COSEGIC

Response to FCA CP 24/20

Changes to the safeguarding regime for payments and e-money firms

INTRODUCTION.

As one of the UK's leading providers of compliance consultancy and regtech services Cosegic is delighted to respond to this Consultation Paper.

Our award-winning services help firms in the payments and E-money sectors that are subject to regulation by the Financial Conduct Authority or the Prudential Regulation Authority to become authorised, manage their ongoing compliance and regulatory obligations and empower their staff with focused compliance training.

What makes us stand out is the skill and expertise of our team, which includes ex-regulators, industry practitioners and subject matter experts. Through the breadth and depth of their collective expertise and experience we offer an outstanding service, interpreting the regulations, providing practical, usable advice and solutions that work for your business and the regulator – and ensuring that compliance makes a positive contribution to your business.

Specialist consultant led services helping to minimise the regulatory burden and using technology to reduce the cost of compliance, provide transparency and traceability and deliver management information that enables more informed risk and compliance management decisions. Our Payment Services Practice has a dedicated team of consultants specialising in payments and, in particular, supporting clients with applications for authorisation and ongoing compliance with the Payment Services Regulations and E-Money Regulations

Since the setting up of our Payments Practice over 9 years ago Cosegic has assisted hundreds of payments firms from across the sector, ranging from small payment institutions to banks, giving us a unique insight into the sector and the issues faced by firms.

It is led by James Borley, formerly Head of the FCA's Authorisations team responsible for payment services, and Accountable Executive for implementation of PSD2 by the FCA. He was also a member of the EBA's Working Group which developed the information requirements set out in their authorisation 'Guidelines.'

Our Senior Advisor - Payments is John Burns, one of the UK's foremost compliance experts in payment services. He was heavily involved in the negotiation and implementation of the first Payment Services Directive and the second E-Money Directive and has worked in senior positions for the Association of Payment and Clearing Services, the Payments Council, the Financial Services Authority (now the FCA) and major banks, including Lloyds. At the FSA, John was the first editor of the Approach Document and the author of Chapter 8 on Conduct of Business and Chapter 10 on Safeguarding.

1. Overview

In our view, the importance of safeguarding cannot be overstated, and any clarification of expectations of the FCA is to be welcomed. Having undertaken a large number of safeguarding audits and advised hundreds of payment firms we are aware of the issues which can arise for firms due to lack of understanding of how to apply the expected standards to widely differing business models.

Safeguarding can be made difficult for firms to comply with due to the unwillingness of banks to offer and maintain safeguarding accounts, notwithstanding the provisions of regulation 105 in the PSRs requiring them to offer such accounts on an objective, non-discriminatory and proportionate basis. A more active approach from the FCA on enforcing this provision would be very helpful.

2. Responses to the Questions

Question 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.

The CP states that the proposed record-keeping and reconciliation rules will largely codify and build on the existing guidance in Chapter 10 of the Approach Document. Greater clarity would generally be welcomed by firms. In particular, some guidance on the FCA's expectations as regards "materiality" would assist firms in deciding whether and when to make the required notifications to the FCA and avoid unnecessary overreporting or, indeed, underreporting.

A further question, which has not been addressed in the CP is that of funds received over a weekend, by Faster Payments or cash. Given the existence of 24/7/365 payment systems, and automated instructions, it is common for firms to receive funds on days which are not "business days" in terms of staff working (i.e. weekends). Clarification on the expected approach to these funds would be of great assistance to the market. In our view, absent such clarification, best practice is for a reconciliation to be carried out first thing on the next working day (i.e. Monday).

The nature of the payments market, particularly in the migrant remittances sector, means that many payment institutions are small businesses with limited resources, both in terms of finances and personnel. It is likely that such firms will find the compilation and upkeep of the proposed resolution packs to be difficult to resource. It is noted that the FCA has costed the implementation of the resolution pack requirement at £0.5 million as a one-off cost to the market, with no cost being allocated to the ongoing upkeep of the packs. In our view, this appears to materially underestimate the cost, both for initial implementation and ongoing upkeep.

When the PSRs were first implemented, a policy decision was made to balance regulatory requirements with the need to ensure continuation of service to migrant communities, with a concern that overzealous regulation would lead to a significant number of smaller firms exiting the regulated market. One worry was that this could lead to migrant remittances, particularly to higher risk jurisdictions, diverting to informal and unregulated channels, such as Hawala.

The requirement to implement and maintain full resolution packs for smaller firms could have a similar unintended effect. The FCA may wish to consider implementing a less rigorous regime for smaller firms.

Question 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?

In our view, the main increase in firms' operational costs relating to record keeping, reconciliation and resolution packs will be the implementation of the requirements at the interim state, so we would not see any material change when the end state rules come into effect.

Question 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?

