ICAEW
REPRESENTATION 85/24

CP24/20 CHANGES TO THE SAFEGUARDING REGIME FOR PAYMENTS AND E-MONEY FIRMS

Issued 17 December 2024

ICAEW welcomes the opportunity to comment on the CP24/20 Changes to the safeguarding regime for payments and e-money firms published by FCA in September 2024, a copy of which is available from this link.

Executive Summary

This consultation response outlines key observations and recommendations regarding proposals for safeguarding audits, focusing on clarity, proportionality, and operational feasibility to support effective compliance.

1. **Definition of "Auditor"**:
    - Proportionality in expectations for small Electronic Money Institutions (EMIs) is critical.
    - Requirements should enable smaller audit firms, potentially better suited to small EMIs, to participate without undue barriers.
2. **Safeguarding Audit Submission Deadlines:**
    - Recommend extending the deadline beyond 4-months, increasing overlap with the financial statement audit period. This prevents resource strain, particularly for specialists also conducting Client Asset Sourcebook (CASS) audits.
3. **Cost-Benefit Analysis (CBA):**
    - Methodological transparency and updated cost metrics are needed. Current assumptions underestimate ongoing costs and the complexity of safeguarding audits.
    - Consideration of costs for limited assurance audits and operational maintenance is insufficient.
    - Introduction of opt-in for payment services money to CASS 7 rules would prevent regulated firms from being audited under two regimes and would therefore reduce the incremental costs associated with the audit, notwithstanding consideration of any potential legal and regulatory framework challenges.
4. **Limited Assurance Scope:**
    - We observe that limited assurance is less understood in the payment sector.

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- Clear guidance on interim approaches (eg, using the CASS Assurance Standard) is necessary, especially before the Financial Reporting Council (FRC) publishes a safeguarding standard.

5. **Appropriate Assurance Standards:**
   - Interim guidance is required for safeguarding audits under current and forthcoming rules.
   - Clarity is needed on whether sections of Chapter 10 of *'Payment Services and Electronic Money – Our Approach the FCA's role under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011'* remain subject to audit in the interim period alongside the new CASS 15 rules.

6. **Recordkeeping and Reconciliation Requirements:**
   - It is unclear if the FCA envisages the "reconciliation point" referred to in CASS 15.12.16 as being the most up to date records.

7. **Regulatory Permissions:**
   - Guidance on additional permissions required for firms using alternative investments for segregation (eg, investment management permissions) is essential. Consideration of the applicability of CASS 6 rules is also requested.

8. **Expectation re: rule-by-rule risk assessments:**
   - Learning from the implementation of the CASS regime, if the FCA expects safeguarding firms to produce a risk assessment on a safeguarding rule-by-rule basis, that should be made explicit in the CASS 15 rules.

9. **Determination of relevant funds:**
   - A more precise definition and illustrative examples are required to delineate the scope of safeguarding obligations for cross-border transactions, with particular reference to the jurisdiction of the regulated firm, PSP, payer and payee.
   - Clarity is also required in terms of scoping with reference to origination and processing of the payment transactions, linked to jurisdiction.

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This response of 17 December 2024 has been prepared by the ICAEW Financial Services Faculty. As a leading centre for thought leadership on financial services, the faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

ANSWERS TO SPECIFIC QUESTIONS

Question 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.

1. The requirement in 15.12.13R to perform a reconciliation of the “most up to date records” could lead to differing approaches – and could make the standard hard to audit against and enforce. Firms and auditors may differ in determining what is a practically achievable interpretation of the most up to date records.
2. It is unclear if the FCA envisages the “reconciliation point” referred to in CASS 15.12.16 as being the most up to date records.
3. CASS 7 helpfully provides clarity by specifying the reconciliations should be of the records as at the close of business on the previous business day.
4. Specifying a precise cut-off time or referencing a standardised definition of what "up to date records" means would enhance the clarity and enforceability of this statement.

Question 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?

