connecting the future

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

Call for Input

Financial Conduct Authority
September 2024

Response from
The Payments Association
December 2024

Introduction

The Payments Association welcomes the opportunity to contribute to the FCA's call for input on 'Changes to the safeguarding regime for payments and e-money firms'.

The community's response contained in this paper reflects views expressed by our members and industry experts recommended by them who have been interviewed and who are referenced below. As The Payment Association's membership includes a wide range of companies from across the payments value chain, and diverse viewpoints across all job roles, this response cannot and does not claim to fully represent the views of all members.

We are grateful to the contributors to this response, which has been drafted by Brett Carr, Associate, Latham & Watkins and Omar Salem, Partner, Fox Williams. We would also like to express our thanks to the following members for their thoughtful contributions:

- Alison Donnelly, fscom
- Dennis Cheng, Gladius Assurance
- James Borley, Cosegic
- Olivia Murphy, Linklaters
- Robert-Turner Kerr, iFAST
- Stuart Davis, Latham & Watkins

Finally, we would like to express our thanks to the FCA for their continuing openness in these discussions. We hope it advances our collective efforts to ensure that the UK's payments industry continues to be progressive, world-leading, and secure, and effective at serving the needs of everyone who pays and gets paid.

Tony Craddock
Director General
The Payments Association

Executive Summary

- Members of The Payments Association (TPA), subject to certain requested clarifications and suggested improvements, are generally supportive of the interim state rules as codification of current expectations alongside helpful enhancements in relation to the safeguarding of relevant funds by UK electronic money institutions ("**EMIs**") and payment institutions ("**PIs**"), (together, "**Payment Firms**")

- However, we have significant concerns about the end state rules, which we consider will not achieve their aims in a cost-effective way. Certain proposals, such as the obligation to receive relevant funds immediately into safeguarding accounts, will significantly impact the business models of many firms, driving many to seek external credit sources which may put undue strain on firms and ultimately risk the viability of firms in times of stress. The proposals also introduce additional uncertainty and complexity to the safeguarding regime that could add to the costs and lengths of administrations.

Need for a strategic approach

- The National Payments Vision accepted the finding of the Future of Payments Review of the need for strategic direction, and the approach to safeguarding is a case in point. We consider that a strategic approach to the end state proposals is needed, led by HM Treasury, to ensure that objectives of the FCA's proposals are addressed in an effective and proportionate manner. There is no getting away from the fact that these proposals will increase the regulatory burden and risks on firms and give banks an undue competitive advantage to non-bank payment firms, effectively reversing the competition objectives of PSD1 and PSD2 (and, consequently, the PSRs). Even though PSD3 remains subject to finalisation, it is clear that imposing this new regime on Payment Firms would result in the UK placing materially higher standards on firms than those likely to apply to firms in the EU or the majority of other jurisdictions, risking UK firms' ability to compete on what is already an increasingly unlevel playing field. Also, an eye must be kept on maintaining broad functional equivalence to certain key EU laws, including the PSD, for the purposes of retaining SEPA access for UK firms. If restructuring payment flows and related arrangements to comply with the new rules is operationally or commercially unworkable, it will prompt firms to move outside of the UK in favour of less prescriptive regimes.

- In January 2023, HM Treasury issued the "Payment Services Regulations: Review and Call for Evidence" ("**PSRs Review**"). The PSRs Review also stated that there would be an independent review of the Payment and Electronic Money Institution Insolvency Regulations ("**PESAR**") within two years of these coming into force. TPA, in our response to the PSRs Review, called for the PESAR review to also consider the safeguarding requirements, as these are intertwined with the PESAR, and should be approached holistically, and for HM Treasury to then set out the policy framework before the FCA consulted on changes to the safeguarding regime. However, the outcome of the PSRs Review, including in relation to safeguarding, has not been published. The PESAR came into force in July 2021, so the independent review was now more than a year past being due before the appointment of the independent reviewer on 13 December 2024.

- The PESAR review covers substantial overlapping group with the FCA's consultation. The terms of reference for it include reporting "*what, if any, changes to law, practice, practical or non-legislative measures, would better deliver the objectives of the PESAR. In particular, it should consider whether any changes could improve the effectiveness of the PESAR's statutory objective on return of customer funds*." This falls squarely in the ground that the FCA's consultation is considering. The terms of reference also state that the "where appropriate, this review should take into account the FCA's proposals, in so far as they are relevant to the PESAR".