As a compliance consultancy firm specialising in payments, Cosegic (originally as Compliancy Services) has been carrying our safeguarding audits for Payment institutions and EMIs since the FCA first introduced the requirements and we have carried out over 140 such audits. In our view, safeguarding audits carried out by external providers who are skilled and experienced in the requirements and have a proper understanding of the business models in the market are invaluable in providing management of firms with insight into the potential risks in their processes and procedures and how their safeguarding processes match against market standards and FCA expectations.

It is noted that the CP suggests that the FCA "assume that all audits carried out under the current guidance are carried out by a statutory auditor." This assumption is totally incorrect and, given that we have had frequent discussions with the FCA regarding safeguarding audits carried out by our firm, we find it surprising that such a misconception should have arisen. Indeed, the Approach Document itself was drafted to recognise such capability (10.72).

We have seen audits carried out by accountancy firms and others focused on financial accounting rather than effective processes and procedures which do not, in our view, meet the required standards. A proper understanding of the regulatory requirements and the different business models within the payments market is required, and we are concerned that using financial auditor qualifications under the Companies Act 2006 as a qualification for providing such audits will result in a reduction in the standards of advice and guidance provided to firms. Given that the fees charged by financial auditors tend to be significantly higher than those charged by specialist consultancy firms such as ours, and the management time involved in explaining a firm's processes and the requirements is likely to be considerably higher, the potential outcome of the proposals as currently drafted is a less effective service at a significantly higher c the firms involved. In our conversations with market participants and trade associations we have found that this view is almost universally held.

As the FCA has not previously had sight of the audits carried out, we would suggest that implementation of any qualification requirements on auditors be postponed until the FCA has had time to review the audits submitted. So that an informed view of the standards in place and those best qualified to carry them out can be formed.

That said, we agree that a common standard be developed that all audits align to.

Question 4: Do you agree with our proposals to require that safeguarding audits are submitted to us? If not, why not?

As indicated in our response to Question 3 above, some of the audits which we have seen carried out by other providers have, in our view, fallen far short of the required professionalism and understanding of the requirements of the safeguarding rules and regulations. Therefore, we think it will be instructive for the FCA to see the audit reports and will place pressure on firms carrying out safeguarding audits to provide a professional service and allow the FCA to form an informed view of the standards and those best-placed to provide the audit service. This will also provide an incentive for the management of firms to act expeditiously on recommendations made by the auditors.

We therefore agree with this proposal.

Question 5: Do you agree that small EMI's should be required to carry out an annual safeguarding audit? If not, why not?

Small EMIs are already required to carry out annual safeguarding audits, by virtue of the FCA's requirement that all Payment Institutions and E-money Institutions required to have an annual audit by the Companies Act 2006 have an annual safeguarding audit and s478 of that Act excluding E-money issuers (regardless of whether small EMIs) from the small companies exemption to that requirement.

To qualify as a small EMI, a firm must have an average daily level of E-money in issue of not more than €5 million over the preceding 6 months. This means that such firms may have balances of significantly more than €5 million on some days and still qualify for small EMI registration.

We can therefore see no justification for removing the requirement to have an annual safeguarding audit from small EMIs.

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

In our view the requirement to submit safeguarding returns to the FCA will provide a good discipline on firms to ensure that they have appropriate processes and procedures in place to enable them to collate the required data items. It will also provide the FCA with a much-improved view of the levels of safeguarding and general market compliance, which is to be encouraged. Indeed, given the time period covered by these returns, this may well (in some respects) provide the FCA with a more up-to-date picture of a firm's safeguarding arrangements than a safeguarding audit which, by definition, covers an historic period with a further time-lag until production of the audit report itself.

We therefore agree with the proposal.

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

The proposed data items appear sensible.

Question 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.

The interim state proposals appear less prescriptive in that they require firms to "consider [our emphasis] how to ensure relevant funds not held in designated safeguarding accounts are clearly identifiable, with the word 'safeguarding' used in the account name when possible [again, our emphasis]" rather than requiring a specific model. However, given that many firms make use of EMI providers to carry out currency exchanges as part of their payments flow, we believe that the naming of these accounts as "safeguarding" accounts may actually cause some confusion.

The removal of the "pre D+1 period" which allows payments firms some flexibility in the receipt and handling of funds proposed for the end state would represent a major change in the market. The removal of this option would have the effect of creating an oligopoly of banks to provide this service, which would be likely to have the effect of reducing competition in the market and effectively raising prices for end consumers. In addition, the proposal does not appear to have taken into account the major difficulty that Payment Institutions and EMIs have in obtaining accounts with banks, which are able to provide Designated Safeguarding Accounts, regulation 105 in the Payment Services Regulations notwithstanding. While the Cost-Benefit Analysis indicates no material difference in fees charged by providers of DSAs and those of NDSAs, if firms are unable to access these accounts with banks at all, fee levels are immaterial.

As mentioned above, there are a number of major providers of FX services to smaller players in the market which are EMIs. Their ability to receive funds, do the currency exchange and pass the funds on for the smaller firms makes them key providers in the operation of the payments market. This provides both competition for the banks and better prices (and choice) for consumers. It seems unlikely that any banks will wish to replicate this service at anything like the same rates. The removal of this option could have much wider impacts and reduction in service for end consumers, which does not appear to have been taken into account.

