Insolvency changes for payment and electronic money institutions:

consultation by HM Treasury

December 2020

Response from the Emerging Payments Association

Abstract

This paper sets out the Emerging Payment Association's response to HM Treasury's Insolvency changes for payment and electronic money institutions in December 2020.

It contains recommendations on how to ensure the UK's payments industry continues to be progressive, world- leading and secure, by creating an insolvency regime to give consumers confidence to open accounts with UK payment and electronic money institutions.

January 2021

Introduction

The Emerging Payments Association (EPA) welcomes the opportunity to contribute to HM Treasury's *Insolvency changes for payment and electronic money institutions: consultation* published in December 2020 ("HMT Paper"). The community's response contained in this paper reflects views expressed by our members. As the EPA'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 represent the views of all members fully.

We are grateful to the EPA's members, who have contributed to this response, drafted and coordinated by Robert Courtneidge, one of the EPA's longest standing advisors. We hope it advances our collective efforts to ensure 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.

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Note:

Terms used in the EPA responses below are taken from regulation 4 of the draft The Payment and Electronic Money Institution Special Administration Regulations 2021 attached to the HMT Paper.

EPA Responses

Special Administration Regime for Payment and Electronic Money Institutions

1 Do you have any comments on the proposal to introduce a Special Administration Regime for Electronic Money and Payment Institutions?

Introduction

The EPA and its members are currently under many pressures. These range from the work being done by firms to comply with many requests, investigations and reviews by the FCA (following an industry-wide toughening of its supervision from 2019 onwards), the effect of Brexit (which ignores Financial Services almost entirely) and not least, the effect the current Covid-19 pandemic is having on operating costs and trading volumes.

In the FCA's most recent publication (Jan 2021) it sets out the results of its coronavirus (Covid-19) financial resilience survey based on responses from 23,000 solo-regulated firms to understand the real-time effect the pandemic is having on their finances (C-19 survey).

They state:
"At end of October we've identified there are 4,000 financial services firms with low financial resilience and at heightened risk of failure"
and
"These are predominantly small and medium sized firms and approximately 30% have the potential to cause harm in failure."

The results go on to state:
"The Payments & E-money sector has the lowest proportion of profitable firms"

Against this backdrop the EPA believes that putting additional burdens on this sector in the form of additional regulation could well be counter-productive and cause irreparable damage to an already fragile sector. The EPA also believes that the proposed additional powers conferred in the pSAR could increase the operating risk and reduce the strategic control of EMIs and PIs operating in the sector. This will reduce the amount of investment available to these companies and increase the return required to overcome the additional risk, i.e. make investing in the sector more expensive.

Rather than provide additional protection for consumers, the EPA believes that the changes proposed in the consultation paper could result in fewer firms providing more expensive services, and the increased dominance of the major providers of such services, i.e. reducing competition. This is counter to the FCA's professed ambition to increase competition in financial services. In addition, it is likely to restrict the competitiveness of UK companies now that they are operating outside the EU and, as a result, to damage the appeal of the UK Fintech and payments sector, a field considered to be strategically important to the Chancellor of the Exchequer, whose Fintech Review with Innovate Finance is due to be published in early 2021. Separately, but no less importantly, the UK is currently in discussions with the EU about financial services and it is critical for British EMIs and PIs that some form of equivalence regime comes in to enable them to offer services in the EEA. If, as it appears, one of the consequences of the pSAR is the de facto removal of the electronic money holder's rights of redemption under EMD2 Art 11, due to a hard bar removing such right, is it appropriate, so soon after Brexit, to be unilaterally changing EU Directives for the UK?

We believe that the establishment of the pSAR for EMIs and PIs far exceeds what is required for the remediation of the issue disclosed of returning funds in a timely manner to customers of insolvent PIs and EMIs. We also question the use of a template developed and applied for a very different market (investment banking), over a decade ago:

- **Investment**, where transactions are largely for wealthy consumers and businesses that are high value, low volume
- **Payments**, where transactions are largely for lower income or disadvantaged consumers that are low value, high volume

The EPA believes this would be a mistake and is likely to have unintended consequences.