- In addition, regulations 2(3) and 4(5) of the Electronic Money, Payment Card Interchange Fee and Payment Services (Amendment) Regulations 2023 amended schedule 3 of the Electronic Money Regulations 2011 ("**EMRs**") and schedule 6 of the Payment Services Regulations 2017 ("**PSRs**"), so that section 137B(1) of the Financial Services and Markets Act 2000 now provides that FCA rules may make provisions which result in relevant funds being held by a safeguarding institution on trust. This was a major change to insolvency law in relation to Payment Firms but does not appear to have been consulted on by HM Treasury

- The result has been fragmented policy making that does not take a strategic view. This is exactly what the Future of Payments Review warned against and what the government is aiming to move away from though the National Payments Vision.

- We, therefore, believe that the FCA should reconsider its end state proposals, especially given the Chancellor's Mansion House speech and new remit letter issued to the FCA, to consider both the strategic value of the end state proposals in their current state and the impact on growth and competitiveness of the proposals, when it does not appear that they will not achieve their objectives in a cost effective way.

- Given that the end state rules will be dependent on amendments to the PSRs and EMRs and are subject to ongoing review by HMT and that the PESAR review has just been launched, the FCA should at least consult again on all of the end state rules after the PESAR interim report is provided in September 2025 and HM Treasury has published the outcome of the PSRs Review.

Limitations of the end state proposals in achieving the FCA's objectives

- We are concerned that the FCA's end state proposals are insufficient to achieve their objectives but will bring with them significant costs, as well as introducing legal uncertainty to the payments framework. We also set out in this response concerns about the FCA's cost benefit analysis (the "**CBA**").

- It is notable that the FCA states in the Consultation Paper that "*we believe that imposing a statutory trust is the only way to ensure adequate consumer protection under our current powers*". This raises the question of whether there would be better ways to ensure better consumer protection using powers that the FCA does not currently have. Given the FCA does not rule this out, HM Treasury should consider through its review of the PSRs whether there is an alternative approach that would better protect vulnerable customers in particular before the FCA's end state proposals are proceeded with.

- While we recognise that today's FSCS coverage is not a substitute for compliance with various regulatory requirements such as the CASS regime, nonetheless, TPA considers that a protection/compensation scheme is a potential complementary approach to safeguarding, as it is under the CASS regime today. One view is that the FCA should undertake a cost benefit analysis of extending FSCS protection (or similar scheme) to the sector, as a measure of risk mitigation which could be deployed in place of some of the other measures being proposed, such as the obligation to immediately receive relevant funds into a safeguarding account.

- We have particular concerns regarding the efficacy of the end state proposals to achieve three of the FCA's objectives:

    - **Reducing shortfalls:** The FCA's proposals are **"***primarily intended to advance the FCA's operational objective to protect consumers by helping to ensure they receive the maximum value of their funds if a payment firm fails*". The FCA says it will measure the success based on the reduction in value of the shortfall of relevant funds if a Payments Firm fails. The FCA is understandably concerned that for firms that became insolvent between Q1 2018 and Q2 2023 there was an average shortfall of 65% in funds owed to clients (i.e. the difference between funds owed and funds safeguarded). However, we are not convinced that the proposals, particularly the end state rules, will have the impact that the FCA anticipates. For example, the FCA's cost benefit analysis ("CBA") assumes 100% compliance with its new rules, which is not realistic. The FCA is aware of this, stating in the CBA "we are aware that this assumption is unlikely to be achieved". TPA understands (to an extent anecdotally) that a fundamental driver for shortfalls in returns to customers has been (i) fraud and (ii) the asset pool bearing the insolvency practitioners costs in distributing the pool. TPA considers that the proposals cannot alone eradicate fraudulent actors (like in any other part of the financial services sector) and areas of uncertainty that remain in the current proposals, particularly with respect to the interaction of trusts law, fiduciary duties, wrongful trading, director's duties, consumer duty etc., could cause delays in insolvency practitioners distributions. TPA has reservations that these new requirements and significant reporting burdens would put the FCA in a position to identify relevant 'early warning' signs in a way that makes a meaningful impact on outcomes for firms and customers.

- **Reduction in number of supervisory cases:** The FCA considers that its **"***proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well by supporting stability and resilience in the payments sector*". The FCA says it will measure its success based on "*a fall in the number of supervisory cases that are raised relating to safeguarding and fewer formal interventions such as requirements are imposed based on failures to comply with safeguarding requirements*". It says that while "*this number may rise in the short term because of enhanced reporting and audit requirements, we would ultimately expect the number to fall*". TPA considers that this will, to a degree, be driven by the FCA's approach to supervision of the new rules since the regime is introducing substantially more areas where compliance is likely to be an ongoing challenge for firms.

