Feature

KEY POINTS

- The collapse of Wirecard AG in Germany has thrown into sharp relief the risks to users of payment processors/e-money institutions presented by a processor's insolvency.
- The FCA's latest guidance on safeguarding customers' funds seeks to impose rigorous safeguarding requirements on processors and e-money institutions.
- Even so, it is clear that risks remain. Customers are not wholly protected against losses and may face delays in obtaining access to their funds.
- Should the Financial Services Compensation Scheme be extended to help out? And could new insolvency laws offer better protection?

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How safe is the pound in your phone? Lessons from Wirecard

In June 2020, Wirecard AG, the substantial German fintech company, collapsed into insolvency. One consequence was that the payment processing services offered by its UK subsidiary were disrupted, exposing consumers (including vulnerable ones) to difficulties and delays in accessing their funds. This article considers how robust the regulation of payment processors and e-money institutions currently is in England and Wales and addresses possible reforms. It examines the FCA's new safeguarding guidance, identifying its strengths and weaknesses, and also asks what part the Financial Services Compensation Scheme and general insolvency law do (and should) play in protecting users of these services.

INTRODUCTION: THE IMPLICATIONS OF THE WIRECARD COLLAPSE IN ENGLAND AND WALES

The collapse in June 2020 of Wirecard, the German payment processor and leading player in European fintech, was noteworthy even in a year of catastrophes. In response, in the UK, the FCA rapidly imposed a temporary suspension on the right of Wirecard's English subsidiary to transfer funds. This immediately left companies which used Wirecard's e-payment facilities unable to meet their customers' needs to make payments or obtain cash. Wirecard's customers included providers of pre-paid cards and e-cards, as well as of accounts into which benefit payments were made by the UK Department for Work and Pensions. An immediate consequence was that numerous users of pre-paid cards and benefits recipients were left unable to gain access to their funds. Many of the victims of the Wirecard crash in the UK were thus those on the fringes of the formal banking system, some of the people most vulnerable when faced with the risk of losses of funds in third-party insolvencies, or merely with delays in receiving their money.

These consequences prompt a series of questions. Had the Wirecard crisis in Germany exposed a serious gap in the UK's regulation of fintech companies? What would have happened if Wirecard had collapsed in England and Wales? What could be done to protect those affected by payment processor insolvencies, and what has been done so far? This article thus considers the implications of Wirecard's collapse for the law and regulation of payment processors in England and Wales.

BACKGROUND: THE RISE AND FALL OF WIRECARD

What then is the factual background to the Wirecard insolvency? Wirecard AG was a company based in Munich and a member of Germany's DAX index. The core of Wirecard's business was the provision of electronic payment processing services. It was not a bank and did not hold a banking licence (although a subsidiary, Wirecard Bank AG, did). Wirecard grew rapidly in the 2000s and entered the market in pre-paid cards, as well as issuing debit and credit cards. In 2011 it set up Wirecard Card Solutions Limited (WCSL), a wholly owned subsidiary in England. WCSL carried on business in the UK, issuing electronic money products and providing payment acceptance services; its business was regulated by the FCA.

As early as 2008, financial analysts and business journalists were probing Wirecard's financial robustness. By 2015, journalists at the *Financial Times* had started to raise significant questions over Wirecard's profitability, and thereafter over the reliability of its accounts. Neither Wirecard itself nor BaFin, the Federal Financial Supervisory Authority (the German equivalent of the FCA), acknowledged that there were any major difficulties. Then, in mid-June 2020, Wirecard announced that €1.9bn, roughly a quarter of its balance sheet, was "missing", and on 22 June that this sum had probably never existed. Wirecard entered insolvency proceedings in Germany on 25 June.

In the UK, on 26 June the FCA imposed various restrictions on WCSL; most importantly, WCSL was prevented from disposing of any assets or funds and was forbidden to carry on any regulated activities. These restrictions were largely lifted on 29 June and WCSL was permitted once more to issue e-money and provide payment services.

Meanwhile, however, as described above, many UK users of Wirecard's payment processing and e-money services were left for several days without access to their funds; this included many people who were dependent on Wirecard's systems to make payments or receive benefits.

The Wirecard insolvency of course raises difficult and troubling questions in the context of German insolvency and regulatory law, and also in the context of cross-border insolvencies, although those issues are beyond the scope of this article. Our focus here is on the UK and specifically England and Wales.

WHO REGULATES THE PAYMENT PROCESSORS?

At the outset it should be admitted that the fall-out from the Wirecard collapse has been fairly limited in the UK. While the fact that significant numbers of consumers

were unable to access their money for several days after 26 June must certainly have been distressing, the money was not lost, and they regained full control over it reasonably quickly. It could have been worse; even so, the events of June have thrown several points into sharp relief.

