribution from the asset pool of firm B in the same way as all other e-money customers of firm B have such a right, regardless of whether the funds underlying their e-money have been segregated or not. While a delay to distribution may negatively affect firm A, this negative impact is limited by the fact that only funds within D+1 may be kept in such a transactional account. Failure of firm B is therefore unlikely on its own to cause the failure of firm A. Furthermore, if firm A held such a transactional account with a bank, its rights on the bank's failure would likely be inferior (with the FSCS not applicable) to its rights as against firm B.

In such a scenario, therefore, entitlement by firm A to the e-money in the transactional account is never at issue or likely to give rise to competing claims. Recovery of funds may be delayed if firm B fails but would still be easier where firm B is an EMI rather

than a bank. EMIs will also offer their customers technology and reconciliation tools that save time and resource and are not offered by banks on the market.

In the light of the risk presented by these different account constellations as well as the acute difficulties payment firms face when seeking to access bank accounts, the ability to hold a transactional account with another payment firm should therefore be retained.

**10. Do you agree that funds received through agents or distributors should either be paid directly into the principal firm's designated safeguarding account, or protected through agent and distributor segregation? If not, please explain why.**

**Distributors and agents**

We think that the exemption provided for in CASS 15.5.5 R, which applies to funds received on behalf of a safeguarding institution by an acquirer and credited to an account with that acquirer, should also apply to funds received on behalf of a safeguarding institution by an agent or distributor, particularly given that agents and distributors may themselves receive funds through an acquirer. Funds received through agents or distributors should be paid directly into the principal firm's designated safeguarding account by D+1.

**11. Do you agree that firms should be able to invest in the same range of secure liquid assets as they can now in the interim state? If not, please explain why.**

We are not aware of any issues related to the current range of currently permitted assets but would recommend extending these to also include low-volatility net asset value money market funds (LVNAV MMF's), which are approved by some European regulators.

**12. Do you agree that firms should continue to be able to invest relevant funds in secure liquid assets in the end state? If not, please explain why.**

Yes, firms should continue to be able to invest relevant funds in secure liquid assets in the end state. However, we would also highlight that the CP does not allow firms to continue to be able to do so.

As the consultation says, (at para. 141) the impact of the statutory trust is that firms will likely be performing a FSMA regulated activity when investing with discretion in these assets when held on trust and "will need to obtain the necessary FSMA authorisations or outsource". The effect of this is that continuing to invest in these assets becomes a criminal offence (a breach of the general prohibition), unless the firm radically changes the way they can use HQLAs today, by either appointing an outsourced investment firm to perform the management or obtaining a permission to do it themselves. Some firms may be unable to make this change. It is simply not feasible for firms to obtain a FMSA permission themselves for just this activity (nor,

ema

presumably, would the FCA want to process those applications or supervise them for just this activity). And the costs of that management are, on the FCA's own estimation, on average £3.6m per firm per year. This is an extreme and remarkable change to firms' abilities to safeguard HQLA. It will be as good as a prohibition on the use of them for many firms.

It is notable that such a significant change is not being made deliberately, or for any policy reason. Rather, the change appears to have simply been accepted as a knock-on consequence of the imposition of a statutory trust. We reiterate that this is an extreme outcome and does not appear to have been intended or to have any direct policy outcome consistent with the FCA's objectives.

We would strongly suggest the FCA explore an exemption from FSMA for HQLA safeguarding, or many firms will be unable to safeguard using HQLAs in future. This, in turn, will have an impact on those firms' abilities to diversify their safeguarding asset portfolio and to mitigate any large exposures where they are subject to the CRR.

13. **Do you agree that Payments Firms should be able to hold the assets they invest in or should they always be held by a custodian? If you disagree that Payment Firms should be able to hold the assets they invest in, please explain why.**

In the case of UCITS, we do not believe the use of a custodian should be required given that the use of a Transfer Agent within a UCITS fund structure effectively prevents the commingling of client assets. Each shareholder is assigned a distinct line item on the shareholder register, which is managed by the Transfer Agent. This, in conjunction with the acknowledgement letter, offers a robust approach to customer protection in the event of insolvency by the underlying payment firm. Assets are redeemed into a designated safeguarding account.