- **Reducing the time for distributions**: The FCA does not explicitly state that one of its objectives is reducing the time for distributions following a firm's insolvency. This is surprising given that the FCA identifies lengthy insolvency processes as a risk that may result in detriment to customers. The FCA states that delays in receiving relevant funds while the insolvency progresses **"***will have the most severe impact on financially vulnerable consumers, who may need to borrow money and go into debt if they are unable to access their funds for an extended period*". The FCA's CBA assumes that its proposals will reduce average time to first distribution from 2.3 years to a central estimate of 1.3 years. This is not realistic and does not appear to have been evidenced. Even if this reduction is achieved, when compared to the FSCS, which pays out within seven working days, a period of 1.3 years still has the potential to have significant detrimental impact.

High-level Summary Table

While we have provided detailed feedback to each of the consultation questions below, we have also set out here a high-level summary of our responses.

Subject	Summary of TPA response
Record-keeping and reconciliation	We broadly support the proposed codification of existing expectations and the proposed enhancements to the record-keeping and reconciliation requirements. We would welcome further guidance, including in the form of relevant templates, from the FCA or the insolvency practitioner sector, e.g., through its representative membership bodies, on the form and functionality of the resolution pack, in order to deliver against the actual needs of an insolvency practitioner overseeing an insolvency.
Safeguarding audits	TPA feels strongly that safeguarding audits should not be the preserve of statutory auditors who may not have any experience with conducting safeguarding audits. There is a wide range of non-statutory auditors who have capably undertaken audits for firms for many years. To ensure the quality of audits and to maintain a level of competition in the market, which should assist with controlling costs, TPA would welcome the FCA's consideration of including a mechanism for suitably qualified and experienced non-statutory auditors, consultants or advisers, to be approved to undertake safeguarding audits using an approved, standardised scope. TPA is concerned that the FCA CBA has hugely underestimated the cost of statutory audits. An alternative approach to requiring that audits be carried out by statutory auditors would be to establish a panel of approved auditors, similar to the panel that exists for section 166 skilled persons.
Safeguarding returns	We agree that safeguarding returns are useful and should be provided to the FCA. However, we would welcome a better understanding of the purpose of collecting the specific data on a monthly basis and how it is proposed the data will be used by the FCA. In practice, it seems a real issue is a lack of a clear view on the actual amounts of funds held in safeguarding accounts, but we note no measures appear to be targeted at working with Payments Firms and banks to give the FCA the insight that might be most valuable. Has the FCA considered how safeguarding banks, custodians and Payments Firms might instead independently report actual amounts held in safeguarding accounts? Such information could be reconciled against monthly firm reports, thereby providing warning of fraud or system/reporting failures.

Requirement that relevant funds are to be received directly into a designated safeguarding account (including for agents/distributors)	We agree with the principle of certain funds being required to be received directly into designated safeguarding accounts but consider that further clarity in the FCA's proposals is needed, and further exceptions are required to deal with scenarios where it is necessary to have the flexibility to delay paying funds into a designated safeguarding account.
Use of secure liquid assets	We agree that firms should be able to invest in at least the same range of secure liquid assets as they can now, although we consider the requirements are currently too restrictive. We are also concerned that in the end state, due to the statutory trust, this could require them to be authorised under the Financial Services and Markets Act 2000, which would be disproportionate and introduce unnecessary complexity.
Use of insurance policies	We agree with the FCA's proposals to maintain the use of insurance policies and comparable guarantees for safeguarding in both the interim and end state.
Statutory trust	We recognise the potential benefits in providing a greater level of certainty as to the legal treatment of relevant funds on an insolvency event and providing an additional legal mechanism to trace funds that should have been safeguarded. However, we are concerned that the move to a statutory trust, without a holistic approach led by HM Treasury, could increase legal uncertainty and increase the length and costs of distributions. The risk is that insolvency practitioners remain reliant on seeking directions of the court, causing delays in distributions.
Implementation periods	We consider that the implementation periods are not long enough. If required to be implemented in their current form, the proposals will fundamentally change business models of certain firms and such firms, operating entirely appropriately under today's regime, would need significant time to adapt.

Members' "responses to the questions" set out in the consultation:

The section numbering below corresponds to the numbering of the 'questions for respondents' in this paper.

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.

