AFEP

Association of Foreign Exchange
and Payment Companies

Dated 11th June 2020

AFEP Response to FCA consultation on
Temporary guidance to strengthen payment firms' prudential risk management and arrangements for safeguarding customers' funds

The **Association of Foreign Exchange and Payment Companies** (AFEP) is a non-profit association for authorised payment and e-Money institutions which operate in the European Economic Area. It was founded in 2012 to act as a representative body for payment companies with an FX focus. With over 70 member firms spread between **Authorised Payment Institutions** (APIs) and **Emoney Institutions** (EMIs) establishments, the association has a strong footing within the industry. Our members are growing at a fast pace, with the FX turnover amongst members around £200 billion, which equates to the members of the association grossing a combined revenue number in the region of over £1 billion.

AFEP has developed into a well-respected association acting as a voice of the industry and liaises with government departments and regulatory bodies on important legislative matters. The aim of the association is to promote the highest standards of practice for APIs and EMIs, advocate on behalf of our members with regulators and government bodies and encourage our members to share and exchange information.

AFEP understand the background to the FCA's approach however we are concerned that a number of these changes are substantial and will require significant operational changes to implement. Many also have a large degree of permanence and should not be quickly rushed through during a short consultation. They may change the market more generally and will certainly result in significant practical changes for APIs and EMIs. A number of these issues should not be covered in this short consultation and we do not believe they are proportionate, often going further than the **Client Asset Sourcebook** (CASS), **2nd Payment Services Directive** (PSD2), **2nd Emoney Directive** (EMD2) or the **Capital Requirements Regulative and Directive** (CRR). This could have the effect of changing the market more generally and present difficulties practically resulting in significant changes.

We understand that there are key messages the FCA want to give APIs and EMIs around safeguarding and good governance and AFEP are supportive of high level messages which could be included in quickly produced FCA guidance. However a number of the issues should not be covered in this short consultation and we would welcome the FCA opening up a more in depth consultation particularly around the issues on the Safeguarding Acknowledgement Letter and the Prudential Risk Management to ensure the legal and practical ramifications are fully understood.

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

1.1 AFEP welcomes a regulatory framework that sets clear and consistent standards with which APIs and EMIs are expected to comply and provides appropriate customer protections. We believe that, applied proportionately, such standards can help develop the reputation of our industry and increase consumer confidence.

1.2 AFEP agrees that practical, clear guidance is of significant use to our members. Over the past few years AFEP members have raised questions regarding the FCA supervisory approach and as such we have produced AFEP Good Practice Guidance. Any move to provide further clarity and ensure consistency by the FCA on their approach is always welcome, and AFEP would encourage the FCA to provide practical examples of good practice when issuing guidance. AFEP will continue to work closely with its members and the FCA to increase industry standards.

1.3 AFEP are concerned that the FCA are using an emergency consultation during COVID19 to address fundamental issues of interpretation around the implementation of PSD2/EMD2 in the UK without a full and proper consultation. We understand that the current unprecedented global pandemic may result in the need for some clarity around existing guidance, however we are concerned that a number of the proposed changes are significant and have a large degree of permanence to them. Whilst we understand the FCA is worried that COVID19 brings additional pressure to firms, we are concerned whether the consequences of the changes have been fully considered.

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

AFEP are supportive of efforts to protect customer money and we understand why this is at the forefront of the FCA's work during this unusual time.

There are a number of additional areas around Safeguarding that we feel require a further level of clarity from the FCA that is not provided by this consultation. Equally, we would like to highlight fundamental changes that will cause significant issues for firms.

As there are many different business models, the current Approach Document does not always make it clear to firms what is required of them. AFEP encourages firms to document their rationale for their Safeguarding methods and to assist with this, we created a Good Practice Guidance on Safeguarding to show examples of what good practice looks like. We would encourage the FCA to provide such examples so that firms can more clearly understand what the expectations are.

There are a number of separate issues regarding Safeguarding that we have detailed below.

2.1 Keeping records, accounts and making reconciliations

2.1.1 If, the intention of the approach document is to ensure that firms perform a daily reconciliation of relevant funds AFEP would suggest that FCA use simple rule-based statements in the clarified guidance such as:

- Reconciliations of relevant funds must be carried out every business day. It is worth noting that under CASS the requirement is to perform the internal reconciliation on each business day and this would be a sensible comparison.
- A named and appropriately senior individual should be assigned responsibility for ensuring that the reconciliation takes place and the results of the reconciliation are dealt with promptly.