When is a technology business a financial services business?

First, in Germany, it has now come to public attention that Wirecard AG, the parent, was not regulated by BaFin. The reason is that so far as BaFin was concerned, Wirecard AG was not a financial services but rather a technology company. By contrast, its subsidiary, Wirecard Bank AG, which took deposits, was treated by BaFin as a bank and was regulated by it. For regulatory purposes, it is suggested, one should look to the substance of the business. It is hard to see how it was justifiable that Wirecard AG fell outside BaFin's regulatory purview, in circumstances where its failure risked bringing the structure of financial services and payment processor companies below it crashing down, to the detriment of commercial users of their services and ultimately the consumer.

The FSCS will not help (but should it?)

Second, the position in the UK is that customer funds were not protected on the collapse of Wirecard by the Financial Services Compensation Scheme (FSCS). The FSCS will step in to assist the customers of insolvent or delinquent financial services businesses in a wide variety of circumstances and can provide compensation (in general) of up to £85,000; it applies to cash deposits in banks, building societies and credit unions, and compensates, eg for the failure of pension providers, bad mortgage advice and the failure of investment entities (where they are authorised by the FCA or PRA). However, it does not apply to entities which issue electronic money or provide payment services.

This lacuna is curious, certainly at first sight. There is significant growth in the provision of payment processing and e-money services by fintech companies; more companies are providing such services and those services are becoming more popular. It might well come as a nasty surprise to a person with, say, a pre-paid card that funds on the card that are lost through a processor's insolvency are not protected by the FSCS, even though it would protect funds in a traditional bank account, accessible by means of a debit card. This presents a material risk to consumers using systems supplied by a payment processor; as we have seen, they may be among those least able to bear losses, or even a temporary restriction on access to their money. In the light of all this, there would be good grounds for one regulatory response to the risks exposed by Wirecard to be the extension of the FSCS to cover such losses.

The FCA to the rescue

It is the FCA which in practical terms is the primary regulator in the context of a Wirecard-type crisis in the UK. The UK regulatory structure means that misconduct or business failure of payment processors should fall within the FCA's remit.

Regulatory requirements for providers of payment services were set out in the EU's revised Payment Services Directive (Directive 2015/2366/EC), which was implemented in the UK by means of the Payment Services Regulations 2017 (SI 2017/752) (PSR). The PSR have created a distinct authorisation and registration regime. In essence, payment institutions have to be authorised by the FCA, unless they are "small payment institutions", account information service providers, or agents of an authorised payment institution, in which case they need only be registered (although all must comply with the conduct of business provisions of PSR Pts 6 and 7). The payment services covered by the PSR are set out in its Sch 1 Pt 1.

There is also a separate regulatory regime for issuers of electronic money, the Electronic Money Regulations 2011 (SI 2011/99) (EMR), which implements the EU's revised Electronic Money Directive (Directive 2009/110/EC). Such issuers must once more be authorised by the FCA, unless they fall into one of the exceptions under the EMR; for example, small electronic money institutions must be registered but do not require authorisation.

As an aside, it should be noted that the scope of both the PSR and the EMR is a subject of ongoing debate; it is fairly clear that they are at most of limited application to the issuing or processing of payments in cryptocurrency (see Proctor 2019, 3.34ff., and the FCA's 'Guidance on Cryptoassets', PS19/22 (July 2019) on its regulatory remit). While that is not strictly relevant to the facts in Wirecard, it remains a regulatory grey area.

Note also that in 2015 a further regulatory body, the Payment Systems Regulator, was established in the UK. In practice, that body's attention is primarily focused on "economic regulation", and it has sought consciously not to step into "conduct regulation", which falls within the FCA's regulatory perimeter.

THE FCA'S GUIDANCE

On 9 July 2020, the FCA issued finalised guidance, "Coronavirus and safeguarding customers' funds: additional guidance for payment and e-money firms" (Guidance), which followed from a consultation paper published on 22 May. This, accompanied by a "Dear CEO" letter, was intended to supplement the FCA's Payment Services Approach Document (the Guidance and the Approach Document should thus be read together); the FCA's stated intention is to open a new consultation in 2020/21 which will ultimately lead to an amended Approach Document, in all likelihood incorporating the Guidance.

The Guidance makes provision in s 1 in relation to the "safeguarding" of "relevant funds". These are funds received in exchange for issued e-money under the EMR; under the PSR, they are:

- "sums received from, or for the benefit of, a payment service user for the execution of a payment transaction"; and
- "sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user".