That said, the EPA is open to objectively reviewing anything which is aimed at making this sector more robust and stronger in the international markets, especially in a post-Brexit scenario, and appreciate the opportunity to respond, albeit within a very tight timeframe. The response below should be considered in this light and it reflects our willingness to be involved in further work to develop practical solutions that will achieve HMT's objectives without seriously damaging the industry that serves those customers HMT is aiming to protect. The EPA along with other industry bodies, like the EMA and UK Finance, strongly believe that a longer and more collaborative consultation process is required. Our members are happy to participate in video round tables of all relevant stakeholders and be involved in working groups etc. to ensure a thorough review of the proposed pSAR is carried out to get the right result for the industry and their end customers.

The Current Position

Under the PSR 2017 and the EMR 2011 a lot of work was done to ensure that firms in this sector had sufficient capital, as well as properly safeguarded customer funds. Reg 23 of the PSR 2017 and Regs 20-23 of EMR 2011 go into a lot of detail to describe how the firms must safeguard relevant funds. Further, the FCA's Approach document for payment services and electronic money together with the "Dear CEO" letters on safeguarding have gone a long way towards ensuring all firms are properly safeguarding relevant funds and reconciling them in a timely and accurate way.

In relation to the methods for safeguarding there are two: holding them in a segregated account; or insurance/guarantee. In respect of the latter there is an obligation as described in the Approach document:

> *"Where relevant funds are safeguarded by insurance or comparable guarantee, it is important that the arrangements will achieve, at the earliest possible time after the PI is subject to an insolvency event, the same sum standing to the credit of the designated account as would be the case if the PI had segregated the funds all along."*

Bearing in mind the above, the EPA does not understand why, in the case of an insolvency, the account holders would have any delay in having their funds returned to them. The EPA would like to better understand HMT's rationale in referring to the cases in 1.4 of the HMT Paper:

> *"However, there is evidence that the existing insolvency process for PIs and EMIs is suboptimal with regards to consumers. Recent administration cases involving PIs and EMIs have taken years to resolve in some cases, with customers left without access to their money for prolonged periods and receiving reduced monies after the cost of distribution. In six recent cases of PIs and EMIs in insolvency proceedings (of which three started in 2018), only one has so far returned funds to customers."*

From this it is not clear how many customers have not received funds (is it only a few remaining customers, or is it all of them?) It is not clear why Regulation 24 of the EMR 2011 has not so far provided a sufficient basis on which the administrators can prioritise the return of funds to the customers/clients of the EMI or PI, and can ensure that no other creditors can access the asset pool

until all claims have been paid. If, indeed, the current regulation means that the process is 'suboptimal' it is not clear how the new regulations will improve the situation other than, if SAR Objective 1 is selected, and:

> *"a special administrator has an explicit objective to return client assets as soon as is reasonably practicable".*

The EPA believes that this could be achieved simply by providing further guidance for insolvency practitioners to act with the specific objective of returning funds as soon as possible. A full SAR for this sector is unnecessary. Additional supervision of EMIs and PIs (paid for through higher annual PI or EMI license fees, perhaps) would achieve the same goal without significantly damaging the UK payments sector, which is, we believe, likely to happen if the new regulations in this consultation are adopted.

The New Regulations – Scope and Objectives

The key tools under the new Regulations are:

1 An explicit objective for the return of client assets as soon as reasonably practicable

The EPA acknowledges this is a good objective but is unsure whether it is any different to the current position, as client funds are redeemable at any time and if they are properly safeguarded then redemption should be the key requirement of the special administrator in any case.

2 A bar date for client claims to be submitted to speed up the distribution process

The EPA believes the addition of a bar date is moving away from the premise of electronic money which is that it should be redeemable at par at any time (Reg 39 EMR 2011). Whilst this may assist in ensuring certainty for collections of consumer funds, HMT must remember that electronic money is very different to the client funds in the Lehman case, where in this case there are a large number of electronic money holders all holding very small amounts on their accounts. A bar such as the one described is likely to mean a large proportion of small value electronic money holders lose their money, which is not what HMT intends with this SAR. In effect those small electronic money holders are funding the cost of the special administrator and other claimants, which was never the intention of the original directive or regulations and this does not effectively protect consumer funds.

3 Provisions for continuity of supply to minimise disruption

The EPA assumes this is a reference to the transfer provisions whereby the administrator has power to bring in an alternative regulated firm to take over the relevant funds and continue to run the payment accounts for the customers. This is new and outside anything previously envisaged in payment services. The EPA does have concerns about the exercise of this new option which is discussed in more detail under "Other areas of the proposed regulations that have been supplied but do not appear to be included in any of the four specific questions above" below.