2.1.2 Using rule based statements to ensure that there is no possibility for misunderstanding will not only reduce the potential for harm, but combined with the requirement to name a senior individual may ensure a level playing field in terms of compliance costs across firms. It may also provide the sector with a greater impetus to make use of technology solutions and go to banking providers that can and are willing to integrate with these technology tools.

2.1.3 We would also suggest additional guidance would be helpful on what constitutes a material issue in respect of failing to reconcile balances.

2.2 Safeguarding Accounts and Acknowledgement Letters

2.2.1 We have concerns around this requirement and believe there are legal ramifications around the wording of the proposed letter and the use of the word 'trust'. AFEP believe the FCA's characterisation of the arrangements as a "trust" is not an accurate representation of the safeguarding account as we do not feel that the safeguarding account is the firm acting as "trustee" over the funds. AFEP believe that this is still legally "firm funds", but it is put into a safeguarding account for the purpose of fulfilling a payment service. In the event of default, creditors would typically follow *pari passu*, but funds in the safeguarding account will be released first. This not being a trustee relationship is one of the key differentiators between safeguarding and CASS.

2.2.2 This proposed letter significantly changes the legal nature of the safeguarding account which requires serious legal consideration to prevent a move towards more complex trust law which would not be to the benefit of the customer.

2.2.3 The position of the accounts under the PSRs/EMRs make them similar to a trust but as the regulations themselves do not (unlike the FSMA equivalent client money regime) use the term "trust" we do not believe that an actual trust was intended to be created here when PSD2/EMD2 were implemented. If the FCA approach is that they are now saying it is an implied trust, AFEP would contest that as a legal interpretation as the legislation does not use that term at all.

2.2.4 To a limited extent AFEP understands why the FCA feel that it provides more customer protection, however we do not believe that the full consequences of that characterisation (and the potential implications on an insolvency) have been fully thought through. This issue is one that would have far reaching consequences and also some very immediate practical implications e.g. that APIs/EMIs terms and conditions are unlikely to refer to a trust meaning firms are required to revisit their T&Cs.

2.2.5 It is also important to note that the concept of a trust is not present in most EU jurisdictions. Given the nature of APIs and EMIs to utilise any EEA credit institution to hold such funds, this only adds a level of complexity and would not have been the intention when PSD2 and EMD2 were passed into law.

2.2.6 Further, whilst AFEP recognise that an insolvency event at and API/EMI comes with inherent risks, a reputable insolvency practitioner is likely to behave cautiously where accounts are described for the benefit of the payment service user (or similar language) whether the account is an actual trust or not. AFEP would also recommend that FCA consider incoming insolvency legislation, further to the Corporate Insolvency and Governance Bill that was introduced to Parliament on May 20th 2020 and will come into force towards the end of June 2020.

2.2.7 AFEP would recommend that if the FCA have not already made arrangements either directly with the credit institutions that they supervise or via liaison with PRA, they contact the credit institutions or ask the PRA to contact the credit institutions on their behalf and ask them to be ready to process large volumes of correspondence. The FCA (or PRA) should also make credit institutions aware of this in advance to avoid banks failing to produce the letters as a result of the above legal uncertainty. There will remain issues from non UK credit institutions who may not recognise the FCAs requirements or where there is no concept of a trust under their jurisdiction. AFEPs banking members are concerned that there could be delays in providing responses as individual relationship directors at different banks approach the response to the letter differently. This is in addition to the constraints caused by COVID19 and physically signing the letters remotely will present an issue for banks.

2.2.8 It would also be useful for the FCA or via liaison with the PRA to work with the credit institutions to ensure that any closure of safeguarding accounts is handled correctly and appropriately to protect customer money. This is particularly important as there is a lack of opportunities for AFEP members to change provider and limited choice when selecting a provider as despite the requirement of the PSR, there are few credit institutions or insurers willing to offer payment accounts to APIs and EMIs.