14. **Do you agree with our proposals to maintain the use of insurance policies and comparable guarantee for safeguarding in both the interim and end state? If not, please explain why.**

**Insurance**

While we welcome the continued availability of the insurance option, we have concerns about some of the new conditions imposed:

- The requirement to have new insurance arrangements in place three months before the current cover expires places firms under unnecessary strain, given the sparsity of insurance offerings and their cost. Currently, whilst renewal discussions may start many months before a policy expires, firms are only able to obtain a formal quote from the underwriter approximately 4-6 weeks before the policy's expiry date. There is currently insufficient competition in the UK insurance market for safeguarding insurance, which will make it difficult for firms to comply with the three-month requirement. We therefore suggest shortening this period to six

weeks, which would still allow sufficient time to consider alternative safeguarding arrangements should insurance cover not be obtainable.
- The proposals do not seem to consider the fact that insurance is often offered by syndicates, affecting the time in which contracts can be negotiated and concluded.
- Payout amount (para. 6.35): Relevant funds may vary significantly throughout the year due to seasonal events. Maximising insurance cover in the way proposed, i.e., that it must exceed relevant funds at all times, may make it harder for a firm that is already under financial stress and unable to safeguard by segregation, to obtain cover, thereby bringing about firm failure. Insurance has proved itself to be a safe way of safeguarding that should be available to as many firms as possible. However, insurance is currently a significantly more expensive option than segregation. In order to limit the costs, we suggest an average-based calculation of the cover.

**15. Do you agree that the use of insurance policies and guarantees leads to the risks identified above? Are there other risks of which you are aware? Please explain your answer.**

[No response provided]

**16. Do you agree that a statutory trust is the best replacement for the safeguarding regime in the EMRs and PSRs? If not, please explain why.**

**The statutory trust**

We do not agree that a statutory trust is an appropriate replacement for the safeguarding regime in the EMRs and PSRs, for the following reasons:
- The trust appears to be a straight read-across from the regime currently applicable to firms holding client money, rather than presenting a strategic solution for e-money and payment firms. E-money issuance involves the purchase of monetary value by customers in exchange for funds. These funds are then owned by the issuer, with the customer's ownership rights having been transferred to the e-money, which they can spend with merchants or transfer to third parties. The envisaged statutory trust over relevant funds will change ownership in these funds, resulting in customers holding both a beneficial equitable interest in the funds and a legal interest in e-money of an equivalent value. This threatens the legal understanding of e-money issuance as a purchase of monetary value, changing it into the provision of a service in relation to the underlying funds.
- Furthermore, it would be legally incongruent to claim that customers of payment firms that use the segregation method retain ownership in the funds under a trust, while customers of payment firms that use insurance lose such ownership. No explanation has been provided as to how this would work from a property law perspective, and it is reasonable to expect successful litigation in this respect by customers of payment firms who want to claim an equal right in the underlying funds.

- The consultation does not address the consequences of this legal change other than by referring to the envisaged practical consequences of providing increased legal certainty on the insolvency of payment firms. This is concerning, particularly as e-money to date occupies a well-defined position between deposit taking, on the one hand, and investments, on the other hand. Such a fundamental legal change should not be taken merely out of a consumer protection concern, which in any case only arises for a small number of failing firms. Without a legal assessment of the consequences of applying a statutory trust requirement to e-money, the consultation remains incomplete, failing to properly assess the costs and benefits of such a change.
- To give an example, to date the asset in question that e-money customers hold is the e-money, and property law will treat them as owners of the e-money for the purpose of both civil and criminal matters, such as unjust enrichment, theft, fraud, etc. If customers are also the holders of beneficial equitable rights in the underlying funds, this will alter their legal position when, for example, e-money is taken from their account without their consent or when the issuer or a third party deals with the trust funds in an unauthorised manner.
- These potential legal consequences are not offset by the perceived benefits of legal certainty on insolvency. The current rules around safeguarding accounts already stipulate that no third party, including the bank involved, may have a right over the account. A trust does not change or improve on this requirement, which guards safeguarded funds from other creditors, including priority creditors. It is only where relevant funds are held outside a safeguarding account that the trust increases legal certainty, although this increase is minor given that the judgment in *Re Ipagoo LLP (In Administration)* [2022] EWCA Civ 302 already defines the asset pool by reference to all relevant funds regardless of whether they have been safeguarded.
- Furthermore, it is questionable whether a trust arrangement would even result in fewer applications to the courts where third-party charges over the issuer's property are concerned, as this area of law is complex, and it is common for trustees to seek directions from the courts. These legal costs would need to be borne by the beneficiaries. A trust is also unlikely to improve the process of repatriating funds held outside the UK in jurisdictions that currently do not even accept the administrator's rights over the funds.
- From a cost benefit perspective, the administrative overheads associated with a trust should also be considered carefully, including those relating to terms and conditions, relevant investment and custody permissions, fiduciary duties and the likely increased cost and difficulty in obtaining safeguarding accounts and acknowledgment letters. It is currently not known how banks would approach safeguarding accounts in which funds are held on trust and how they would interpret their responsibilities in relation to the underlying beneficiaries, but it seems clear that a statutory trust would reduce the commercial incentives for banks to offer such accounts, thereby exacerbating the already-existing issues with access to bank accounts by payment firms.