Interim State

- **Record-keeping and reconciliation** – TPA welcomes the proposed codification of existing expectations alongside the proposed enhancements to the regime.

  TPA notes the emphasis on the distinction between internal records and external records in the proposed CASS 15.12.5G(1) and CASS 15.12.10R. We would welcome confirmation that internal records sourced from bank records, whether via API or otherwise, are satisfactory as internal records.

- **Resolution pack** – TPA would welcome further guidance, including in the form of relevant templates, from the FCA or the insolvency practitioner sector, e.g., through its representative membership bodies, on the form and functionality of the resolution pack, in order to deliver against the actual needs of an insolvency practitioner overseeing an insolvency process for an EMI or PI.

End State

- **Record-keeping and reconciliation** – TPA agrees that if the broader end state rules are implemented then the record and reconciliation requirements should be updated to reflect this.

- **Organisational requirements** – TPA agrees with putting in place organisational requirements if the end state rules are implemented.

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?

- While we do not consider that the move from interim to end state will be the driver of significant operational costs, we do consider that the FCA's estimated industry-wide implementation costs materially underestimate the actual costs likely to be incurred by firms. Significant costs likely to be incurred by firms include the need to allocate/recruit full time resources to comply with the significant new obligations, and the borrowing costs incurred in order to maintain business models which necessitate a delay between the receipt of relevant funds and the placing of the funds in a safeguarding account.

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?

Interim State and End State

- TPA agrees that audits are worthwhile exercises, but the proposal must be considered in light of the substantial costs that can be incurred in undertaking audits, the historical nature of an audit period (and relevance to the amount of relevant funds being held under safeguarding at today's date) and the expectation (based on experience in the CASS sector) that audit costs will increase annually.

- Requiring the audits at both interim and end state will create unnecessary cost and complexity.

- TPA feels strongly that safeguarding audits should not be the preserve of statutory auditors who may not have any experience with conducting safeguarding audits. There is a wide range of non-statutory auditors who have capably undertaken audits for firms for many years. Indeed, the FCA itself acknowledged this by making explicit reference in 10.72 of its Approach Document to audits being undertaken by parties with, or "access to, appropriate specialist skill in auditing compliance with the safeguarding requirements. To ensure the quality of audits and to maintain a level of competition in the market (which should assist with controlling costs), TPA would welcome the FCA's consideration of introducing a mechanism for suitably qualified and experienced non-statutory auditors, consultants or other advisers, to be approved to undertake safeguarding audits against an approved, standardised scope.

- An alternative approach to requiring that audits be carried out by statutory auditors would be to establish a panel of approved auditors, similar to the panel that exists for section 166 skilled persons. However, TPA is keen to ensure that expectations of auditors are not elevated to a 'quasi-section 166' safeguarding compliance review.

- TPA also has concerns that:
    - The proposed four month deadline to deliver the report to the FCA will typically not allow enough time for the auditor to interrogate findings and for the firm to respond to the auditor's findings and draft a report before submission to the FCA. The relevant Companies House deadline is nine months, and it is suggested that the proposed four month period be extended to nine months.
    - The suggested rules are not clear about the actual periods to which the safeguarding audit relates; for example, should they coincide with the financial year, or can a firm choose a period?

4. Do you agree with our proposals to require that safeguarding audits are submitted to the FCA? If not, why not?

- We agree with this proposal. We assume that the FCA has provisioned sufficient resource to deal with c.670 audit reports annually.

5. Do you agree that small EMIs should be required to arrange an annual safeguarding audit? If not, why not?

- We have concerns with including Small EMIs in the obligation, given the relative greater cost for them in undertaking audits. The fact that a Small EMI can only have outstanding e-money balances of EUR5m results in them having a significantly different risk profile for the sector and its users, and there is a risk that placing such burdens on these firms could force important service providers (often targeting specific and under-served sections of society) out of the market.

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

- We agree that safeguarding returns could be useful and should be provided to the FCA.
- We would welcome further details on the purpose of collecting the specific data on a monthly basis and how it is proposed the data will be used by the FCA.
- We consider that monthly reporting by Small EMIs is unlikely proportionate and consider that this should be less frequent.