2.2.9 AFEP do not feel that this is an area of change that should be pushed through via a short consultation without due care and attention paid to the legal ramifications. The FCA has a duty to properly consult on such wide-reaching legal issues and we would encourage the FCA to undertake a more detailed consultation.

2.3 When the obligation to Safeguard ends

2.3.1 We appreciate the efforts to clarify when the obligation to Safeguard starts however there remains confusion and inconsistency because of historical FCA supervisory action on when the obligation to safeguard ends.

2.3.2 In July 2019 Maha El Dimachki confirmed in writing to AFEP that the guidance regarding where the obligation to safeguard ends is set out in paragraph 10.27 of the Approach Document and that firms are not expected to match the value of payments firms make on behalf of their clients. If a chain of PSPs is involved, an institution's safeguarding obligation continues while it holds the funds and ends when it has transferred them to another PSP which holds the funds on behalf of the payment service user. The funds must be safeguarded by the institution for the benefit of the payer or payee. It is not sufficient for the funds to be safeguarded for the benefit of another institution in the payment chain.

2.3.3 Since this clarification, a number of AFEP member firms have continued to receive conflicting instructions from the FCA on when the obligation to Safeguard ends and this is not applied consistently between firms leaving some firms are at a significant disadvantage. AFEP have summarised these issues below:

2.3.4 *The FCA have told some firms that the obligation to Safeguard doesn't end when the funds are paid out to the payee or the payee's PSP, it ends when the money has been* ***received by*** *the customer.*

- This is in direct contradiction with both section 10.27 in the Approach Document and Maha El Dimachki's letter from July 2019.
- It is not possible for a firm to know when the money has been received by the payee.
- Once the money has been paid out to the payee's PSP it would be Safeguarded by the new PSP or the payee's bank. The approach document is very clear that you cannot Safeguard for the benefit of another PSP.

2.3.5 *The FCA continue to obligate some firms 'to match the value of payments they make on behalf of their clients from their own funds because they will have to both keep the value in a safeguarding account and remit it to the payee'. They have told other firms that "The concept introduced in section 10.27 of "Chain of PSPs" - does not mean that an institution can stop safeguarding (and take out the funds from the safeguarding account) upon sending the funds to the next PSP in the chain under any circumstances (more specifically - even when (i) there is wording in the agreement between the financial institutions according to which the funds are being kept by the next institution for the benefit of the payer; and (ii) there are accurate records and ledgers of the ownership of the funds) - unless the next PSP in the chain is also the last - the Payee's PSP."*

- This is in direct contradiction to 10.27 which says it is not possible to safeguard for the benefit of another PSP.
- This will cause firms significant capital issues as they will be required to pre and post fund the safeguarded money. Such increased capital pressures in the current market could well have the effect of destabilising firms and the wider the industry which is not in the customer interest.
- This will limit competition in the market as smaller firms will not be able to both fund safeguarding requirements to receipt and maintain adequate liquidity resource.
- This may cause issues of 'polluting the pool' as once funds have been sent to the payee or the payee's PSP the firm should no longer safeguard them.
- There is no clear timeframe on how long the firm should continue to safeguard funds for once it has been sent to the payee or the payee's PSP as it is impossible to know when the money has been received.
- Once the money has been sent to the payee or the payee's PSP it is safeguarded by that iinstitution (or protected under FSCS if it is a bank).
- It is inconsistent with the application of PSD2 in other member states resulting in a competitive disadvantage for UK firms.

2.3.6 *The FCA have told some firms that "There are 2 ways available to correctly safeguard the funds of the clients, when a chain of PSPs is involved: prefunding (the first PSP to prefund the next PSP in the chain so that the first PSP in the chain can continue and hold the sent funds in the safeguarding account until the funds are sent to the payee's PSP) and insurance."*

- If prefunding is going to be a requirement going forward, there needs to be clarity about how to do this so as to not pollute the pool, and the FCA should be clear on when the obligation to safeguard ends. This is especially complicated when a chain of PSPs is involved as the FX firm cannot be expected to have an idea of when the funds have been received by the payee.

- While there is the alternative of insurance, the level of cover in the market is low and certainly inadequate to cover all firm requirements.

