Electronic Money Association
Crescent House
5 The Crescent
Surbiton
Surrey
KT6 4BN
United Kingdom
Telephone: +44 (0) 20 8399 2066
Facsimile: +44 (0) 870 762 5063
www.e-ma.org

Payments Policy Team
Financial Conduct Authority
12 Endeavour Square
London E20 1JN
UK

12 June 2020

Dear Sir/Madam

Re: EMA response to FCA consultation: "Coronavirus and safeguarding customers' funds: proposed guidance for payment firms"

The EMA is the EU trade body representing electronic money issuers and alternative payment service providers. Our members include leading payments and e-commerce businesses worldwide that provide online payments, card-based products, electronic vouchers and mobile payment instruments. They also include a large number of smaller Payment Service Providers, including startups. The majority of EMA members are authorized in the UK, and operate across the EU, most frequently on a cross-border basis. A list of current EMA members is provided at the end of this document.

I would be grateful for your consideration of our submission.

Yours sincerely

Thaer Sabri

Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

EMA response to consultation

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

Response:

The EMA welcomes FCA guidance, but has found the short period available for response rather challenging. EMA members represent a diverse range of payment propositions and have a range of issues to raise. We would welcome a stay of publication following completion of the consultation and the opportunity to engage with the FCA on the issues raised. Similarly, sufficient time for implementation is requested, whilst firms prioritise the introduction of new regulatory provisions, deal with Covid related issues and continue Brexit planning.

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

Response:

General comments:

We would like to address safeguarding in relation to e-money firms first and will then consider arrangements for payment institutions, and e-money firms safeguarding funds for unrelated payment services.

(i) Safeguarding in relation to e-money issued by electronic money institutions ("**EMI**")

There is a suggestion in the consultation that safeguarded relevant funds relating to issued e-money, comprise a trust held by the EMI for the benefit of holders of e-money, and that EMIs therefore hold such funds for the benefit of e-money holders ("**Users**").

We cannot see any evidence to suggest that Users have any right to relevant funds held by an EMI, during the normal course of business, and nor is there a need to.

(a) Users purchase e-money, a dematerialised financial instrument that represents a claim against the issuer. It has inherent value, can be utilised to undertake payment transactions in fulfilment of debt obligations or transferred as a gift. It can also be presented for redemption at par at any time. The purchaser of the e-money has full title to the instrument, and does not, as set out below, have any claim on the price paid for it.

(b) The claim against the e-money issuer for redemption is personal and not proprietary; this is clear from the definition of electronic money at Regulation 2(1) of the Electronic Money Regulations 2011 ("**EMR**") which states:
"electronic money" means electronically (including magnetically) stored monetary value as represented by a claim on the electronic money issuer which..."

The claim is clearly against the issuer and not a claim for the safeguarded funds. There is no evidence for a beneficial proprietary right in the funds.

(c) The EMR additionally makes two provisions:

a. one intended to introduce a measure of protection for relevant funds, by limiting the range of assets in which they can be invested – see Regulation 21(6) EMR (or by requiring an insurance policy or guarantee to be in place); and,
b. the second provides for the crystallisation of a right over the funds in the event of, and on the condition of insolvency - see Regulation 24 EMR. There is, however, no such proprietary right whilst the issuer meets its day to day redemption obligations. Indeed, it would be impossible to have such a right if an insurance or guarantee approach is taken to safeguarding.

(d) Given that EMD2 is a maximum harmonisation Directive, we do not believe there is scope for introducing additional restrictions over safeguarded funds, other than those provided under EMD2.

Therefore, we do not find that declaring a trust over the safeguarding account of an EMI is appropriate or justified. Furthermore, it introduces a level of complexity in the administration and operation of the account that is not contemplated by the drafters of the legislation. This complexity adds to the cost of the business of EMIs, and erodes their competitiveness, compared to credit institutions that issue e-money.

