AFEP

Summary of FCA consultation

Overview

The FCA are opening a short consultation (deadline 5th June) to update guidance on Safeguarding, managing risk and wind down procedures. The aim is to prevent harm to customers if firms fail, by making the wind-down process as orderly as possible and facilitating the return of customer funds in a timely manner.

Background & Context

Over the past 18 months, the FCA have made clear that payment services are a priority for supervision and intervention activities.

They remain concerned some firms have not implemented the EMR 2011 or PSR 2017 correctly and against the backdrop of COVID19, they are concerned that firms are under increasing financial pressure. As a result the FCA intend to issue temporary guidance to provide additional clarity to help strengthen firms' prudential risk management and their arrangements for safeguarding customers' funds.

They will open a full consultation with our industry later in 2020 and it is likely that the temporary guidance will be in force until that point when it will be include into an updated Approach Document.

The proposed guidance covers the changes proposed in 3 key areas:

1. Wind Down Plans
2. Safeguarding
3. Prudential Risk Management

AFEP have summarised the proposed changes/clarifications and it is important firms read and understand how their apply to their business to be able to implement the changes quickly. Firms should ensure they have read and responded to the consultation on the FCA website and if appropriate have taken independent legal advice as to how it affects their firm individually.

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Proposed Guidance - Wind Down Plans

APIs and EMIs are required to satisfy the FCA that they have effective procedures to manage any risks to which they might be exposed.

The FCA will require firms to have a wind-down plan to manage their liquidity and resolution risks.

The wind-down plan should consider the winding-down of the firm's business under different scenarios, including a solvent and insolvent scenario.

In particular, the wind-down plan should include/address the following:

a. funding to cover the solvent wind-down of the firm, including the return of all customer funds

b. realistic triggers to start a solvent wind-down

c. the need for any counterparties (ie merchants) to find alternative providers

d. realistic triggers to seek advice on entering an insolvency process,

e. information which would help an administrator or liquidator to quickly identify customer funds and return them as a priority

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Proposed Guidance - Safeguarding

1.Keeping records, accounts and making reconciliations

The requirement to safeguard applies to 'relevant funds' in both the EMRs and the PSRs (10.14 to 10.17). Firms should keep records and accounts to enable it to identify what relevant funds it holds, at any time. (10.59).

These records should also enable the firm and any third party, to distinguish relevant funds from the firms' own money, and relevant funds held for one customer against those held for another.

Some permitted forms of safeguarding create the potential for discrepancies that are difficult to avoid (10.60). e.g. funds are held in a currency that is different to the currency of the payment transaction. Where there is potential for discrepancies, firms should carry out reconciliations as often as is practicable and no less than once during each business day.

The FCA will require firms to clearly document their reconciliation process and provide an accompanying rationale to help with the distribution of funds if the firm becomes insolvent.

Firms should without delay notify FCA in writing in any material respect, they have not or are unable to comply with safeguarding requirements, or if they cannot resolve any reconciliation discrepancies (10.65 & 10.66).

The FCA have clarified that examples of the type of non-compliance they expect to be notified about:
not keeping up to date records of relevant funds and safeguarding accounts, where a firm is unable to comply due to the decision by a safeguarding credit institution to close a safeguarding account.

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Proposed Guidance - Safeguarding

2.Safeguarding Accounts and Acknowledgement Letters

The safeguarding account in which the relevant funds are held must be named in a way that shows it is a safeguarding account (10.38).

The FCA have clarified that this means the account name should include the word 'safeguarding' or 'client'. If this isn't possible firms should provide evidence from their credit institution confirming designation.

Only the firm may have any interest in or right over the relevant funds or assets in a safeguarding account except as provided by regulation 21 of the EMRs or regulation 23 of the PSRs (10.40).

FCA will require firms to have a prescribed letter from the safeguarding credit institution stating they have no interest in, recourse against, or right over the relevant funds or assets in the safeguarding account and they hold all the relevant funds or assets in the safeguarding account as trustee.

FCA have stressed that only relevant funds should be held in the safeguarding account (10.24) and the pool should not get 'polluted' as mixing assets may cause delays in returning funds to e-money holders or payment service users if the firm becomes insolvent.

3.Selecting, appointing and reviewing third parties

Firms should exercise due skill, care and diligence when appointing and reviewing credit institutions (10.59) and any reviews should be as often as appropriate. This means they should be carried out whenever a firm believes that anything affecting the appointment decision has materially changed, such as a credit downgrade, and in any event, at least once in each financial year.

