CBI Audits on Safeguarding Requirements for Payment and E-Money Firms

Author: Shane Farrell, Compliance Manager at An Post and member of the Consumer Protection Working Group.

Trust

Trust is an irreplaceable element in the provision of all financial services products. This trust manifests itself in many ways. The most basic form being the expectation that deposits will be available to customers when requested, be it at a point of sale or a branch's counter. When this trust is eroded financial institutions fail. This is true from the times of the Medici family to the collapse of Anglo Irish.

Such was the degradation of trust in the wake of Anglo's crash that the Irish State guaranteed deposits in Credit Institutions up to €100,000. Since the recovery from the recession, trust has been regained. Albeit slowly. This recovery also saw rapid innovation amongst Electronic Money and Payment Services Firms (collectively 'Firms'). Sectors which were, and remain, outside of the Deposit Guarantee Scheme. Data from the Central Bank of Ireland (CBI) shows a 289% rise in E-Money transaction value in Ireland through 2021 alone, growing from €7.2bn to €28bn.

Firms are required to safeguard users' funds. At its simplest, this means they're required to keep customers' money separate to money used in the day to day running of the Firm. These obligations are set out in Regulation 17 of the European Union (Payment Services) Regulations 2018 and Regulation 29-31 of the European Communities (Electronic Money) Regulations 2011 (as amended).

The requirement for both types of Firms in relation to safeguarding is similar in so far as there are three broad types of safeguarding approaches accepted:

1) Insure or otherwise guarantee user funds (i.e. customer's money), by an insurance company or a credit institution, that does not belong to the same group as the Firm;
2) Invest it in assets designated or approved by the CBI as secure, liquid and low risk; and/or
3) Deposited in a separate account in a credit institution.

The key benefit of safeguarding customers' money is that in the event of a failure of the Firm, no liquidator, receiver, administrator, examiner or creditor of the Firm, nor the Official Assignee in Bankruptcy, has any recourse or right against user's funds which have been safeguarded. Moreover, where funds have been appropriately safeguarded sufficient funds should exist to make all customers whole in the event of an insolvency.

The importance of this requirement will be highlighted in the following section which assesses what can happen when it all goes wrong.

When Firms Fail

There have been several high-profile instances of Firms failing in recent years. The most prominent of these are the insolvencies of Ipagoo and Premier FX.

In 2019 the Financial Conduct Authority (FCA) ordered Ipagoo's customers' accounts be frozen. Ipagoo's founder Carlos Sanchez rebuffed claims this was due to safeguarding deficiencies in 2019. Through 2021 and 2022 however, the treatment of non-safeguarded funds was the subject of litigation involving Ipagoos administrators and the FCA in the UKs High Court and Court of Appeal. The High Court adjudicated that non-safeguarded funds were to be treated as unsecured creditors. The FCA appealed this decision in the context of Payment Services and E-Money requirements. This appeal was dismissed by the UKs

Court of appeal. The result was that non-safeguarded funds landed in the insolvent Firm's asset pool.

The precedent of this decision means customers whose money ought to have been safeguarded but which was not may lose some, or all of their money should the Firm go into insolvency. While this is not an Irish decision and does not necessarily reflect what the Irish legal position may be, it does serve as a chilling reminder as to the importance of the obligation to safeguard customers' money.

In 2021 the FCA issued a Final Notice in relation to the failings at Premier FX Ltd, a Payment Services Provider. This notice found the Firm mislead their customers in relation to:

- It was able to hold their funds indefinitely without the need for a payment order for onward transfer.
- Their funds would be held in secure, segregated client accounts; and
- Their funds would be protected by the Financial Services Compensation Scheme.

The FCAs notice paints a picture of a Firm run by a sole director who made promises to customers it was unable to keep. These related to the above points as well as the making of interest payments which the Firm was neither authorised to undertake, nor financially capable of making, together with sweetheart exchange rate deals. In all the FCA concluded the firm was using new customers' money to pay existing obligations. This all occurred in the absence of appropriate safeguarding controls.

Just over £10 million of Premier FX customers' funds was later voluntarily repaid by Premier FX's bank, Barclays. The quantum of this payment illustrates the exposure Premier FX customers had on account of their money having not being safeguarded.

The failures at Ipagoo and Premier FX reiterate the importance of safeguarding requirements as well as the steadfast need for these requirements to be paired with an appropriate supervisory oversight mechanism.