5. Formal audit requirements have demonstrably improved the quality of historic CASS compliance.
6. An audit requirement was introduced into the safeguarding regime as well, which has begun providing important oversight and has increased firms' accountability. These existing requirements have driven significant progress in safeguarding processes and controls over the past 3-5 years. We agree that this should be formalised and that external safeguarding audits should be required in both the interim and end state.
7. The introduction of an auditing standard under which safeguarding audits must be completed is also a crucial step. Currently there are vastly differing approaches to the performance of safeguarding audits, and consistency is vital to ensure they adequately support compliance with the regime and provide a level playing field for regulated firms to be assessed against.
8. Audit firms are concerned about the potential for a period in which the new audit requirements set out in SUP are effective, yet there is no standard against which those audits must be performed. We appreciate that this is a temporary state of affairs, but it could hamper firms in achieving consistent, timely and effective implementation of the new rules. Aligning the auditing standard with the interim phased implementation of CASS 15 allows firms to continually assess their processes against both the interim and final requirements, fostering ongoing improvement and a smooth transition to the new standards.
9. The CP suggests that the statutory financial statement auditor and the safeguarding auditor will often be the same entity. Whilst that may be true, it should not be made a requirement and, consistent with CASS, it should be made clear that the safeguarding audit could be conducted by a different audit firm. This would also help ensure that safeguarding audits are conducted by firms with relevant specialised expertise and allows for a spread of workload considering the introduction of the formal 4-month submission to the FCA
10. There is an inconsistent use of "statutory auditor" and/or "auditor" in the CP. Reference to "statutory auditor" in the CP does not appear in line with the definition provided in existing CASS and SUP rules.
11. Chapter 10 of Payment Services and Electronic Money – *Our Approach the FCA’s role under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011*, (“Chapter 10”) is not included in the definition of ‘relevant funds regime’ in the CP.
12. However, we understand from discussion with the FCA that in the interim period, Chapter 10 will still be applicable alongside the new CASS 15 rules. Clarity is needed as to whether the sections of Chapter 10 that remain applicable will be subject to audit alongside the new CASS 15 rules in the interim period.

13. There are no rules in CASS about firms being required to perform a rule-by-rule risk and controls assessment. Yet, due to a clause in the FRC's CASS Assurance Standard, audit firms have considered this to be an expectation, and where it is not present, audit firms have identified this as a breach of the requirement for firms to maintain adequate organisational arrangements. The FCA has also indicated that it is expected (eg, in the Charles Schwab final notice of 21 December 2020, paragraph 4.25).
14. If the FCA's expectation is that safeguarding firms should complete a rule-by-rule risk assessment, we request that this is made explicit within the CASS 15 rules, to avoid ambiguity. Making FCA's expectations clear provides safeguarding auditors a clear benchmark against which to audit.

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

15. Yes, we agree that requiring the submission of safeguarding audits to the FCA is a positive step. This aligns with existing feedback that CASS audits are a valuable tool for regulatory oversight and encourage firms to proactively address issues.
16. However, we recommend extending the proposed 4-month submission deadline. This adjustment is justified for several reasons:
    - **Alignment with Financial Statement Deadlines:** The common deadline for financial statement submissions to the FCA is 9-months, and audit work is often done on these engagements up to that deadline. Given the occasionally significant overlap between financial statement and safeguarding audits, particularly concerning IT controls, for example, closer alignment of the submission deadlines would promote efficiency and reduce duplication of efforts, allowing the financial and safeguarding audits to be conducted simultaneously.
    - **Resource Constraints:** Safeguarding audits are typically conducted by the same specialists who perform CASS audits. A compressed 4-month timeframe would place undue pressure on these already limited resources. This could also negatively impact the CBA proposed in the CP.
    - **Industry Concentration:** The industry's concentration of December year-ends would create a significant bottleneck if a 4-month deadline were enforced. Whilst firms could build their resource pool over time to competently deliver these within the 4-month deadline, this would not result in an optimum model. It would mean that both CASS and safeguarding audit work would be concentrated around the October – April period and delivered under increased pressure. Extending the deadline to allow safeguarding engagements to be completed over a longer time period would enable practitioners to work on client assets and safeguarding engagements all year round and deepen their specialism.

Question 5: Do you agree that small EMI's should be required to arrange an annual safeguarding audit? If not, why not?

17. Yes, we agree that requiring small Electronic Money Institutions (EMIs) to undergo annual safeguarding audits is crucial. Adequate protection of safeguarded funds is paramount regardless of a firm's size.
18. However, it's essential to ensure that the implementation of this requirement considers proportionality and avoids unintended consequences:
    - **Proportionality in Audit Scope:** The expectations placed upon auditors of small EMIs should be proportionate to the scale and complexity of their operations. A risk-based approach, focusing on areas of higher potential risk, would be more effective than a one-size-fits-all approach.
    - **Competitive Landscape:** The requirements should not disproportionately disadvantage or disqualify smaller audit firms. These firms are often well-positioned to

serve small EMIs due to their understanding of the niche market and cost-effective service models.