2.3.7 Since many cross-border payments involve a chain of PSPs AFEP believe that the FCA need to be clear on their guidance as to whether a PSP can stop safeguarding upon transferring the funds to the next PSP in the chain. Our understanding from section 10.27 is that the firm can stop safeguarding once they have paid out the money to the next PSP as the next PSP in the chain safeguards the funds for the payment service user. To do otherwise would result in double safeguarding and AFEP do not believe it is proportionate to double safeguard. This could have the unintended effect of making the position of the EMI or API more difficult than it was before.

2.3.8 AFEP suggest that to provide clarity on when Safeguarding ends, the FCA should be clear that they expect firms to adhere to 10.27 and that this means when money is paid out (as it reads in the approach document) not 'received by'. The FCA should also provide detailed guidance on any scenarios where they consider this to mean safeguarding until funds are received by the ultimate payee taking into account practical issues, including not safeguarding for someone else in the chain, and implementing changes in the banking structure to notify firms when money has been received in the payees account.

2.4 Unallocated Funds

2.4.1 While we agree that firms should seek to allocate funds as quickly as possible, we disagree with the exclusion of unallocated funds from safeguarding.

2.4.2 We note that the proposed guidance says that unallocated funds are not relevant funds, on the basis that they are not "funds received from, or for the benefit of, a payment services user for the execution of a payment transaction" (Reg 23(1) PSRs or "funds received in exchange for electronic money that has been issued" (Reg 20 (1) EMRs). We disagree with this assertion as, although they are unallocated that does not imply that they have not been received from a payment service user for the execution of a payment transaction or in exchange for electronic money. In our view, the fact that the funds in question will have been paid into the account used for the collection of relevant funds means that the funds were likely intended for a payment service or the issue of e-money.

2.4.3 Additionally, the treatment of unallocated funds as non-relevant seems to contradict with the principle set out in 10.65 in the Approach Document that, in the case of a reconciliation discrepancy the higher amount should be safeguarded. We would therefore suggest that it would be simpler and provide greater protection for customers if these funds were also to be safeguarded, with guidance that, if the funds are unable to be identified within 10 working days, they should be returned to the remitter which would be consistent with the rules under CASS 7.13.36-7.13.38.

2.4.4 We would also note that the proposed treatment of unallocated funds is contrary to the treatment of client money under CASS which requires that:

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"If a firm receives money (either in a client bank account or an account of its own) which it is unable to immediately identify as client money or its own money, it must: (1) take all necessary steps to identify the money as either client money or its own money; (2) if it considers it reasonably prudent to do so, given the risk that client money may not be adequately protected if it is not treated as such, treat the entire balance of money as client money and record the money in its books and records as "unidentified client money" while it performs the necessary steps under (1)."

2.4.5 While we appreciate that CASS does not apply, it seems illogical to create inconsistencies where unnecessary. Many of our member firms operate CASS accounts as well as safeguarding accounts, often for the same customers. Deviation increases operational risk and increases confusion for customers.

2.4.6 We would also suggest that the FCA provide clear guidance on how to treat unallocated funds that have been held for a number of years and where allocation is not possible (for example where non UK jurisdictions won't provide relevant payment details). For consistency we would encourage the FCA to follow the CASS rule 7.11.50 and allow firms to transfer money to charity after a period of 6 years of demonstrable efforts to return the money to the client.

2.4.7 If it is proposed that unallocated funds are not deemed as relevant funds, we would expect the guidance to provide further clarification on the FCA's expectations how these are protected under PRIN 10 and what practical measures should be taken to deal with these funds. The implementation implications of such a change could have wide reaching consequences, such as requiring firms to maintain a separate bank account which is not a safeguarding account. Unallocated funds may be received by FX firms in a considerable number of currencies.

2.4.8 If firms are required to open another full set of currency bank accounts in order to hold unallocated funds this again makes reconciliations more difficult, increases the cost and operational complexity and potentially impacts customer service due to the additional cash movements. While we appreciate segregation could be in a different currency this leads to the need to double fund accounts which is not feasible or proportionate. Not only does this new guidance increase the volume of daily reconciliations, it would increase the number of internal transfers to and from safeguarding accounts.

2.4.9 We would also note that many firms in our sector struggle to get one safeguarding account due to the limited number of banks who support the payments services and e-money sector. It may not be possible for them to obtain other segregated accounts and the timeframes involved are likely to be considerable even for those who are able to put them in place.