It is important to note that the concept of a trust is noticeably absent from legal systems in most EU jurisdictions. Given the ability of EMIs to utilise any EEA credit institutions to hold such funds, it would seem reasonable to suggest that this was not contemplated by the European legislator when EMD2 was adopted in law.

We therefore ask that the FCA reconsider the wording of the letter of attestation at Annex 1, which proposes that (i) safeguarded funds belong to Users, (ii) that funds are deposited on behalf of Users, and (iii) that the EMI stands in the capacity of Trustee.

We disagree that e-money related relevant funds belong to Users, or that they are deposited on behalf of Users, or consequently that the EMI does so as trustee. Given the scope of the impact of this construction –(please see paragraph (ii) below), we request that the letter is drafted to focus on the nature of statutory safeguarding and the absence of a right of set-off.

(e) The manner of confirmation will again need to take account of the differing jurisdictions that safeguarded funds could be held in; it may be sufficient that the bank confirms that they understand it is a safeguarding account as defined in relevant legislation and that they consequently have no right of set off against the account. This can be provided in differing formats and need not be prescribed in Guidance.

(f) The requirement for the account to have the words 'safeguarding' or 'Client' are also overly restrictive, and 'Client' suggests that funds do not belong to the EMI. We do not believe it is necessary to elaborate on Regulation 21(3)(a) EMR's provisions that the safeguarding account be: "*designated in such a way as to show that it is an account which is held for the purpose of safeguarding relevant funds*"

(ii) Impact of regarding safeguarded funds as a trust.

There are two significant and adverse effects to the construction currently proposed in the FCA Guidance.

The first and most immediate risk is to suggest to credit institutions who have, until the present time, regarded safeguarded e-money funds as belonging to the EMI, that the credit institutions are, in fact holding funds belonging to third parties, and that they may, therefore, have some customer due diligence obligations in relation to the third parties themselves. Irrespective of the merits of this position, this is the concern that has fuelled credit institutions' de-risking phenomenon, leading to widespread closing of accounts held by money transfer service providers. EMIs have suffered less, although they are not entirely immune to banks' evolving risk appetites.

It is the view of industry and of our members individually that the potential impact of the letter will be a reassessment by credit institutions of the merits of holding account for EMIs and a reasonable fear of widespread account closure. This could give rise to more significant risk to Users' funds than is likely to be caused by the Covid 19 event itself, as more EMIs struggle to keep or to obtain safeguarding banking services.

Secondly, and of longer-term importance, a 'trust' model necessitates a significant number of restrictions being placed on the safeguarding account that result in a range of unintended consequences. For example, EMIs have to avoid over-compensating for FX and other risks when placing funds in the asset pool, to the detriment of Users. A buffer could undermine a trust arrangement but need not impact the statutory arrangements that apply as a result of the EMRs provisions.

Similarly, as the cost of distribution of funds can be deducted from the safeguarded pool, the funds available to Users will necessarily be less than those required for redemption. It would be advantageous to Users therefore, if firms held safeguarded funds that were 'no less' than the total outstanding e-money, again allowing for a buffer.

The FCA should therefore carefully consider the merits of a trust construction, particularly if this reduces the ability of firms to mitigate a number of risks to relevant funds, or to ensure a more effective distribution of assets following insolvency.

The FCA could apply a more pragmatic approach to a range of issues, simplifying business, introducing efficiencies and increasing User protection.

(iii) The analysis in respect of Payment Institutions ("**PI**") and safeguarded funds held by EMIs in relation to unrelated payment services.

Whilst the funds held by a PI or funds held by an EMI that comprise unrelated payment services (unrelated to e-money), are clearly funds belonging to their customers, the arguments set out above distinguishing statutory safeguarding obligations from a trust, continue to hold and are made again in this context.

Whilst the phenomenon of de-risking is not increased by the trust construct for these funds, because in this case, these are acknowledged as belonging to customers, the restrictions that are introduced in FCA Guidance based on the trust construction do give rise to additional complexity and restrictions on business.

We therefore urge the FCA to reconsider the trust proposition in the context of PIs and unrelated payment services offered by EMIs, with a view to enabling the benefits of adopting the statutory safeguarding approach for such funds without additional restrictions.