CBI Audit

In the absence of the Government guaranteeing deposits of these Firms, and in the context of the harm caused by failing Firms, what can drive trust amongst consumers? One possible answer; distrust. Or 'professional scepticism' as the CBI and auditors alike would posit. In recent months the CBI has asked Firms to undergo audits in relation to their safeguarding controls.

Within the last two years the CBI has issued three communications outlining their expectations for Firms, particularly in relation to Safeguarding.

The first communication was in December 2021 which took a holistic look at the CBI's supervisory expectations across seven key themes. Included within

these seven themes, briefly, was the expectation that Firms safeguard users' funds. While the section in the letter discussing safeguarding requirements was the briefest of seven themes, the letter concluded with a requirement that Firms, together with their Boards, undertake a comprehensive assessment of their firms Safeguarding Obligations. Once completed, firms were required to provide an attestation as to their compliance with those requirements by 31 March 2022.

Through 2022 the CBI identified significant deficiencies in the governance, risk management and control frameworks of some Firms.

A second letter was sent in January 2023. This letter set out the CBI's expectation that Firms have an audit of their compliance with the safeguarding requirements conducted. The audit findings were to be reviewed by their Board of Directors and a response drafted and issued before 31 July 2023. While this letter set out nine areas to be tested, it did not prescribe the level of assurance which was required.

In May 2023 the last of the three communications form the CBI relating to Safeguarding requirements was issued. This letter, specifically relating to the audit, set out the assurance standard to be achieved, namely being an ISAE 3000 Assurance Engagement. The third letter set out a list of 15 topics to be covered in the audit.

Challenges with CBI Audit

While this article vindicates the importance and priority which must be placed on safeguarding audits, many within the E-Money and Payments industries were taken aback as to the ambitions timelines imposed upon them by the CBI in completing the safeguarding Audits.

While some similarity existed between the 15 actions in the May letter and the original 9 form the January letter the differences were numerus and substantive. By way of example the letter from January required the below in relation to testing where insurance/guarantee was used as the segregation method:

- An assessment of the Insurance policy/comparable guarantee administration process - including how the firm satisfies itself as to appropriateness of the policy/guarantee, the process for renewing the policy/guarantee, in addition to the process for increasing level of cover where required or making a claim on the policy/guarantee.

The revised ask in May was all together more prescriptive as to the audit requirements in this area:

- The processes and controls the regulated firm has in place for the insurance policy/comparable guarantee. In addition, to the reconciliation requirement noted above, this should include:
    - The initial and ongoing due diligence/assessment undertaken on the chosen underwriter and whether they have adequate resources to fulfil the policy,
    - An assessment of the appropriateness of the insurance policy evidencing how those charged with governance are satisfied that it meets the firm's legislative obligation under the EMR/PSR as applicable.
    - An assessment of the adequacy of the cover obtained on an ongoing basis, the process for updating the level of cover in a timely manner as required,
    - The process for ensuring that the policy is renewed in a timely manner and
    - The process that the regulated firm has in place for safeguarding the insurance proceeds in the situation where the policy is called upon.
    - Details of the process in place for the administration of the policies including appropriate timelines for the renewal process

and ongoing due diligence/assessment of the underwriters.

While the May letter was accompanied by a revised timeline, extending the deadline from 31 July to 31 October, such was the enhanced granularity of the ask the revised timeline was nullified, if not a more challenging ask.

All Firms are required to engage with the same, limited pool of statutory auditors to undertake and complete the audit to the same deadline. Likewise, audit firms have been flooded with requests to perform safeguarding audits and must now spread resources from within their existing talent pool amongst the Payment and E-Money Firms.

Next Steps / Conclusion

Every compliance professional will appreciate the importance and priority which must be placed on protecting customers. Safeguarding by design ensures customer's interests are protected and prioritised when Firms fail. This instils trust amongst consumers. This protection only exists in circumstances where the funds are actually safeguarded. Where funds have not been safeguarded, customers may find they have no protection when things go wrong. They may find the trust they placed in a regulated entity misplaced.

Firms not adhering to their safeguarding obligations are not only putting their customers' money at risk, they undermine the foundation upon which the industry operates; trust.

Firms having received the December 2021 letter will have undertaken a comprehensive assessment of their safeguarding controls. Although the goalposts have moved between January and May, the previous review will be a strong source of reference for the audits now underway. And, while the timelines set out by the regulator are challenging few would contend the exercise is not deserving of prioritisation. Customers trust our Firms with their money. This trust must be vindicated through a robust demonstration of our control environment.