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

- We understand that the FCA has been piloting completion of aspects of the proposed return with a number of firms, and we defer to the feedback of those firms and we request, in particular, that the FCA place focus on the time taken by firms to complete the returns and the costs incurred, and the FCA adjust its CBA assumptions accordingly.
- We would welcome further details on the purpose of collecting each of the data items, in order to assess the appropriateness (both in light of achieving the FCA's objectives and with respect to government expectations of the FCA not to unduly increase the burden on firms) and how the FCA proposes to increase its capacity to assess such data.
- If the objective is for the FCA to obtain early warning of breaches of safeguarding requirements and risks to users and firms, we ask whether the FCA has considered requiring the sharing of safeguarding account statements and/or requiring safeguarding banks, custodians and insurers to independently provide the FCA with information on safeguarding account balances (and related information). Such information would allow the FCA to corroborate returns being filed by firms. No aged monthly return can prevent against the risk of firm failures and customer harm, in light of the potential for inaccurately completed returns, through system error, fraud or other such firm failings.
- With respect to safeguarding by the insurance method, we consider that it may better serve the FCA to also collect information on:
    - The firm's compliance with segregation and/or collateral requirements under the policy or related agreements with the insurer;
    - Whether the insurer has provided notice to terminate cover.
- It should be made clear that firms will not have breached their reporting obligations where they fail to disclose something in a return which has already been disclosed to the FCA (e.g., under Principle 11)

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.**

- We agree that prescriptive rules are beneficial, particularly those which codify guidance and expectations set out across other documents and/or held internally by the FCA. However, we have concerns about the workability of some of the proposals and their potential impacts on firms.

- We consider that any prescriptive rules and guidance must:
  - ensure that firms can understand when the requirements apply;
  - be suitably tailored to specific models and use cases deployed in the sector (e.g., remittance, payment accounts, acquirers);
  - provide clarity on the difference in obligations for SPIs (those entities which are not required under legislation to safeguard but are still expected to 'keep customers' funds safe').
- Further guidance is requested from the FCA on the expectations for firm's diversification efforts. Under CASS today, in certain circumstances no more than 20% of client money can be held with a single provider. The implicit implication is that Payment Firms will need multiple safeguarding options, which might not be available to them due to the limited supply of banking. The other concern is that the fiduciary duty of the trustee means that firms would only be acting appropriately when placing funds/assets with firms which have specific credit ratings. What are the FCA's views of an appropriate credit rating?
- The FCA is asked to confirm whether its proposals will continue to allow firms to operate multiple safeguarding accounts for the purposes of separately safeguarding relevant funds received in return for e-money issued and relevant funds received in relation to unrelated payment services. We do not read the proposals as requiring firms to safeguard such funds together.

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 with the principle that certain funds should be required to be received into designated safeguarding accounts but consider that further exceptions are required to deal with scenarios where it is necessary to have the flexibility to delay paying funds into a designated safeguarding account.
- There are often good reasons for firms to receive relevant funds into operational accounts and to sweep them into a safeguarding account on an intra-day or next business day basis. This can be particularly important for firms that are part of broader international corporate groups with multiple regulated entities and those handling cross-border payments in multiple currencies across multiple time zones. The proposed exemptions for firms receiving funds via an acquirer or payment system are insufficient to cover a lot of these legitimate use cases.
- We are of the view that risks can still be effectively managed whilst certain other arrangements remain outside of scope of this obligations, for example where:
  - the requirement is not operationally practicable;
  - relevant funds are transferred to a relevant funds bank account, or a relevant funds bank account is topped up using own funds, as soon as is practicable; and
  - the EMI/PI has assessed that this arrangement is in the best interests of its PSUs/e-money holders.
- We consider that the exceptions should not be drawn so tightly in advance of understanding what the impact of these proposals might be in practice in a complex sector with a wide variety of products and cross-border payment flows. For this reason, and others highlighted below, we consider that the FCA should retain a discretion to permit a firm to utilise D+1 safeguarding where it has demonstrated to the FCA that its systems, controls and risk profile are effective and suitable. For some firms, the requirement may necessitate increased reliance on third

party credit facilities. This could have the unintended adverse effect of increasing the risk of the firm's insolvency, and that risk would be higher at a time the firm is holding high values of relevant funds.

- To the extent that the FCA's rationale for these requirements is that it considers there to be unreasonable risks with EMIs and PIs using other EMIs and PIs for segregation purposes, presumably the next step would be to first mandate segregation at a bank, rather than remove entirely the flexibility that segregation provides to firms and the products that can be offered to users as a result.

- Payment Firms providing customers with multicurrency accounts will be constrained or even have their ability to perform currency conversions eliminated, and this will likely reduce the availability of services to users (driving up costs and putting banks at a competitive advantage over non-bank payment firms). This is because they will no longer be able to receive customer funds into a proprietary account with the functionality to make payments to, and receive payments from, FX providers, before moving relevant funds to a safeguarding account the business day after their receipt.