Other issues relating to safeguarding

(iv) <u>Mixing of assets</u>: under the section relating to safeguarding accounts and acknowledgement letters, the consultation clarified that the provisions restricting the mixing of relevant funds with other assets is intended to avoid delays in the distribution of assets to users in the event of insolvency.

We assume that this refers to delays as a result of potential challenges being made by creditors, seeking to find fault in the integrity of the safeguarding arrangements. We believe this is a consequence of expectations relating to a trust arrangement and are less likely to impact statutory provisions that are immune to the attacks that are possible on the integrity of a trust, in the event of insolvency.

Delays would therefore be less likely where the statutory approach is relied upon.

(v) <u>Selecting, appointing and reviewing third parties</u>: we acknowledge the premise of risk management and the exercise of skill due care and diligence in the appointment and review of third parties holding safeguarded funds. We would like to note, however, that the scarcity of providers of banking services to EMIs and PIs means -except for the largest firms, that this is unlikely to result in changes to safeguarding arrangements in practice, as alternatives will be few and far in between.

We take this opportunity to raise the issue of de-risking, and to bring to the FCA attention the provisions of Regulation 105(2) of the Payment Services Regulations 2017 that require credit institutions to comply with minimum provisions on access, stating: "access to payment accounts services granted to a payment service provider pursuant to paragraph (1) must be sufficiently extensive to allow the payment service provider to provide payment services in an unhindered and efficient manner."

We ask that the FCA considers whether this condition is being met by credit institutions, and to put in place tests or to initiate market research to assess whether it is being met on a periodic basis. This will help demonstrate compliance with the legislative provision and help identify detrimental practices that impact Users and the competitive landscape alike.

(vi) <u>When the safeguarding obligations start</u>: the new guidance addresses situations where user funding is undertaken with a payment instrument, and the issuer wishes to benefit from the allowance at Regulation 20(4)(b) of the EMR for safeguarding to commence when funds are made available to the EMI -up to a maximum of 5 business days after issuance of the e-money. The proposed guidance suggests that this allowance does not extend to permit issuers to use safeguarded funds to meet obligations in relation to redemption requests – through card schemes, until funding payments are actually received. We are unable to find a legislative basis for this.

The implication of this restriction is a suggestion that safeguarded funds are non-fungible, that funds held in the safeguarding account can be attributed to one part of the e-money pool in preference to another, in this case relating to e-money for which payments have been received, in preference to e-money for which funds are in the process of being delivered to the EMI.

There is no evidence in the EMR or in the EMD2 that safeguarded funds should not be treated as fungible, and attributed equally to all outstanding claims by holders, irrespective of the settlement status of the funding transactions. The legislative allowance for a 5-day delay did not come with any restrictions on redemption requests in relation to that e-money, and there is therefore an expectation for the safeguarded fund to be lower in value than the total outstanding e-money issued. This was contemplated by the legislator.

Therefore, and given that the allowance for 5 days for receipt of funds is explicitly provided for in EMD2, without limitation on the timing of redemption requests in relation to such e-money, we suggest that this guidance should be reviewed in order not to introduce a restriction on the scope of redemptions from safeguarded funds that are allowed under EU level 1 legislation. The restriction would be super-equivalent to the provisions of the Directive, and inconsistent with the maximum harmonisation provisions of EMD2.

(vii) Unallocated funds: we are in agreement on the obligation to protect unidentified funding transactions but suggest a more pragmatic treatment may be available. This would involve the firm issuing an equivalent value of e-money, which can be held in a separate account, pending identification of the origins of the payments received or return of the funds to the crediting account. This should allow unidentified funds to be safeguarded pending resolution of the source of funding.

(viii) Annual audit of compliance with safeguarding requirements: EMIs fall within the scope of section 475 Part 16 of the Companies Act 2006 and are required therefore to conduct annual audits. The scope of such audits will include safeguarded funds, and systems relating to safeguarding. In addition, firms will have internal compliance, and where internal audit functions are in place, also internal audits of compliance.