4 An explicit objective for timely engagement with market infrastructure bodies and authorities

The EPA welcomes the interaction with such players by the special administrator as, in all situations of this kind, it is for the industry to work together to ensure the customer is made whole. What is HMT's reason for wanting to stop or complete inflight payment transactions for customers? This could have adverse unintended consequences up the payment chain and may not be in the best interests of either customers or the firm (chargebacks, disputes and refunds, for example, won't work). Furthermore, giving this as a legal right rather than the industry working together, as it does today[1], raises the question of why it needs to be made law - what examples has HMT seen of this not

[1] The Industry did work together, for example, when assessing what needed to be done if a Bacs participant failed. A similar process of industry discussion is needed if this were to be introduced for EM & PIs.

working in practice to date without such regulation? What is the issue this is trying to resolve and is this the best way to deal with it?

Powers of the appropriate regulator to direct priority of the SAR Objectives

Again, this highlights that it is not simply the post-insolvency distribution process that HMT is looking at with these new regulations, it is far, far wider. Indeed, the Objective 1 to distribute assets as soon as reasonably practicable could be left until last or ignored altogether under this regulation.

Whilst in 1.4 HMT it states:

> *"The Government is [ ] proposing to introduce changes that will help protect customers in the event of a PI or EMI being put into insolvency."*

Objectives 2 and 3 do not directly relate to an insolvency and could equally apply to any situation by which a special administrator has decided to put a firm into special administration. Again, HMT has not given any relevant industry examples of real situations where applying these new regulations would have made a difference to the firm's customers receiving a return of their assets.

It is therefore difficult for EPA members to understand how these new powers in the proposed regulations could be brought in with very little industry consultation and without concrete real world examples of why they are needed, save that they were needed in the investment banking sector (which, as has been explained, is a very different sector) or the fact that only one out of six cases of insolvency from 2018 has had customer funds returned. The industry needs professional guidance from the insolvency sector (lawyers, accountants and insolvency practitioners) setting out why this is needed and how it will alleviate the problem.

Small Institutions

The applicability of the pSAR to Small Institutions seems a sensible recommendation in the proposed regulations as in many cases it is these smaller firms that are more likely to have problems due to the lighter regulation on them and the fact that safeguarding may not apply. The EPA is concerned, however, that the pSAR may have a detrimental effect on investment in and the growth of fintech businesses entering the market because any additional regulatory burden on these fragile businesses could stop them setting up at all. The companies that would benefit would be the larger, more established companies and newer, progressive and innovative companies would not be attracted to the sector due to the higher risks and lower return on investment. In time, this reduction in competition would likely result in higher prices and lower service quality for consumers.

Return of customer funds in insolvency

2 Do you have any comments on the proposed distribution principles?

The EPA and its members are fully behind any actions that HMT can take to strengthen the industry, especially in a post-Brexit and Covid-19 lock down situation which is hitting much of the industry hard as is shown in FCA's C-19 survey referred to in 1 above.

If the proposed pSAR offering a greater focus on return of customer assets will give greater consumer confidence into payment services and electronic money, then that is welcomed. However, the EPA believes all such benefits should be proportionate to any problems the pSAR may bring and hence the pSAR should be given as much scrutiny by the industry as is required to do this. In these difficult Covid-19 times, bringing together EPA members to properly analyse the pSAR within a month over Christmas (indeed some of the pSAR are referenced in Annex B and C because they are not yet drafted so can only be summarised) is difficult.

The initial Objective 1 is drafted in pSAR regs 13-23 and cover the reconciliation of the asset pool at the date of the special administration based on the previous calculations done by the firm. This is sensible and should immediately let the special administrator know if there is any shortfall.

The next step, assuming another firm is not brought in to transfer the asset pool to and continue to run the payment account (discussed later), is for all transactions in and out to be stopped (in effect freezing the customers' accounts). This is an area that the EPA feels could lead to many problems. As the FCA is acutely aware, when with no notice, the regulator freezes the ability for customers to use their payment accounts (reference, Wirecard Card Solutions) there are many knock-on effects:

- Customers' standing orders and direct debits are stopped;
- Customers are unable to access their account to take out cash or make essential payments, such as for rent, food and utilities (many customers using payment accounts are the most vulnerable in society; mainstream banks don't like servicing them and hence they have to come to EMIs and PIs for account services);
- Because of the above, the option suggested of simply paying funds back to customers (regulation 16) won't work as this is likely to be their only account and they will be paying in via a local retailer using a PayPoint terminal or equivalent, and hence not able to get funds remitted back to them;
- Many providers offer payment accounts with real time pull-payments from other accounts, similar to direct debits – how will this be dealt with?
- Unlike investment banks, customers using payment accounts don't want their funds back, they want to be able to have an account they can use to pay and be paid;
- How will virtual accounts be dealt with, such as those in the travel industry, whereby travel agents often hold many virtual accounts each to pay for single items from their suppliers (flights, accommodation, ground services etc.)? Many of these accounts will be 'in transit' at the point of any special administration and hence will make reconciliation and stopping them very difficult.

Working Group

The EPA is sure, given time, further examples could be discovered and would ask HMT to set up an industry working group to work through all the different scenarios prior to bringing in pSAR to ensure that it will be able to work in all, or at least most, circumstances without causing customer detriment.

Further regulations

The provisions of pSAR regulations 14 and 15 are there, the EPA believes, to reduce the need for the special administrator to have to apply to court to liquidate funds and manage the asset pool and to this extent the EPA welcomes the pSAR.

pSAR regulations 17-22 effectively set out how the special administrator determines the amount in the asset pool and those able to claim from it. It is these regulations in the pSAR that the EPA has concerns about, as they seem to go against the principles of electronic money being redeemable at par at any time (EMD2 Art 11). By barring claims from customers, many holders of funds in accounts will lose their rights to those funds and, in effect, be giving those funds to the customers who are not barred. The EPA believes this could be unfair on those barred customers whilst unduly enriching the customers who have not been barred. The correct answer here should be for the special administrator to properly account for all customers funds and only after the 6-year period required in the UK to hold such funds as have expired. At that time a further distribution of funds should take place in the event that customers had a shortfall in original distribution of the asset pool.

Bar date and hard bar date

The EPA would like to have further discussions with HMT on the bar date and hard bar date to see if there are any better ways to manage distribution. In discussing bar dates it must be remembered that many of the typical customers will be the most vulnerable and the least able to understand what a bar date is, unlike the savvy investors in an investment bank scenario. Separately, many gift card and promotion programmes are run using payment accounts and in these cases, unless the holder of the account registers themselves, which is rare, how is a special administrator expected to find all the relevant customers? Currently, notice to unknown account holders in such circumstances is given on the website of the issuer, but this is no guarantee nor is it likely that all account holders will see this.

None of this appears to have been taken account of in the drafting of the ‘bar’ regulations.

Transfer provisions

3 Do you have any comments on the proposed transfer provisions?

The EPA notes that the proposed transfer provisions have not been drafted yet and hence only a summary of the envisaged pSAR is given in Annex B specifically B2. These provisions set out the framework for a transfer of safeguarded funds from the firm that has a special administrator appointed to another firm capable of having those assets, and the relevant contracts with third parties novated to it (payment processor, Scheme BIN, card bureau etc.).

Many EPA members have gone through transfers of BINs from other issuers in the past with the relevant transfer of safeguarded funds. It is not a simple process and often requires several months, much negotiation and considerable technical integrations – it is not 'plug and play'. If you find another firm that is a member of the same Scheme with contracts in place with the same third parties, it is possible that such a transfer mechanism could work. However, finding such a firm and being able to show that it was fairly selected under some proper form of tender process would be impossible in the timescales HMT are discussing to protect customers in the case of a fast-moving appointment of an administrator. In contrast, in the investment bank scenario, there would be little to do except transfer the funds to another suitable investment bank and sign a new contract with the new bank.

The whole process of how a firm is selected and how the transfer would take place needs to be carefully looked into and agreed by the industry and full details of the proposed pSAR dealing with this need to be scrutinised.

Part 24 of the Financial Services and Markets Act

4 Do you have any comments on the proposal to extend the remaining provisions of Part 24 of FSMA to Electronic Money and Payment Institutions?

This extension of the FCA's rights with other regulated firms in insolvency situations to apply equally to EMIs and PIs seems reasonable but again no actual regulations are given, simply Annex B B22-30. Once drafted these regulations will need proper scrutiny and review.

Other areas of the proposed regulations that have been supplied but do not appear to be included in any of the four specific questions above.