- The proposals may constrain card scheme acquirers' ability to access certain liquidity accessed today. Card schemes settle and pay out at a certain time of day. Card scheme acquirers need to be able to make payments irrespective of when funds are received from the card scheme. Some acquirers draw on third party credit lines to make outbound payments before scheme funds arrive. These credit lines can be secured on the proprietary account into which scheme funds flow, as a pre-requisite or to reduce the cost of lending. The FCA's requirement for receipt of customer funds into a safeguarding account (over which third party interests cannot be granted) means that such a structure will no longer be workable.

- The proposal makes operating a network of international collection accounts potentially challenging and possibly unworkable from an operational perspective. Many global payment firms operate by using affiliate accounts to collect funds in multiple jurisdictions. The proposed rules would require those collection accounts to be safeguarding accounts. Such accounts must be in the name of the payments firm providing the customer with payment services. Accounts belonging to a group affiliate will not meet this requirement. In practice this means that where a jurisdiction requires that payment accounts are held by an entity in that jurisdiction, a UK payments firm will find it very difficult to collect funds in that jurisdiction. Again, this risks severely limiting the competitiveness of UK Payments Firms and putting banks at an undue competitive advantage.

- This requirement may also negatively impact upon the financial position of firms by:
    - causing certain cash pooling products to no longer be made available to this market;
    - resulting in liquidity intensive 'double safeguarding' e.g., where agents are used; and
    - creating the need to access additional credit lines.

- Further guidance is required on the meaning of 'sole purpose' in the context of the disapplication of CASS 15.5.1 R where funds are received into an account held for the sole purpose of enabling the firm to participate in or receive funds through a payment system. Who is anticipated to be the provider of this 'account'? Additionally, the definition of *Payment System* for the purposes of the exception is, we assume, as currently set out in the FCA Glossary. This is not territorially limited, but in practice a UK entity would not participate in foreign payment systems and group companies would instead. Is the intention to prevent such group arrangements? As that would severely limit firm's use of the exception.

- The definition of *Acquirer* for the purposes of the exception is, we assume, as currently set out in the FCA Glossary. This limits this to UK authorised acquirers (EMIs, PIs and banks etc.). Is this the intention? As that would severely limit a firm's use of the exception and put UK firms at a significant competitive disadvantage to others. The definition of acquirer should include non-

UK firms operating as acquirers, including by group companies not subject to regulation as an acquirer where a group exemption is applicable. Such funds should instead be placed in a safeguarding account by the end of the business day following receipt.

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.

- There are good operational reasons for some firms to segregate relevant funds through agents and distributors. Requiring such funds to be received directly into a relevant funds bank account will not always be operationally feasible. The proposal risks putting firms at a competitive disadvantage to their international peers operating in this market, and as against banks. If providers need to exit the market due to increased costs, we consider that these proposals could have a significant and adverse impact on access and the provision of services to consumers who rely on such networks to make important payments.
- It is possible that firms will not be able to open designated safeguarding accounts in the jurisdictions of the agents in order to receive funds in a timely fashion.
- The alternative under the draft rules of topping up a relevant funds bank account with other funds will create liquidity issues for the firm. For some firms, it may necessitate increased reliance on third party credit facilities. This could have the unintended adverse effect of increasing the risk of the firm's insolvency, and that risk would be higher at a time the firm is holding high values of relevant funds. This might also drive unnecessary over-segregation because of delays in relevant data being provided by agents, again having an adverse effect on the liquidity of the firm.
- We consider that the FCA should retain a discretion to permit a principal firm to deploy agent and distributor segregation if it can demonstrate that its systems and controls are effective.

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.

- Yes. However, members have expressed concerns that the current range (as transposed onto CASS 15.6.2 G (2)) are restrictive, although it refers to UCITS, those available in the market do not 'solely' invest in the assets in (1) - they have a proportion which are exposures to counterparty banks via repo transactions which are in turn collateralised by treasury bills and hence are exposed to counterparty credit risk which does not attract a 0% risk capital charge.

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 that firms should continue to be able to invest relevant funds in at least the range of secure liquid assets they can today, although many members expressed concern with the time it can take the FCA to approve relevant SLAs for investment.

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.**

- Yes, we agree that firms should have the choice to apply for permissions which enable them to undertake such activity, however, if a payments firm has to become a custodian and comply with CASS 6, this is likely to be incompatible with the proposed CASS 15 (for example as a result of the custody rule record keeping requirements not being designed for payments firms investing customer funds).