In the absence of evidence suggesting the current level of oversight is failing, we would request that the FCA rely on the current controls. If evidence does call for additional provisions, we would suggest that the explicit obligation for the annual audit to address safeguarding compliance obligations is sufficient.

Where internal audit processes are in place, as a response to the size and complexity of the business, these should provide the additional safeguards that are sought, and given that such processes are applied in a proportionate manner, these are more likely to be risk based. The FCA is also invited to consider whether as set out in the opening paragraph, internal audit could also be sufficient for the purposes of the annual reviews of safeguarding obligations.

Additional interim audits upon changes to the business model are in our view disproportionate. These are likely to raise the cost of innovation, and to have a chilling effect on the evolution of firms' business models. The cost of audits could quickly become disproportionate to the business of EMIs and act as a disincentive to product development. We urge the FCA to take a measured approach to safeguarding oversight and to restrict the additional guidance to the scope of the annual audit.

(ix) Disclosing information on treatment of funds on insolvency to customers: the EMA supports the objective of ensuring that firms do not give a misleading impression of either the degree of protection that is available for e-money holders in the event of insolvency, and the scope of services that benefit from safeguarding obligations. We understand that the Guidance does not propose any specific wording but seeks to ensure this outcome; and this approach is welcome.

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

Response

(i) Governance and controls: guidance in relation to senior management responsibility for regular reviews of systems and controls is welcome.

(ii) Capital adequacy:
We concur with the objective of formalising the status of intra-group balances but disagree with the approach proposed by the FCA to exclude intra-group receivables from the calculation of Own Funds.

Specifically, we disagree with the underlying principle of treating assets representing intra-group receivables differently from assets representing receivables from third-parties. Additionally, we disagree with the broad and generalized assumption that group businesses introduce their own additional risk to payment firms.

This is for the following reasons:

1. The valuation and recovery of an intra-group receivable is more likely to be capable of accurate assessment by the payment firms' management than would be the case for a third-party debtor.
2. The risks associated with an intra-group receivable cannot be generalized as being different from those associated with a third-party debtor; in many cases, and for a variety of reasons, they could be viewed as lower risk.
3. An intra-group receivable position represents a deployment of capital resources to the payment firm from within the group. Exclusion of intra-group receivables would therefore introduce financial inefficiencies, and risk, to both the payment firm and its group.
4. Intra-group receivables, if excluded from a payment firms' capital calculation, may result in a requirement for the group to provide additional capital investment to compensate for the reduction in the Own Funds calculation - in effect a doubling of resources allocated to the payment firm by the group thus introducing an unreasonable level of financial burden and risk which is contrary to the objective of the proposal.

5. Intra-group trading is common amongst payment firms that provide services to group companies, or which receive outsourced operational support from their group. Intra-group balances represent a dynamic and low-cost means of allocating capital within a payment firms' group and can be an effective method of supporting, or smoothing, cash flows. This has a consequent, and significant, benefit for mitigating risk for payment firms and supporting consumer protection.
6. Many payment firms' business models rely upon the intra-group movement of funds in order to support efficient and low-cost consumer payments – an example being, cross border transfers where business models often create extensive intercompany payables / receivables, which are netted on a daily basis, but which can retain a significant balance for a short period of time.
7. Accounting standards already require intra-group transactions to be calculated based on 'arms-length' pricing and for debtor balances to be reviewed for potential provisions against recovery. Many payment firms' will also be subject to annual financial audits whereby balances will be critically reviewed. Mechanisms are therefore already in place to ensure accuracy of intra-group balances.
8. This onerous approach to intergroup receivables will put UK EMIs and PIs at a competitive disadvantage to both EU based firms and also to Credit Institutions that offer e-money services. This distinction will extend to the period during which EU firms may be operating in the UK under the temporary permissions regime.
9. The risk assessment with regards to intergroup receivables, upon which guidance will have been based, should also take into account the various adverse consequences of this approach; and in our view, it would be unlikely to meet the criteria for good or best practice.