The definitions are apt to cover the kind of funds to which users (and their customers)

were briefly denied access in the initial stages of the Wirecard insolvency.

Section 1 of the Guidance further provides (in very brief summary) that:

- firms are required to keep the records and accounts necessary to identify "at any time and without delay" what relevant funds the firm holds, and that enable both the firm and third parties (such as the FCA or insolvency practitioners) to distinguish:
  - relevant funds from the firm's own money; and
  - relevant funds held for one customer as against those held for another;
- where there is a risk of discrepancies (eg by reason of currency fluctuations), the firm must carry out reconciliations "as often as is practicable" and at least once each business day;
- the reconciliations and their rationale must be documented, to assist in distribution on an insolvency;
- firms are required to notify the FCA without delay in respect of non-compliance with these requirements;
- relevant funds must be held in segregated "safeguarding accounts", separate from the firm's own funds, and safeguarding accounts must be identifiable as such by their names, which must include the words "safeguarding", "customer" or "client" (or must be identifiable by means of a letter from the firm's credit institution where the account is held, confirming the designation as a safeguarding account);
- the FCA:
  - takes the view that the EMR and PSR implicitly provide that users have a beneficial interest in funds held in safeguarding accounts; and therefore
  - will treat such funds as held on trust by the firm for the users;
- firms are required under the Approach Document to have an acknowledgement from the credit institution/custodian providing the safeguarding account (or must otherwise be able to demonstrate) that it has no interest in, recourse against or right over the relevant funds. Under the Guidance, this should now be in the form of a letter, an example of which is given at Annex 1;
- only relevant funds should be held in the safeguarding account. The Guidance expressly states (at para 1.12): "It is important that the asset pool from which to pay the claims of e-money holders or payment service users in priority to other creditors in the event of insolvency is not improperly mixed with funds, assets or proceeds received or held for different purposes … We are now clarifying that this is because mixing these assets may cause delays in returning funds to e-money holders or payment service users following an insolvency event of the firm."
- funds should still be treated as relevant funds even where (for example because they have been transferred with an incorrect name or account number) the firm is unable immediately to identify the customer entitled to the funds.

Provision is also made for steps that firms should take when selecting third parties, such as credit institutions, custodians and insurers (para 1.13). Firms are required to exercise due skill, care and diligence when doing so, and to review their use of third parties regularly (at least once a year). Further provision is made with regard to audits and the duties of firms' auditors (paras 1.17-22), prudential risk, and wind-down plans (ss 2 and 3).

The Guidance represents a robust attempt by the FCA to increase the protection afforded to customers in the event of (eg) a payment processor's insolvency. It makes explicit what was probably already implicit in the EMR and PSR, that "relevant funds" are to be segregated and treated as held beneficially for the user; it requires firms to hold those funds in such a way that they can be identified and applied rapidly in the case of an insolvency; it imposes duties on firms in respect of: (i) which third parties they engage; and (ii) how they are to insulate users' funds from claims by such third parties; it requires firms to review their compliance with the Guidance frequently; and it imposes further duties on firms' auditors to identify non-compliance.

WHAT ARE THE RISKS IN A WIRECARD-TYPE INSOLVENCY IN ENGLAND AND WALES, AND HAS THE FCA ABATED THEM?

The terms of the Guidance might reasonably increase confidence that a Wirecard-type crisis should not happen in the UK. Even so, there are grounds for caution.

First, as para 1.25 makes clear, the Guidance only applies to FCA-regulated activities. The safeguarding requirements do not apply to non-regulated business; that might include, eg processing various cryptocurrency transactions, as noted above. Second, para 1.25 also states that firms must not suggest that repayment of safeguarded funds would take priority over an IP's costs of distributing safeguarded funds; users are thus not to expect that on a payment processor's insolvency they would necessarily recover 100p in the pound. Third, at para 1.26, the FCA emphasises that firms should not suggest that the FSCS applies to relevant funds (as we have seen, it does not).

It follows that the Guidance, welcome though it is, does not amount to a water-tight shelter for users of payment processor services. Significant risks remain, most obviously:

- failure by the payment/e-money business to comply with the Guidance, which is not identified by the auditor or the FCA before an insolvency ensues. (This is not quite the position in Wirecard, because it appears likely that Wirecard's problems were much more long term);
- a fraud being perpetrated on the payment/e-money business which causes it not to comply with the Guidance, again with insolvency resulting before this is identified;
- fraud or bad practice by an agent of the payment/e-money business, which might not be discovered by it, or by the auditor or the regulator;
- inadequate due diligence by the payment/e-money business in selecting third parties, eg credit institutions, with the result that the safeguarding protections are compromised in some way;
- fraud or bad practice at the third party, with the same result.