- Members would welcome express guidance from the FCA on why other permissions such as arranging deals in investments and/or arranging safeguarding and administration would not be required by a firm investing in SLAs.

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.**

- Yes. We envisage a growing need for these options given the increased restrictions in using the segregation method.

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.**

- Yes, we recognise that certain of the identified risks are real and should be guarded against through prescriptive rules. However, in practice, we consider that safeguarding by insurance (which has effectively been put in place) is likely to result in a quicker distribution to customers than under the segregation method, because relevant funds are clearly identified, whereas insolvency practitioners will likely be working on identifying and in some cases collecting the relevant funds for distribution under a segregation model.

- In our view, greater thought is needed, and separate arrangements need to be considered, for the protection of vulnerable customers in an insolvency scenario. There are too many competing legal interests for it to be a simple decision to prioritise vulnerable customers ahead of one another, other customers, staff or creditors of the firm; for example: Companies Act director's duties, wrongful trading laws, duties of the administrator, fiduciary duties of the firm etc.

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.**

- We recognise the potential benefits in providing a greater level of certainty as to the legal treatment of relevant funds on an insolvency event and providing an additional legal mechanism to trace funds that should have been safeguarded.

- However, we consider that the best approach to take forward a statutory trust would be in legislation by HM Treasury in a way that is consistent with other legislation relating to the insolvency of Payment Firms (e.g. PESAR).

- It is notable that the FCA states in the Consultation Paper that “we believe that imposing a statutory trust is the only way to ensure adequate consumer protection under our current powers”. This raises the question of whether there would be better ways to ensure better consumer protection using powers that the FCA does not currently have. Given the FCA does not rule this out, HM Treasury should consider through its review of the PSRs whether there is an alternative approach that would better protect vulnerable customers in particular before the FCA’s end state proposals are proceeded with.

- There also seems to be a flaw in the logic by the FCA, given that it states that the implementation of the end state rules is dependent on the repeal of the PSRs and the EMRs by HM Treasury under powers provided repeals under the Financial Services and Markets Act 2023. It is unclear whether the FCA expect HM Treasury to retain, or re-provide in some form, the powers granted to the FCA by regulations 2(3) and 4(5) of the Electronic Money, Payment Card Interchange Fee and Payment Services (Amendment) Regulations 2023

- It is also not clear how the statutory trust would operate with respect to safeguarding accounts outside the UK.

- Additional guidance from the FCA on its expectations for firm’s compliance with the competing obligations under the Consumer Duty, wrongful trading laws, director’s duties, and new fiduciary duties, will be critical.

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.

- Firms must have an entitlement to over-segregated funds which are beneficially that of the firm’s and should be removed from the safeguarding account. Consideration needs to be given to the effectiveness of the relevant insolvency rules to ensure that these funds are swiftly removed from the safeguarding account and available to the creditors of the firm.

- Care needs to be taken not to make the sector unattractive to lenders, by leaning too heavily to the protection of customers where the regime is not intended, or structured, to be zero-risk.

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

- In principle we agree that clarification would be helpful. In particular, we seek greater clarification in relation to the following.

    - Funds received by other PSPs outside of the UK as part of the chain for the receipt of funds by the UK PSP and, equally, the reverse when paying out;
        - Firms do not always have sufficient information to determine the country of the payer’s PSP to define relevant funds. For example, if clients are banks, it is not always clear where the bank’s customer resides. International banks can have customers all over the world. More clarity/guidance on this would be helpful. For example, if the payer’s PSP cannot be determined immediately then what duration is acceptable and how absolute is this requirement? The corporate customer's country of incorporation could be an acceptable alternative. This

alternative is based on assuming the customer will use a bank located in the same country.

  - When spent e-money should no longer be safeguarded (there is a strong view that the obligation is rescinded when the card payment is authorised but we also understand that some safeguard until the funds are paid to the card scheme while there is another view that they should be safeguarded until it is estimated that the acquirer of the merchant has received the funds; and
  - the treatment of FX funds when linked to a payment.

- Guidance is requested from TPA members on FCA expectations when firms move relevant funds between safeguarding accounts. Are the funds required to stay on the balance of the debiting safeguarding account until such time as actually received by the crediting safeguarding PSP? Therefore, own funds may need to be applied to the debiting account to cover transit times?

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.

- Members are not yet in a position to accurately assess the implementation timeline, particularly as certain proposals will necessitate changes to business models, engagement with third parties to open new bank accounts, secure new credit lines etc. But it is clear that 6 -12 months will unlikely be enough time.