- **Long-Term Risk Mitigation:** Mandating safeguarding audits for small EMIs from the outset promotes a culture of compliance and risk management from an early stage. This proactive approach mitigates the risk of inadequate systems and controls as these firms grow and handle increasingly larger volumes of relevant funds.

Question 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.

19. We agree that requiring the submission of safeguarding returns to the FCA is a positive step towards enhanced regulatory oversight. The proposed monthly reporting frequency in both the interim and end-state strikes a balance between providing timely information and minimising the reporting burden.

Question 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.

20. We agree that introducing prescriptive rules for segregating relevant funds is beneficial. This approach promotes market consistency, reduces the risk of misinterpretation, and provides firms with clearer expectations, ultimately enhancing the protection of customer funds.
21. However, we propose the following refinements to ensure a smooth transition and ensure that the rules are applied and audited consistently:
    - **Timing of Reconciliations:** There is an inconsistency in terminology regarding reconciliation timing. The internal reconciliation proposed rules use the phrase "the most up-to-date records" and the external reconciliation uses the "close of business the previous day" timeframe.

      Defining a standardised cut-off time for all reconciliations would increase clarity and consistency. It would ensure that both internal and external reconciliations are conducted using a consistent data set, reducing the risk of discrepancies and facilitating a more accurate insolvency assessment. The FCA should consider changing the wording of the internal resource for the internal reconciliation to state that records are taken at the close of business on the previous business day.
    - **Clarity on Deposit Internal Reconciliation:** Further clarity on the application and exceptions related to the deposit internal reconciliation is necessary, i.e., use of acquirers or payments systems (vs a normal payments flow) and examples of what these mean in practice could alleviate market confusion and ensure consistent implementation.

Question 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.

22. We agree that requiring the direct receipt of relevant funds into designated safeguarding accounts, subject to specific exceptions, significantly enhances the protection of customer funds. This approach minimises the risk of misappropriation and segregation errors, ultimately reducing potential harm to clients.
23. However, several factors warrant careful consideration during implementation:
    - **Banking Sector Capacity:** As highlighted, the anticipated increase in safeguarding account applications may strain the risk appetite and operational capacity of banks. The FCA should engage with banking institutions to ensure they are prepared to handle the influx of applications and provide adequate support to firms transitioning to this model.

- **Operational Complexity and Exemptions:** The application of these rules will introduce operational complexities, particularly for firms dealing with both in-scope and exempt transactions. Clear and comprehensive guidance on the scope of exemptions is crucial to avoid misinterpretation and potential abuse. The FCA should provide detailed examples and use cases to illustrate the application of exemptions in practice.

Question 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.

24. We principally agree with range of secure assets. However, to bolster the clarity and robustness of the regulatory framework, augmenting the existing provisions with further guidance is recommended by the following, in respect of the general principles of 15.6.7R:
25. By providing specific instructions to firms on managing exposures to third-country central governments and central banks, as stipulated in Article 114(7), which should encompass clear directives on navigating and identifying relevant UK regulatory sources and frameworks for assessing the equivalence of supervisory and regulatory arrangements in third countries;
26. By enhancing the guidance provided on diversification, eg, what is a suitable spread, should there be concentration or geographic limits, what is an appropriate liquidity strategy.

Question 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.

27. Payment firms should be able to hold the assets they invest in, provided they comply with CASS 6 and have the necessary permissions. The rationale is that existing regulations already address this scenario by requiring firms to demonstrate compliance and obtain appropriate permissions for managing client assets, including investments.

Question 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.

28. The FCA should consider the risks associated with the accuracy and timeliness of the daily reconciliations of relevant funds under this method of safeguarding to ensure that the insurance's and/or guarantee's cover remains at the appropriate level that matches the entity's relevant funds. If headroom is used, the firms should provide basis of the percentage in their policy.
29. The FCA should clarify the process in which firms should notify the regulator if at any point in time the cover becomes insufficient.
30. There is also a risk that firms do not have adequate processes in place to monitor proceeds from the insurance provider, or guarantor, that should be transferred to the safeguarding account, therefore, clarification on required clauses included in the policy/guarantee letter terms, including how firms ensure that proceeds are being transferred on a timely basis, will also be helpful to ensure timely distribution process in the event of insolvency.

Question 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.

31. A statutory trust presents the most viable replacement for the current safeguarding regime. Our view stems from:
    - **Alignment with Legal Precedents:** Recent court decisions highlight the need for a robust safeguarding mechanism, and a statutory trust provides the necessary legal clarity.