2.5 Auditors Requirements

2.5.1 The requirements of auditors are already well established. Auditors already have significant obligations and a direct dialogue with the FCA, so if the FCA are requiring specific changes they should talk directly to auditors. If there is a requirement for a new Safeguarding audit report, the FCA should be specific about what that is and what it should contain. AFEP would also welcome clarity from the FCA if there are any additional audit requirements beyond those of

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the annual financial audit and AML audits that are already required by liquidity providers, many of whom are govered by the PRA.

3. Do you agree with our proposed guidance on managing prudential risk? If not, please explain why.'

3.1 AFEP understand the FCA's desire to ensure firms are managing risk in a controlled and sensible manner and we agree that it is essential for firms to have strong governance and controls and to effectively manage their prudential risks. Equally, we agree that firms should carry out liquidity and capital stress testing and use the results to inform their decisions around adequate liquidity and capital resources.

3.2 We believe that cross reciprocal holdings of capital instruments between firms should be deducted to prevent contagion within the financial system. However, based on the points below we disagree with the new requirement that firms deduct assets representing intra group receivables from their own funds from the regulatory capital calculation.

3.3 Our understanding is that under the EMRs and PSRs the FCA can issue rules and guidance that apply to PSPs, however it cannot do so where the effect of those rules or guidance would be inconsistent with the legislation from which that power derives (in this case the EMRs and PSRs). The imposition of any new binding deduction to APIs and EMIs' own funds would therefore have to take effect as an amendment to the EMRs and PSRs and cannot be imposed by the FCA acting alone.

3.4 We would highlight that the deduction of intra group receivables is well in excess of what investment firms are required to do under the Capital Requirements Regulation (CRR) and the new proposed prudential investment firm requirements which aims to provide a more proportional approach for firms. In addition, there are already clear accounting guidelines for recognition of assets and liabilities which are well understood and implemented. The vast majority of APIs and EMIs are significantly less complex than most banks and investment firms, and generally pose fewer systemic risks. We therefore consider that it is disproportionate to impose a more punitive capital treatment on intra-group exposures incurred by APIs and EMIs than would apply to the same exposures if incurred by banks and investment firms. As a result, this approach cannot be justified from a prudential perspective.

3.5 We would note that PSD2 sought to align the definition of capital and own funds with the CRR. Banks and Investment firms provide capital on receivables of between 1.6% and 8% of their value, so the suggestion that APIs and EMIs should provide capital against this asset class at 100% seems disproportionate and unfair and not in accordance with PSD2 principles of alignment with the CRR.

3.6 The provision of currency exchange and settlement facilities is inherently a cross border business and many firms operate a centralised treasury function which is used to manage risk to the individual firm, the group and the ultimate clients whilst maximising liquidity and reducing costs. This structure is of clear benefit to customers. We feel the requirements will be particularly punitive to international groups who will normally have more sophisticated controls, governance and monitoring in place.

3.7 There has been a great deal of innovation in this sector in recent years, leading to increased competition in the market and the availability of a greater range of products and services for customers which is to be welcomed. We are concerned, that the current proposals would place

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pressure on the funding and operating models adopted by a number of groups in the sector, particularly those benefitting from venture capital and private equity investment, the knock on effect of which could have a detrimental effect on innovation and competition.

3.8 We have noted that the FCA has framed its expectations in relation to this point as "best practice" guidance. Given the legal consequences of such action we do not believe the FCA would be able to implement such a change as a binding requirement. There is a clear inconsistency in the proposed guidance between the FCA's articulation of "best practice" and the deduction of intra-group receivables being an actual requirement that is binding on APIs and EMIs, as the FCA's proposals in relation to the submission of FSA056 or FIN060a returns would imply. It is unclear from the proposed guidance which treatment is intended.

3.9 Overall, the proposal would put APIs and EMIs at a considerable competitive disadvantage across other member states and appears disproportionate to the risk particularly where the other firms in the group are also subject to capital requirements. It would also increase operational risk and increase resource requirements and cost as firms may need to settle all intercompany balances on a frequent basis. For firms that have legitimate commercial transactions with group companies, the impact of this guidance will be to require those firms to raise additional capital. The proposed short time scale means that the additional capital will have to be raised quickly and, as the FCA itself notes in the consultation page, "the pandemic will affect these firms' financial strength and may affect the availability of their external funding".