Biog box

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Further, while the FCA considers that safeguarded funds are to be regarded as subject to a trust for the benefit of the user, it is not hard to imagine scenarios where creditors of an insolvent payment firm (or of eg an insolvent third-party credit institution) might wish to challenge that analysis in court; rapid resolution might well prove impossible.

In theory at least, the Guidance should offer protection against the actual Wirecard scenario (serious financial problems/ insolvency at the parent of the payment/ e-money entity, which compromises the latter's ability to meet its obligations), since in that event users' funds should be segregated and readily accessible. Even so, as should be apparent, the position of customers under the Guidance remains not without risk.

WHAT ARE THE ALTERNATIVES AND COULD INSOLVENCY LEGISLATION HELP?

The question remains whether statutory intervention, and in particular some amendment to the insolvency laws, might afford better protection to users of payment processors.

By an odd coincidence, on 25 June 2020, just days after the Wirecard crisis had broken and the day before the FCA imposed restrictions on WCSL, the most important reform of UK corporate insolvency law for a generation received Royal Assent. The Corporate Insolvency and Governance Act 2020 (CIGA) was passed into law in little more than a month from publication of the Bill, and can be described (perhaps uncharitably) as a somewhat awkward cobbling together of emergency measures prompted by the COVID-19 pandemic and long-term reforms that had been the subject of extensive government study and consultation over the last five years or so.

It is unfortunate that there was no real opportunity for the UK Parliament to consider whether the Wirecard collapse should prompt amendment or additions to CIGA. Even so, it is notable, and potentially helpful, that financial services companies are excluded from using the new free-standing company moratorium introduced by CIGA; that exclusion expressly embraces both e-money institutions (as defined by the EMR) and payment institutions (as per the PSR). There may be good reasons for legislation to go even further.

The problems likely to be faced by users of payment processors on a processor insolvency are of two kinds: first, the risk of losing some or all of their money; and second, the problem of being unable to gain access to that money for some time (even if it is ultimately found to be safeguarded). The FCA's Guidance has sought to address both problems; by contrast, insolvency law is only likely to be able to help with the first. Even so, there is at least arguably a justification for processor users' funds to receive some form of "super-priority" on a processor's insolvency, eg in circumstances where they have not been adequately segregated; absent super-priority, users could in principle be left competing with other creditors for a dividend.

Exploring how such a "super-priority" regime might work in practice is beyond the scope of this article; and in any event it may well be that there is little appetite for further corporate insolvency legislation at present (although many of the details of CIGA are still in the process of being hammered out through regulations). Even so, further insolvency reform to protect customers of payment processors should be considered, perhaps in parallel with the FCA's review of its Guidance over the next year.

WHAT NEXT FOR PAYMENT PROCESSOR REGULATION?

There are reasonable grounds to hope that the UK is in a better position to avoid a Wirecard-type crisis than Germany was. It appears, particularly in the light of the Guidance, that the FCA is more alert to Wirecard-type risks than BaFin proved to be (though time will tell). Specific problems remain, however:

- the Guidance, while rigorous, is not all-encompassing. The FCA's analysis is that users' money should be safeguarded in a trust structure; but we may find that the question of whether a processor has effectively created a trust will need to be tested in court in a Wirecard-type insolvency;
- there are areas where it is doubtful the FCA's writ runs, eg in relation to payment processing of cryptocurrencies;
- even where the Guidance has been followed, there remains a material risk to users that they will not recover 100% of their funds in a processor's insolvency.

In the light of this, it is suggested that:

- the FCA will need to consider whether it can tighten its Guidance further in the next Approach Document;
- more fundamentally, the question of whether users of payment processors should be protected by the FSCS ought to be revisited; it is hard to see a good justification for their exclusion from the Scheme;
- lastly, there is a case for considering whether users should have statutory protection in the form of (say) super-priority on a processor's insolvency, although that raises complex considerations beyond the scope of this article. ■

References:

- FCA, 'Coronavirus and safeguarding customers' funds: additional guidance for payment and e-money firms', 9 July 2020.
- Proctor, C 2019, 'Cryptocurrencies in International and Public Law Conceptions of Money', in D Fox and S Green, *Cryptocurrenices in Public and Private Law*, 33-55.

Further Reading:

- Crypto-assets: regulating a new economy (2018) 11 JIBFL 715.
- In Open Banking's brave new world could using a third party to initiate payments weaken consumer protection? (2019) 1 JIBFL 25.
- LexisPSL: Financial Services: Wirecard class action raises regulator immunity questions.