E-money and payment firms will pay a price if they don't act on new safeguarding rules

This week the FCA closed its Consultation Paper on enhancing the safeguarding requirements for e-money and payment institutions (EMIs/PIs), moving them closer to the full Client Assets Sourcebook (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.

The purpose of safeguarding rules is to ensure that the financial consumers have adequate protection in the event of insolvency of the firm. Currently banks, investment firms and payment and e-money firms are each subject to different sets of rules, with those applicable to EMIs/PIs representing a lighter touch. For safeguarding purposes, firms can choose between protection through insurance or guarantee (which is closer to the current Financial Services Compensation Scheme (FSCS) regime applicable to deposit takers) or segregation of client money (which is in essence a less strict CASS regime).[1]

The fact that the requirements for EMIs/PIs are not as advanced as the requirements prescribed for investment firms in CASS has led to certain shortcomings, and several concerns from FCA's side. EMIs/PIs have failed to evidence documented processes for identifying 'relevant funds' which must be protected, the existence of adequate reconciliation procedures, and due diligence and acknowledgement of segregation from banks and custodians.[2]

Recent court judgements have created legal uncertainties and raised further concerns for the regulator. In the Ipagoo and Allied Wallet judgments, funds and assets EMIs/PIs received from customers are not held under statutory trust, meaning that the relationship between EMIs/PIs and the client was a mere creditor/debtor relationship, rather than a fiduciary one, entailing much stronger obligations and duties. 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.

The FCA's proposed changes

The FCA plans to begin introducing the changes in the first half of 2025 and 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. Stricter operational requirements will also follow, to ensure that the funds are received into safeguarding accounts and cannot be received by agents or distributors.

---

[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).

[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).

In addition, the requirements will demand that firms have more detailed record-keeping, and maintain a resolution pack in line with CASS 10. Firms will need to return a monthly regulatory report on safeguarded funds, as well as an annual audit of safeguarding arrangements, to the FCA.

New Year's resolutions for firms

Given that the new rules should be in place relatively soon, 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 (likely with an accompanying implementation period).

As firms are conducting gap analyses and reforming their operations, it is key that they bear in mind the requirement for firms to receive funds directly to a safeguarding account, or to hold sufficient funds to cover the relevant funds received by its agents or distributors.

The regulator will expect firms to properly document their safeguarding, reconciliation and discrepancy management processes. EMIs/PIs should be able to evidence how they identify in-scope funds and assets, when protection starts and ends, and how reconciliation is conducted. They should also document any root cause analysis they undertake following a discrepancy, and that they have resolved shortfalls or excesses by the end of the business day.

These are significant changes, and firms should consider training for their staff, so that they are clear on what the new rules are. Given the requirement that a specific individual is allocated safeguarding compliance oversight responsibility, they may also need to appoint a person with right skillset and experience to oversee these operations.

Heading into the New Year, it is advisable that firms start working to prepare themselves for a set of much stricter requirements, which will have a drastic effect on a number of EMIs/PIs.