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UK FCA Proposes Changes to Safeguarding Regime for Payments and E-Money Firms

The UK Financial Conduct Authority (FCA) has proposed significant changes to the safeguarding requirements for UK registered payments and e-money firms (CP24/20). The FCA's goal is to replace the current safeguarding regime with a new one influenced by existing client money rules that apply to authorised firms holding client money (CASS).

The safeguarding requirements are fundamental to the activities of UK payments firms. The FCA says that its consultation is a response to what it sees as widespread failures across the UK payments sector to follow its existing safeguarding rules. There have also been recent high-profile UK court cases that exposed (and the FCA says perpetuated) a lack of clarity in the statutory regime, particularly the treatment of shortfalls in safeguarded funds in the context of firm insolvency. Payments firms should take notice of these proposed changes.

Summary of the Proposals

The FCA proposes a two-stage approach to implementing the reforms.

First, "interim-state" rules would seek to bolster and enforce the existing safeguarding requirements set out in the Payment Service Regulations (PSR), the Electronic Money Regulations (EMR), and some of the best practice requirements in the FCA's Payment Services Approach Document. Key points to note in the FCA's proposals for this interim state:

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- **Enhanced record-keeping and reconciliation requirements.** Firms would need to develop written policies and procedures to comply with PSR and EMR rules. Many firms may have these already. Additionally, the FCA proposes a new requirement for daily, internal reconciliations and comparisons with third-party records of safeguarded funds, with any discrepancies being addressed and remediated on the same business day.
- **Enhanced monitoring and reporting.** This includes an annual audit of safeguarding compliance performed by an appropriately qualified external auditor, who provides an annual report directly to the FCA. The FCA also proposes a new monthly regulatory return covering topics such as amounts safeguarded and shortfalls.
- **Additional requirements in respect of safeguarding.**
  - The FCA's proposals aim to reduce the risks it perceives as being generated by the time period permitted by the EMR and PSR between a firm receiving customer funds and when it must safeguard them (the business day following receipt). The FCA reports that around 35% of firms hold money at other payments firms during this window (payments firms cannot be used to meet safeguarding requirements). This feature of the PSR and the EMR would not change in the interim state, but firms would be required to exercise greater control and diligence over third parties that hold funds in this window.
  - There are also proposals for additional requirements on payments firms that elect to invest safeguarded funds in permitted liquid, secure investments, or through the use of an insurance policy or comparable guarantee. These proposals address specific risks that the FCA perceives to be generated by these safeguarding options.

In the second stage, or "end state" rules, the FCA would introduce a statutory trust concept and the granularity of the CASS rules. In the "end state," the FCA would revoke and replace safeguarding requirements in the PSR and EMR. Key points to note in the FCA's proposals for the end state:

- **Consumer funds (or relevant assets or insurance policy proceeds) would be held in a statutory trust.** This reverses recent UK court precedent to the effect that neither the EMR nor the PSR create a statutory trust over safeguarded funds. The primary relevance of this would be in the event of the insolvency of the payment firm – the trust assets would fall outside the assets of business, meaning that customers should be made whole. However, as the FCA notes, the use of a statutory trust also puts the payments firm in a fiduciary relationship with its clients (rather than a creditor-debtor relationship), and this should influence a firm's decision-making if it faces solvency issues or other existential threats.
- **More detailed requirements on fund segregation and agents and distributors' handing of funds.** This includes a proposed requirement that funds would have to be paid directly into designated safeguarding accounts, removing the flexibility outlined above. Where agents or distributors receive funds, the firm would have to segregate an equivalent amount of its own funds and these funds would be held in the new statutory trust.

Timing and Transitional Measures

The current consultation closes December 2024. The FCA anticipates final rules for the interim state will be published by the end of Q2 2025. The FCA then expects to give payments firms a transitional period of six months from finalisation of the interim-state rules before they take effect, so the interim-state rules could be in place by the beginning of 2026. The rules for the final state will be published at a later, to-be-

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determined stage, and the FCA intends to provide payments firms 12 months from finalisation to implementation.

Takeaways

For decades, FCA-authorised firms that hold client money have generally been required to devote considerable resources to comply with the CASS rules. These proposals may be a challenge for payment services firms. While the interim-state proposals may be manageable, the end-state proposals may change the regulatory landscape for UK payments firms and e-money firms, who would also be required to comply with these higher standards. Smaller payments firms may be unable to devote sufficient compliance resources to meet these enhanced expectations. The greater visibility that the FCA hopes to obtain through enhanced reporting requirements may also increase the use of the FCA's supervisory and enforcement tools.

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