Impact of the Proposed Changes on the PSR and EMR Safeguarding Rules

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Introduction

The FCA's recent Consultation Paper materially enhances the requirements on payment and e-money institutions, moving them closer to the full CASS framework. In the consultation, the FCA has recognised the weaknesses in the current safeguarding arrangements and in key areas such as the identification of 'relevant funds'; reconciliation procedures; and the segregation of funds. These are key for consumer protection. The consultation runs until 17 December 2024 and the FCA plans to introduce the changes in the first half of 2025.

Background and Objective of the Safeguarding Rules

The purpose of safeguarding rules is to ensure that the financial consumers have adequate protection in the event of insolvency of the firm. The resolution of banks, investment firms and payment and e-money firms are subject to different sets of rules. Broadly speaking, the resolution of banks focuses on deposit protection (Financial Services Compensation Scheme (FSCS) regime), Client Assets Sourcebook (CASS) regime applicable to investment firms focuses on ensuring that the ownership of assets can be clearly identified, and safeguarding rules applicable to EMIs/PIs have a lighter touch with providing an option to choose between protection through insurance or guarantee (which is closer to the FSCS regime) or segregation of client money (which is in essence a less strict CASS regime).[1]

Overview of PSR and EMR Safeguarding Rules

Certain conditions apply to insurance and guarantee arrangements to ensure that there is no restriction when a claim needs to be made in the event of insolvency and that there is enough headroom to meet obligations to customers. For the segregation method, daily internal reconciliations, segregating the assets and placing them into a designated safeguarding account (i.e. not comingling them with non-relevant funds or assets), adequate processes for the management of discrepancies, and acknowledgement letters or equivalent assurances regarding the funds or assets held in banks or custodians are some of the expectations set by the regulator (see the FCA Approach para 10.35-55). Finally, the FCA also expects certain governance arrangements to be in place, such as strong risk management systems, annual external audits, clear documentation of safeguarding compliance, an individual responsible for safeguarding oversight, adequate due diligence of banks and custodians (para 10.70-88).

[1] UK EMIs and PIs are covered by Payment Services Regulation (PSR) 23 and Electronic Money Regulation (EMR) 20-27. The FCA's 'Payment Services and Electronic Money - Our Approach' (version 6) Section 10 elaborates the regulatory expectations on safeguarding (the FCA Approach).

FCA Concerns Leading to the Proposal

Although abovementioned expectations provide certain safeguards for customer funds and assets, these are not as advanced as the requirements prescribed for investment firms in CASS. This led to certain shortcomings and several concerns from FCA's side. EMIs/PIs failed to evidence documented processes for identifying 'relevant funds' which must be protected, existence of adequate reconciliation procedures, and due diligence and acknowledgement of segregation from banks and custodians.[2]

The FCA also notes that the Ipagoo and Allied Wallet judgments created legal uncertainties regarding the treatment of funds held by EMIs/PIs upon resolution. According to those judgments, funds EMIs/PIs received from customers are not held under statutory trust. This meant that the relationship between EMI and the client was a mere creditor/debtor relationship, rather than fiduciary. In addition, the FCA observed that during insolvency processes, insolvency practitioners continuously sought directions from the court which led to increasing costs and delays.[3] The proposed rules aim to address these problems as well.

Proposed Changes

The FCA aims to introduce the proposed changes in two phases: interim and end state. In the final phase, the rules will be added into the FCA Handbook and they will clarify the point that the funds are held under statutory trust. Also, stricter operational requirements will follow to ensure that the funds are received into safeguarding accounts and cannot be received by agents or distributors.

In summary, the rules will require:

- Having more detailed record-keeping and reconciliation requirements (see CASS 7),
- Maintaining a resolution pack (see CASS 10),
- Completing a new monthly regulatory return about safeguarded funds and safeguarding arrangements (see SUP 16.14),
- Submitting annual audit of safeguarding arrangements to the FCA,
- Allocating safeguarding compliance oversight responsibility to an individual,
- Considering diversification of third parties which hold the funds and assets or which provide insurance or guarantee as well as due diligence of those third parties,
- Receiving relevant funds directly into a designated safeguarding account, with certain exceptions (e.g. accounts providing access to payment systems), and
- Ensuring that agents and distributors do not receive relevant funds unless the principal firm safeguards sufficient funds in designated safeguarding accounts to cover such funds. (The last two points being end-state requirements.)

[2] Not all funds are subject to safeguarding according to the PSR and EMR rules. For example funds relating entirely to the transactions among non-UK residents or funds relating to foreign exchange transactions (instead of payment execution or e-money issuance) are not protected under those rules (see FCA Approach para 10.23-26)

[3] See FCA Approach para 2.14. According to PSR and EMR, the relevant funds do not have priority over insolvency costs (para 10.15).

Impact for the Firms

The FCA plans to publish final interim rules within the first half of 2025. So, the firms should review their current safeguarding practices and make a gap analysis against the rules at least by the end of first quarter of 2025. This will ensure that they have enough time to comply with the requirements when the changes are introduced within the second quarter (probably with an accompanying implementation period).

The impact of these changes for EMIs/PIs can be summarised as follows:

- The requirement for firms to receive funds directly to the safeguarding account or should hold sufficient funds to cover the relevant funds received by its agents or distributors will require a review of the current operational arrangements.
- The firms will have to prepare for:
    - Documenting their safeguarding, reconciliation and discrepancy management processes to evidence:
        - How they identify in-scope funds and assets,
        - The point in time which the protection starts and ends,
        - How the reconciliation is conducted daily,
        - That they conduct a root cause analysis following discrepancies, and
        - That the shortfalls and excess are resolved at the end of the business day;
    - Conducting due diligence to the banks holding their safeguarding accounts;
    - Evidencing that they considered diversification;
    - Training their staff about these changes;
    - Appointing a person with right skillset and experience to oversee the safeguarding operations; and
    - Creating a resolution pack with the content included in CASS 10.

Conclusion

Changes to safeguarding rules may drastically affect EMIs/PIs. Post-implementation period, the firms will have to comply with stricter requirements similar to those applicable to investment firms. Thus, it is advisable that the firms focus their compliance efforts in this area with gap analyses and further preparations in the first quarter of 2025.