In addition to S24 FSMA rights, Annex B B4-21 gives the special administrator additional rights to determine which Objective to follow first (this needs further discussions on what basis such decisions can be made and what rule of law can ensure it is exercised properly and fairly). There are then a number of other proposed regulations within the pSAR which follow the Investment Bank SAR and which are suggested can be adapted to cover PIs and EMIs but with no detail. These need to be properly drawn up and reviewed in the fullest to ensure they are appropriate in the very different circumstances that apply to PIs and EMIs.

In the draft pSAR, Regulation 9 sets out the grounds under which a special administration order may be granted. Whilst the discussions in the consultation refer to 'insolvency changes' for PIs and EMIs, none of the grounds for the appointment of a special administrator require a firm to be insolvent. Items 1.4 and 1.5 talk of insolvency cases taking a long time to distribute funds and the Government wanting to introduce new laws:
"introduce changes that will help protect customers in the event of a PI or EMI being put into insolvency".

But looking at the grounds for appointment in regulation 9:

9.—(1) In this regulation—
(a) Ground A is that the institution is, or is likely to become, unable to pay its debts,
(b) Ground B is that it would be fair to put the institution into special administration, and
(c) Ground C is that it is expedient in the public interest to put the institution into special administration.

Those who can apply under Grounds A *or* B are the FCA and those persons set out in regulation 8 (1) (a)-(f):

8.—(1) An application to the court for a special administration order may be made to the court by—
(a) the institution,
(b) the directors of the institution,
(c) one or more creditors of the institution,
(d) the designated officer for a magistrates' court in the exercise of the power conferred by section 87A of the Magistrates' Courts Act 1980 (fines imposed on companies),
(e) a contributory of the institution, subject to paragraph (7),
(f) a combination of persons listed in sub-paragraphs (a) to (e),

And the Secretary of State can apply under grounds B *and* C.

The EPA requires further clarification on these grounds and under what circumstances they could be evoked. As drafted they seem to be very wide and far more draconian than current insolvency laws. Indeed, the fact that a single creditor of a PI or EMI could make such an application seems to be an invitation to have many claims made by unscrupulous creditors as a lever to getting paid and does not seem appropriate in the circumstances.

Both the Grounds A-C and the persons entitled to make applications require deep scrutiny by the industry.

Conclusion

The EPA is pleased that HMT has produced a large part of the draft pSAR aiming to give greater certainly to customers of PIs and EMIs with a view to giving them greater protection in the event of insolvency of a firm. There are many good concepts within the draft pSAR and using the Investment Bank SAR offers a good starting point given that it appears to be helping that part of the financial services industry.

Notwithstanding the above, the EPA is concerned at the speed with which HMT is bringing forward the proposed pSAR and the lack of time for proper scrutiny of such regulations. The EPA does not believe that the current problem requires the indicated speed to bring the pSAR into force. The EPA fears that by rushing through the pSAR, without the benefit of a full draft available for the industry to consider, debate and properly review, could lead to unintended consequences that would be avoided with proper consultation.

Our industry is well represented by associations like the EPA, EMA and UK Finance, who seek always to work collaboratively with Government, HMT and the regulators to ensure the PIs and EMIs come out of Brexit and the Covid-19 crisis in a strong position to keep the UK at the pinnacle of the world in the provision and regulation of financial services.

About the Emerging Payments Association

The Emerging Payments Association (EPA), established in 2008, sets out to make payments work for everyone. To achieve this, it runs a comprehensive programme of activities for members with guidance from an independent Advisory Board of 16 payments CEOs.

These activities include a programme of digital and (when possible) face-to-face events including an online annual conference and broadcast awards dinner, numerous briefings and webinars, CEO Round Tables, and networking and training activities. The EPA also runs six stakeholder working groups. More than 100 volunteers collaborate on the important challenges facing our industry today, such as financial inclusion, recovering from Covid-19, financial crime, regulation, access to banking and promoting the UK globally. The EPA also produces research papers and reports to shed light on the big issues of the day and works 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.

The EPA has over 130 members that employ over 300,000 staff and process more than £7tn annually. Its members come from across the payments value chain including payments schemes, banks and issuers, merchant acquirers, PSPs, retailers, TPPs and more. These companies have come together to join our community, collaborate, and speak with a unified voice.

The EPA collaborates with its licensees at EPA EU and EPA Asia to create an interconnected global network of people passionate about making payments work for all.

See www.emergingpayments.org for more information. Contact malik.smith@emergingpayments.org for assistance.