Whilst an argument could be made for long-term intra-group receivables to be paid down, or otherwise excluded, as a matter of good practice, in order to eliminate risk, the exclusion of short-term intra-group receivables would undermine a number of payment firms' business models and exacerbate capital and funding risks.

Furthermore, if the objective is to reduce overall enterprise-wide risk within payment firms' businesses, a reasonable alternative, and one consistent with existing risk management requirements, is for payment firms to be required to perform risk assessments, supported by stress testing, in relation their Balance Sheets and the impact on Own Funds and to treat inter-company balances in the same manner as balances derived from external relationships. During the performance of such risk assessments payment firms could, for example, consider differences in risk arising in relation to intra-group balances between regulated and unregulated, as well as, audited and un-audited group businesses.

We are therefore opposed to the distinctions being made between intra group and third-party receivables, and request that the FCA recognize the significant harm it could cause to a broad range of firms.

(iii) Risk management arrangements: the distinctions made between intragroup and third-party credit facilities raise similar issues as those set out above, emphasizing that credit worthiness and likelihood of payment are far more easily assessed within a group context than they are in relation to third parties.

One consequence of the proposed approach is to increase the cost of operating UK businesses for foreign owned groups, and a consequent disincentive for investment.

(iv) Liquidity and capital stress testing: we welcome the FCA's guidance regarding liquidity and capital stress testing, including their use to inform decisions on adequate resources and liquidity.

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

Response

The FCA's reading of the requirement to have effective procedures to manage risk to include provisions for wind-down planning are reasonable, provided that they are also risk based and proportionate to the size and complexity of the firms. We do not for example believe it would be appropriate to require firms to comply with the detailed provisions of the Wind Down Planning Guide (WDPG) volume of the FCA Handbook.

Wind down planning has not been an explicit requirement of the EMI or PI regulatory regime, and some time will need to be provided for firms to develop an appropriate response.

Other Comments

Underlying issue
We understand from the FCA that the proposed guidance is intended to address challenges in insolvency proceedings that have been made during the course of the wind down of one or more PIs or EMIs. It would be helpful to better understand the nature of the challenges that arose, and to identify the shortcomings that led to the difficulties. If these relate to operational practices by such firms, then this could be better addressed by a focus on supervisory work, whereas if the challenge is borne from shortcomings in legislative provisions, then these can be elaborated, and consideration given to amendment to the text.

We would be grateful for additional information on the practices or interpretations that have led to the proposed guidance.

Duration of the guidance: the introduction to the consultations states that the proposed guidance is 'temporary' and is introduced 'in light of the exceptional circumstances of the coronavirus pandemic (Covid-19)'. The introduction also suggests however that the guidance will remain in place until the full review of the Approach Document has taken place. We would be grateful for additional clarity on the timing and response process of the full consultation.

List of EMA members as of June 2020

AAVE LIMITED
Airbnb Inc
Airwallex (UK) Limited
Allegro Group
American Express
Azimo Limited
Bitstamp
BlaBla Connect UK Ltd
Blackhawk Network Ltd
Boku Inc
CashFlows
Ceevo
Circle
Citadel Commerce UK Ltd
Coinbase
Contis
Corner Banca SA
Curve
eBay Sarl
Em@ney Plc
Ecommpay.com
ePayments Systems Limited
Euronet Worldwide Inc
Facebook Payments International Ltd
First Rate Exchange Services
Flex-e-card
Flywire
Gemini
GoCardless Ltd
Google Payment Ltd
IDT Financial Services Limited
Imagor SA
Intuit Inc.
Ixaris Systems Ltd
Modulr FS Europe Limited
Moneyhub Financial Technology Ltd
MuchBetter
myPOS Europe Limited
Nvayo Limited
One Money Mail Ltd
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Own.Solutions
Park Card Services Limited
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PPRO Financial Ltd
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Stripe
SumUp Limited
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