3.10 This change could cause significant damage to the industry as a whole and even if some elements were reviewed to an acceptable level, there would need to be a significant implementation period where firms that are part of a group can review their treasury functions to implement it appropriately. We compare the FCA's proposed approach to payment firms to the Bank of England's Financial Policy Committee's (FPC's) approach to banks and larger investment firms in response to the same issues. The FPC's approach to the situation has been to ease, for the time being, certain capital requirements on banks and large investment firms. The FCA's proposal in response to the same situation appears to be to increase the capital requirement on payment firms. No explanation has been offered as to why such diametrically opposing measures might be appropriate for these two sectors.

3.11 The FCA have been vocal on the issue of capital requirements and liquidity over the past 12 months but have not raised this issue previously. AFEP don't believe it is appropriate to make such wide reaching policy changes with very little notice, or analysis, especially when it may have such a large adverse effect on firms, and there seems to have been no consultation or consideration about the impact of this on APIs and EMIs. There has been no evidence provided to support the need for its introduction or the scale of the imposition. AFEP believe a more appropriate and proportionate approach would be for the FCA to collect financial data on firms' parent companies in the FSA056 /FSA059/FIN060a returns, so that they can assess the potential impact of the risk materialising across the sector and then take rational, evidence-based decisions on how to mitigate it.

3.12 Whilst we don't agree with this section of the consultation, if the FCA intend to progress this point they need to provide clear guidance on what would be regarded as best practice in terms of the regularity by which firms should undertake a capital adequacy assessment and what would be deem as an acceptable 'legally enforceable netting arrangement' between group entities? For example, this could include an inter-company loan agreement.

3.13 If the FCA considers that the potential risks posed by APIs and EMIs intra-group arrangements need to be addressed, this must be through measures that are proportionate to those risks. The FCA should not impose measures that are more onerous and restrictive than those which apply to credit institutions and investment firms. Any move to implement such requirements without due consideration may result in firms breaching their capital requirements, withdrawing from the market and harming the consumer in a number of ways.

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

4.1 AFEP are supportive of the FCA ensuring orderly wind downs occur but it is important to note that this is a new requirement for APIs and EMIs and as such firms will have little understanding or experience of what good practice looks like. Whilst the 5 bullet points provided by the FCA in the short consultation are useful we would welcome clear examples of what good looks like with a greater level of detail to ensure firms can produce meaningful documents. Firms who are investment firms will already calculate a cost to close for their ICAAP, and whilst this does not apply to APIs/EMIs we will be encouraging members to review this issue so they create their own effective ICAAP calculation.

4.2 Whilst we agree with the proposed requirement, smaller firms may not have available resources to deal with the burden imposed via an ICAAP/RRP style requirement and further clarity on the regulator's expectations would be needed. Any wind down plans would also need to be proportionate to the firm's size, resources, risk perception and clear examples from the FCA would assist with this.

4.3 AFEP would also encourage the FCA to be consistent with its own Guidance on adequate financial resources which states:

"For wind-down planning we are recommending and encouraging a best practice approach to manage the risks of disorderly failure, rather than imposing additional requirements making wind-down planning mandatory. The existence of a winddown plan and the scope of it will be a decision to be taken in a proportionate manner by firms, depending on factors including their size, complexity and exposure to the market."

This clearly contradicts the safeguarding consultation, which mandates winddown plans for payment services firms.

Timescales

We can see no mention in the consultation of the timescales firms will have to implement these changes. It is important to be clear that whilst the FCA state that the consultation is around clarification to existing guidance, some areas do represent significant changes, especially given the EU rules that relate to some of this legislation are 'maximum harmonisation' which mean they should not be exceeded.

Many of the issues raised are already part of AFEPs Good Practice Guidance, however many will require more time to implement, particularly around appointing new auditors, getting letters from banks , opening new bank accounts and reviewing capital requirements and treasury functions. It is important that timescales are realistic. The increased workload to ensure customers have continuity of service despite the unprecedented challenged that our members are facing due to the COVID19 crisis, means firms do not have teams together in an office, and most likely have many staff furloughed making it difficult to implement such large changes quickly.