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

- We agree that transitional provisions will be necessary and should remain under review as the proposals are developed.

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

- The transitional provisions will be necessary and should remain under review as the proposals are developed.
- Members have raised concerns that it is unclear when the audit requirements will apply, i.e. effective for periods commencing on which date? The new SUP 3A appears to go-live effective immediately after the PS is published as there is seemingly no transitional for the audit requirement. This would be problematic for firms as the interim state CASS 15 are not in force until 6 months after. Members propose a 12 month transitional for SUP3A after PS published to enable firms sufficient time to be “audit ready” after CASS 15 interim state rules implementation with the option to early adopt if firms choose to do so.

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.

- We have serious reservations about the credibility of the assumptions made by the FCA in its CBA.
- These include that:
    - the FCA's assumption that "all firms will fully comply with our proposed rules" is not realistic, given the context of an average 65% shortfall identified by the FCA's insolvencies analysis, and is also not consistent with the FCA's statement about this assumption that "we are aware that this assumption is unlikely to be achieved";
    - the FCA's assumption that its rules will reduce average time to first distribution from 2.3 years to a central estimate of 1.3 years is not realistic and does not appear to have been evidenced. Furthermore, when compared to the alternative option of applying the FSCS, which pays out within seven working days, a reduction of 1 year is insignificant when distribution still takes 1.3 years, particularly in relation to vulnerable customers;
    - the implementation costs identified are likely to be significantly underestimated. For example, the CBA only assumes on-going costs of 3 hours per month to complete the Safeguarding Return.
    - in relation to annual audits, there is no consideration of costs associated with a limited assurance engagement, which is in addition to the audit requirements set out in existing guidance by the FCA. It also assumes no one-off implementation cost by the firm when they are audited to a new auditing standard to be introduced by the FRC. The FCA should get data on one-off costs to be "audit-ready" based on experience of firms that went through the first FRC Client Assets Standard introduced in 2016;
    - there are also no on-going annual costs associated with review of auditor's safeguarding report and providing management responses as required in SUP 3A.10. This cost will not be negligible given there is no materiality on reported items (i.e. all items regardless of value and materiality are included in the auditor's safeguarding report); and
    - it is assumed that the on-going costs in resolution packs are negligible, which is not the case given the requirement to make updates to changes within 5 business days.
    - Given these weaknesses in the Cost Benefit Analysis in relation to key claimed benefits of the proposals, we consider that it is fundamentally flawed. This brings us back to one of our central points – it is not clear that the FCA's proposals will address the issues of shortfalls and delays in distributions.

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

- Please see the response to question 22.

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?

- We consider that given the limited extent to which the FCA's proposals address the issue of shortfalls and the time for distributions, and the profile of Payment Firm customers, the FCA's proposals may disproportionately fail support vulnerable customs who may also be more likely to have certain protected characteristics, such as being younger or from an ethnic minority.

About The Payments Association

The Payments Association is for payments institutions, big & small. We help our members navigate a complex regulatory environment and facilitate profitable business partnerships.

Our purpose is to empower the most influential community in payments, where the connections, collaboration and learning shape an industry that works for all.

We operate as an independent representative for the industry and its interests, and drive collaboration within the payments sector in order to bring about meaningful change and innovation. We work closely with industry stakeholders such as the Bank of England, the FCA, HM Treasury, the Payment Systems Regulator, Pay.UK, UK Finance and Innovate Finance.

Through our comprehensive programme of activities for members and with guidance from an independent Advisory Board of leading payments CEOs, we facilitate the connections and build the bridges that join the ecosystem together and make it stronger.

These activities include a programme of monthly digital and face-to-face events including our annual conference PAY360 and PAY360 Awards dinner, CEO round tables and training activities.

We run seven stakeholder working Project groups: Inclusion, Regulator, Financial Crime, Cross-Border, Digital Currencies, ESG and Open Banking. The volunteers within these groups represent the collective view of The Payments Association members at industry-critical moments and work together to drive innovation in these areas.

We also conduct exclusive industry research which is made available to our members through our Insights knowledge base. These include monthly whitepapers, insightful interviews and tips from the industry's most successful CEOs. We also undertake policy development and government relations activities aiming at informing and influencing important stakeholders to enable a prosperous, impactful and secure payments ecosystem.

See www.thepaymentsassociation.org for more information.

Contact malik.smith@thepaymentsassociation.org for assistance.