- From a consumer perspective, it would be incongruent to be told that the money with which one purchases e-money will be held on trust for oneself. The e-money product proposition is clear in that consumers expect to be issued with monetary value in relation to which they receive a financial service, i.e., that they can spend at merchants or transfer to third parties. There is no expectation of ongoing services in relation to the purchase of e-money. This is especially so for e-money products issued under Reg. 38 MLR 2017 (such as small-value non-reloadable prepaid cards), which are exempted from the usual customer due diligence measures and may be passed to persons other than the original purchaser. For such products, the beneficiary under the statutory trust would not be clear until the holder of the card and instrument identified themselves.
- Finally, the approach to safeguarding for e-money should be informed by the evolving payments landscape, including stablecoins and CBDCs, which also involve issuance, and which may possess similar attributes to e-money (i.e., backed by fiat currency and accepted by parties other than the issuer in payment). The FCA's views in this respect are relevant to the proposals but have not been disclosed.

**Interest payments on trust funds**

The consultation does not make any reference to interest that may be paid on relevant funds held in a safeguarding account. Currently, interest paid on safeguarded funds constitutes a significant revenue stream for EMA members, which can amount to 30-40% of overall revenue. E-money issuers may not pay interest to customers in relation to e-money balances, as per Reg. 45 of the Electronic Money Regulations 2011.

It is uncertain whether and how the contemplated change to the ownership of relevant funds under a trust would affect firms' ability to derive income from safeguarded funds or the prohibition of paying interest under Reg. 45 EMRs, and this should be addressed in any final rules. If the statutory trust is implemented, we strongly recommend that firms continue to be entitled to any interest paid on trust funds, subject to appropriate contractual agreement with their customers. Payment of interest to the firm's own accounts/withdrawal of interest from safeguarded accounts should be permitted.

**17. Do you agree with the proposed terms of the trust, including the Payments Firm's interest after all valid claims and costs have been met? If not, please explain why.**

[No response provided]

**18. Do you agree with our proposals to clarify when the safeguarding requirement starts and ends? If not, please explain why.**

**Payment chains**

Where the payment chain involves one or more intermediary payment service providers, it is not practicable to require the safeguarding requirement to persist until funds have been paid to the payee or a PSP acting for the payee (para. 7.17 and CASS 15.11.2R). This is because the safeguarding institution will not necessarily be notified that such payment to the payee or payee's PSP has taken place, particularly for cross-border transfers. Therefore, CASS 5.5.80R(1) cannot simply be read across to payment firms operating in complex payment chains. Instead, the safeguarding requirement should only persist until the institution's account has been debited. CASS 15.11.2R should be amended accordingly.

**Card scheme payments**
Furthermore, to cater for card scheme payments, we suggest amendments to CASS 15.11.2R to include an additional sub-paragraph so that funds cease to be relevant funds once paid to a card scheme in settlement of scheme transactions.

**Collateral**
Some payment firms have collateral arrangements with the card schemes whereby the schemes acquire rights over funds that have ceased to be relevant funds (e.g., because the e-money in respect of them has been redeemed via the authorisation of card transactions). The current end state rules do not take these arrangements into account and may mean that schemes bring an end to these structures, which will result in firms having to find substantial amounts to lodge with the schemes as an alternative to collateral.

19. **Do you agree that the implementation arrangements give Payments Firms sufficient time to prepare for the interim and end state rules coming into force? If not, please explain why.**

We strongly urge the FCA to pause the implementation of end-state rules until the effects of the interim rules have been ascertained and the need for further rules assessed. This will allow any further rules to be targeted to any remaining issues as well as alternatives to be considered with appropriate stakeholder involvement.

At the very least, the implementation period for both the interim and final rules should be extended to 12 months to enable firms to properly implement the significantly more onerous governance and reporting requirements that these rules entail (including sourcing and assigning appropriate resources, planning and testing solutions).