Question 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.

We agree in principle, although there are likely to be many more scenarios where an exemption' could be applied than the FCA appears to have allowed for. Firms offering multicurrency accounts to their customers may similarly be impacted by this requirement as the typical ability to make payments to/receive payments from FX providers and then move any relevant funds into a safeguarding account, will be removed.

Question 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.

This proposal would have major liquidity implications for those firms with multiple agent networks, and could severely negatively affect vulnerable customer segments, such as migrant workers wishing to send funds back to their countries of origin. Many of these customers have difficulties getting bank accounts and therefore use cash.

Many firms in the migrant remittances market also use payout agents in the recipient countries. Such agents may require prefunding, meaning that the UK based PI is required to fund safeguarding before it has received the funds and also fund the payout agent. Provision of liquidity at this level is unlikely to be sustainable for many of these firms, leading to their exit from the regulated market. As indicated in our response to Question 1, this could lead to such migrant remittances diverting to informal and unregulated channels such as Hawala.

As also mentioned above, there are a number of major providers of FX services to smaller players in the market which are EMIs. Their ability to receive funds, do the currency exchange and pass the funds on for the smaller firms makes them key providers in the operation of the payments market. It sems unlikely that any banks will wish to replicate this service. Its removal could have much wider impacts and reduction in service for end consumers, which does not appear to have been taken into account.

It is noted that, at 6.8 in the CP, the FCA proposes two exemptions in circumstances where Payments Firms would face operational challenges in receiving relevant funds directly into a designated safeguarding

account, where:

"• relevant funds are received either through a merchant acquirer or into an account that is held only to participate in a payment system or

• the firm receives relevant funds as cash"

We would suggest that a third qualification for the exemption be added, to address the operational issues in the FX section of the market outlined above.

Question 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.

This appears sensible.

Question 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.

We agree.

Question 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.

The costs of holding assets and managing their level to ensure that it is appropriate has proven a disincentive for firms to make use of this method of safeguarding, however the costs of obtaining authorisation and ongoing overheads involved in gaining permission to safeguard and administer investments is likely to make this of limited attraction to firms which do not have a need for the permission for other purposes.

Question 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.

We agree.

Question 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.

In our view, the risks identified appear to cover those of which we are aware.

Question 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

A statutory trust would appear to provide the best option to protect customer funds. However, given that EMIs are specifically prohibited from paying interest on balances, and that the Handbook currently says that, if a PI were to pay interest it would be likely to be in breach of regulation 33, the question of whether firms can benefit from the interest paid on relevant funds deposited with a bank or authorised custodian does not appear to have been addressed in the consultation. Clarity on this point is therefore required.

Question 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.

While the proposed terms of the trust mention EMIs' ability to write off unclaimed funds after 6 years and provides for the alternative option of donating to charity, no mention is made of the fact that there is currently no mechanism for payment institutions to write off unclaimed funds. We are aware that some firms have significant unclaimed funds (values in the £ millions) which they are safeguarding but have no means to write off. It would be helpful if this could be addressed as part of this process.

COSEGIC

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

Clarification is welcomed. However, a further question of whether when an EMI which is a member of a card scheme has authorised a payment, and therefore has undertaken an obligation to the merchant (through the Card Scheme) the safeguarding obligation in respect of the cardholder has been extinguished in that the funds are no longer available to be spent, and the EMI's obligation to the merchant has not been addressed. It would be helpful if this interpretation could be confirmed as being correct.

Question 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.

It is clear that for some firms the proposals as currently drafted will require wholesale changes to business models and procedures. At a Cosegic webinar on the proposals, with over 200 attendees, we took a poll and fewer than 50% of respondents felt that the proposed implementation timescale gave sufficient time for firms to make the required changes.

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

In general the transitional provisions appear appropriate, other than the timescales.

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

We do not consider that any other transitional provisions are required.

Question 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.

It is unclear where these assumptions come form, as many are unrecognisable to us. The FCA's overriding assumption that "all firms will fully comply with our proposed rules" is confusing: surely, firms are expected to comply with FCA requirements today; will making 'Rules' really improve the level of compliance? Especially, when the FCA itself admits that "this assumption in unlikely to be achieved". Why make it?

Additionally, the assumption that "all firms will be able to obtain appropriate safeguarding accounts following our interventions" has not been supported with evidence and, we believe, is contrary to anecdotal experience/expectations of firms' experience of securing safeguarding accounts. The FCA does not appear to have presented any evidence itself in this regard.

Generally, it appears the costs to firms have been significantly underestimated, with no real compelling balancing items in the 'benefits' column.

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

No comments.

Question 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?

Only to the extent outlined in our response to Questions 1 and 10; with regards the diaspora communities in the UK, and the protected characteristic of ‘race’.