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Proposed Guidance - Safeguarding

4.When the safeguarding obligation starts

Firms must have organisational arrangements to minimise the risk of loss of customer funds through fraud, misuse, negligence or poor administration (10.57).

FCA are requiring that the EMI does not treat relevant funds it is required to safeguard as being available to meet the commitments it has to a card scheme or another third party to settle these payment transactions.

The FCA are providing no clarity around when the obligation to Safeguard ends, and AFEP believe this should be included in the temporary guidance.

5.Unallocated Funds

In some cases, firms may not be able to identify the customer entitled to the funds it has received, and so cannot issue e-money, or provide a payment service.

FCA are clarifying that these funds are not relevant funds, but they should be protected according to Principle 10 of the Principles for Business, in a segregated account separate to firms own funds and relevant funds.

Firms should identify the customer to whom the funds relate and once the customer has been identified the funds should be returned to the customer or safeguarded appropriately.

The FCA have confirmed that if a firm issues e-money on low value pre-paid gift cards, where the identity of the ultimate card holder is not known, the funds received from customers are relevant funds, even though the identity of the e-money holder might not be known to the EMI.

Paragraph references refer to the FCA's Payment Services Approach document

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Proposed Guidance - Safeguarding

6.Annual audit of compliance with safeguarding requirements

A firm's auditor is required to tell the FCAif it has become aware in its capacity as an auditor, of a breach of any requirements imposed by or under the PSRs or EMRs that is of material significance to us (10.58).The conditions of authorisation for APIs and EMIs require them to satisfy us that they have robust governance arrangements.

The FCA will require firms which are required to be audited, stock arrange specific annual audits of their compliance with the safeguarding requirements under the PSRs/EMRs.

Such audits should happen when there are any changes to their business model which would materially affect their safeguarding arrangements and the auditor should exercise due skill, care and diligence in selecting and appointing auditors for this purpose.

7.Small payment Institutions

FCA confirming that they will be adding that SPIs should keep a record of funds received from customers and any accounts held by the SPI into which those funds are paid. The FCA encourage SPIs to opt in to the safeguarding regulations in the PSRs.

8.Disclosing information on treatment of funds on insolvency to customers

Firms will need to avoid giving customers misleading impressions about how much protection they will get from safeguarding requirements.

This is both in terms of the services to which the safeguarding requirements apply or by implying that the claims of customers would be paid in priority to the costs of distributing the safeguarded funds.

This is necessary in order for firms to comply with the Consumer Protection for Unfair Trading Regulations 2008. Firms should not suggest that funds are protected by the Financial Services Compensation Scheme where this is not the case.

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Proposed Guidance - Prudential Risk Management

Governnance and Controls

APIs and EMIs should ensure they have robust governance arrangements, effective procedures, and adequate internal control mechanisms.

A firm's senior management should ensure that the firm regularly reviews its systems and controls, including its governance arrangements. It should also ensure that the firm's governance functions, procedures and controls appropriately reflect the firm's business model, its growth and relevant risks.

Capital Adequacy

It is essential that firms accurately calculate their capital requirements and resources on an ongoing basis, and report these correctly to the in regulatory returns.

A firm's senior management should ensure that its capital resources are reviewed regularly. To reduce exposure to intra-group risk, the FCA consider it best practice for firms to deduct any assets representing intra-group receivables from their own funds. If there are legally enforceable netting arrangements in place, a firm could deduct only the net receivable amount. Any such deduction of intra-group balances from own funds should be reflected in a firm's reporting of its regulatory capital position to the FCA.

Liquidity and capital stress testing

Firms should carry out liquidity and capital stress testing to analyse their exposure to severe business disruptions and assess their potential impact, using internal and/or external data and scenario analysis. Firms should use the results of these tests to help ensure they can:

- continue to meet their conditions of authorisation and own funds requirements,
- inform their decisions around adequate liquidity and capital resources,
- identify any changes and improvements to required systems and controls.

Risk Management Arrangements

The FCA expect firms to consider their own liquid resources and available funding options to meet their liabilities as they fall due, and whether they need access to committed credit lines to manage their exposures.Firms should not to include any uncommitted intra-group liquidity facilities when assessing whether they have adequate resources in place to cover the liquidity risk to which they are exposed.

Paragraph references refer to the FCA's Payment Services Approach document