20. **Do you agree that the transitional provisions are appropriate? If not, please explain why.**

[No response provided]

21. **Do you consider that any other transitional provisions are needed? If so, please explain why.**

[No response provided]

**22. Do you agree with our assumptions and findings as set out in this CBA on the relative costs and benefits of the proposals contained in this consultation paper? Please give your reasons.**

**Assumptions about benefits**

it is notable that, at a compliance rate of 68%, these proposals merely break even and thus hardly present an unqualified overall benefit. Even so, we have serious reservations about the credibility of the assumptions made by the FCA in its cost benefit analysis. Not only have the costs to the sector been significantly underestimated or not accounted for at all (see below), but the benefits are calculated by reference to the forgone interest that could have been earned by consumers on relevant funds (para. 195). This shows a misunderstanding of the way in which most consumers use payment firms, which is to make mostly low-value payments to merchants and other parties. From a consumer perspective, the loss of interest income is not a relevant consideration when losing such funds should a payment firm fail, as the payment was never meant to generate interest or would otherwise have been held in an interest-bearing account. While interest may be relevant to corporate customers, these proposals are not aimed at the protection of corporate customers. Therefore, while superficially valid, we consider this benefit analysis largely irrelevant to the overall evaluation of the proposals.

**Costs that have not been accounted for**

Please see our answers to questions 1, 2, 3, 8, 9 and 16 for a description of the significant impact of the proposals, much of which has either not been accounted for or has been underestimated in the CBA. These include:

- One-off legal and consultancy costs associated with the transition to CASS, which we estimate for a small to medium-sized firm to range between £150 to 200k;
- Significant ongoing compliance and treasury operations costs associated with the vastly more complex CASS regime of reconciliations, record keeping and reporting;
- Additional treasury operational staff and oversight for weekends and bank holidays due to the intended meaning of ‘business day’;
- The radical re-design of funds flows and related technological infrastructure, as well as of operational policies and procedures;
- Costs related to the extension of the length of time period that the safeguarding obligation applies;
- Loss of liquidity due to the loss of the D+1 rule;
- Ongoing compliance costs in relation to due diligence of banking partners and other third parties involved in safeguarding;

- Loss of banking partners in the UK and abroad due to the acknowledgment letter and statutory trust;
- Costs associated with new duties and liabilities as fiduciaries under a statutory trust, including litigation and court directions;
- The seeking of new investments/custody permissions;
- Audit costs;
- Costs associated with evidencing the requirements tested in the audit and by the audit standard;
- The non-viability of certain business models under the proposals, as well as loss of competitiveness.

These costs have not been adequately captured by the CBA, which therefore fails to make a persuasive case for the overall benefits of the proposals.

**Distribution timelines**

The assumption stated in para. 194 that the new proposals will reduce average time to first distribution from 2.3 years to 1 year is not realistic and does not appear to have been evidenced. Insolvency practitioners involved in the recent insolvencies of payment firms have told us that timelines for distribution of funds to customers will unlikely be reduced by the proposals where the firm's insolvency is governed by the special administration regime for EMIs and PIs. PSAR involves a statutory court distribution process whose timelines are independent of the availability of relevant funds and run to one year even in relatively straight-forward cases. The proposals will have no impact on these timelines, as the reduction envisaged is only to 1 year.

In any case, it is questionable whether a reduction of distribution time to 1 year justifies imposing such significant changes on industry, particularly changes aimed at the protection of vulnerable consumers. Such consumers would be much better served by the application of the FSCS to relevant funds, which pays out within seven working days.

**Access to safeguarding bank accounts**

Access to bank accounts by payment firms has been an ongoing issue, of which the FCA has been made aware on multiple occasions in the past. The issue is exacerbated by the proposals of the consultation, including the requirement to receive relevant funds directly into a safeguarding account and the statutory trust. We consider that the following statement in para. 163 of the cost benefit analysis is not an appropriate response to the problems faced by firms who are unable to obtain a required safeguarding account, or are able to do so only at a disproportionately high cost:

> "While we acknowledge that these firms will face additional costs from using a DSA and a few may not be able to find a suitable provider, we consider it impracticable to estimate these costs based on the data received and because of uncertainty over the applicability of these conditions to other firms. Should

firms not be able to find a suitable provider, we acknowledge they may no longer be able to continue operating."

Rather than costing in these difficulties, including the significantly higher cost of insurance as an alternative to segregation, the cost benefit analysis simply includes as one of its key assumptions that 'all firms will be able to obtain appropriate safeguarding accounts following our interventions' (para. 6). It is notable that, unlike the other key assumption, this assumption has not been addressed in the 'Risks and uncertainty' section in paras 217ff. This leaves the cost benefit analysis incomplete and suggests that some of the already known outcomes of the proposals have intentionally been left unaddressed so as not to skew the presented balance of costs and benefits.

**23. Do you have any views on the cost benefit analysis, including our analysis of costs and benefits to consumers, firms and the market?**

Please see our response to question 22 above.

**24. Do you have any views on whether our proposals will materially impact any of the groups with protected characteristics under the Equality Act 2010? If so, please say how?**

[No response provided]