- **Enhanced Protection for Retail Clients:** Given the significant volume of retail clients utilising payment services, a statutory trust offers a higher level of protection for their funds.
- **Clarity in Insolvency Proceedings:** A statutory trust reduces ambiguity regarding the treatment of safeguarded funds during insolvency, streamlining the process for insolvency practitioners.
- **Resolution of Existing Conflicts:** It effectively addresses the conflict highlighted in the Ipagoo case between safeguarding requirements and insolvency legislation's order of priorities.

32. However, we would like to emphasise the importance of considering the availability and accessibility of statutory trust accounts through third-party providers. This consideration is crucial to avoid replicating the challenges payment firms currently face when opening and maintaining segregated accounts.

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

33. We agree with the FCA's proposal to clarify the commencement and termination of safeguarding requirements. This consensus stems from the recognition that enhanced clarity mitigates the risk of firms inadequately safeguarding customer funds, thereby bolstering consumer protection. Furthermore, explicitly defined rules concerning the safeguarding timeframe foster a deeper understanding among firms of their fiduciary responsibilities as custodians of customer funds, ultimately leading to improved documentation practices.
34. However, respondents emphasise the need for further clarification regarding specific aspects of the proposal. Firstly, detailed guidance is sought on exceptions related to funds received directly into safeguarding accounts, particularly in the context of participation in payment systems or funds held at acquirers.
35. Current guidance in the Approach document and proposed CASS 15 rules do not provide sufficient clarity in respect of the scoping of safeguarding funds. A more precise definition and illustrative examples are required to delineate the scope of safeguarding obligations for cross-border transactions, with particular reference to the jurisdiction of the regulated firm, PSP, payer and payee. Clarity is also required in terms of scoping with reference to origination and processing of the payment transactions, linked to jurisdiction. Addressing these nuances will strengthen the framework and ensure clarity for all stakeholders.

Question 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.

36. The methodology applied for parts of the CBA is unclear, for example, the sources of data used and whether on-going costs are included.
37. The cost of the audit appears to be driven by old metrics based on 3, 6, 7, 8 CASS engagements. They are a very mature control environments, and well understood assurance engagements and does not reflect the nature of a safeguarding audit and as a result, the CBA under-states the likely cost of these audits.
38. It is unclear whether the cost of limited assurance audits has been fully considered.
39. Whilst limited assurance is a known quantity in the investment space, payment firms are much less likely to understand the concept of limited assurance.
40. We anticipate that a lot of firms will not know of whether they will be in scope for a Safeguarding audit (SUP 3A (1) requirements).
41. Clarity is needed on the FCA's expectation on the approach for a limited assurance review before the FRC publishes its safeguarding standard, for example, whether it would be acceptable to follow the CASS Assurance Standard.

42. We welcome clarity on what determines small, medium and large classification of firms under safeguarding, as this is linked to expected audit costs. In CASS, there are set parameters for small, medium and large firms based on level of client assets held. The size of firms noted the CP appears to correspond with the Companies Act definition, as opposed to the level of relevant funds held. Convergence on the definition of the size of firms under CASS and safeguarding will be helpful.

43. Finally, some regulated firms carry out both payment services business that will be subject to CASS 15 and investment business that is subject to CASS 6/7. This will mean that such firms will require two audits: one for each regime. Notwithstanding the potential legal and regulatory framework challenges, the FCA could consider including an opt-in to the CASS 7 rules for relevant funds relating to payments business (as firms can opt client money relating to insurance intermediation into CASS 7) this would allow the regulated firm to operate under one regime and be subject to only one audit. This would reduce the cost to firms.

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

44. We largely disagree with the cost-benefit analysis presented for estimated audit costs.

45. Key concerns raised include:

- **Underestimation of Audit Costs:** The FCA's assumption that all audits are conducted by statutory auditors at a uniform cost is deemed unrealistic.
- **Lack of Auditing Framework:** The absence of a defined auditing framework makes it challenging to determine accurate audit costs, potentially leading to inconsistent service levels. The FRC is urged to provide clarity on the CASS 15 auditing framework.
- **Unrealistic Pricing Expectations:** The stated audit costs, particularly for smaller firms, are considered too low to ensure a high-quality audit, especially given the specialised expertise required for systems and controls assessments. This could lead to under-pricing, impacting audit quality and potentially discouraging firms from undertaking the work.

46. We suggest that the FCA's analysis may underestimate the true costs of implementing the proposed changes, potentially impacting the feasibility and effectiveness of the intended outcomes.