

Payment services firms

October 2020



Payment services firms – navigating operational and regulatory challenges amidst an age of uncertainty

The payment services landscape has evolved significantly over the last few years, with consumers and businesses increasingly using payment institutions and electronic money firms to undertake activities traditionally undertaken by banks. This has significantly picked up with the rising market and economic uncertainty brought about by Brexit and the COVID-19 pandemic. There is now even more focus on payment institutions and electronic money firms to mitigate harm to customers and increase operational resilience.



FCA's focus to protect payments services consumers has stepped up prudential risk supervision to standards that are more akin to banking

The FCA's July 2020 Dear CEO letter highlighted that financial crime and prudential risk are a key area of focus; along with its short consultation proposing additional temporary guidance to strengthen payment firms' prudential risk management. The regulator's recent guidance covering stress testing, risk management and wind down plans is more akin to what we would normally see for banks. However it should be noted that management procedures and controls should be robust and appropriate for the size and complexity of the business. The demonstration of effective oversight by senior management is also a prominent FCA focus, and firms should have an effective governance framework, clearly documented ownership and accountability to comply with regulatory requirements. The FCA may use the principles for effective governance emphasised in the Senior Manager Regime, even though it does not apply to e-money and payments firms.



Step change needed for capital management and stress testing

Firms should ensure they meet their own fund requirements and maintain sufficient capital to absorb losses and remain solvent. Firms need to ensure that internal systems and controls accurately reflect minimum requirements set out by the Payment Services Regulator (PSR), and relevant executive or board committees are frequently monitoring the firm's capital position to maintain a forward-looking capital plan which aligns with business growth. Stress testing is typically used to determine capital sufficiency, which may be beyond the minimum capital requirements.

The FCA requires firms to carry out both liquidity and capital stress testing to analyse exposures to business disruptions and their impact. Stress scenario assumptions development should involve all relevant first line business areas and be driven by the risk function, enabling firms to consider relevant macroeconomic variables and firm-specific factors as stress test inputs aligning to key risks. An assessment of how scenarios materialise should be documented with references to variables associated with key risk drivers, together with justification based on historic data or expert judgement. Management actions should be practical and reasonable in order to reduce the impact of stress; in particular they should consider at what trigger points certain actions are taken. Firms will face distinct challenges as the appropriateness and ease of implementing management actions continues to be a key focus of the regulator.



Failure to manage financial risks associated with poor operational controls across cash and liquidity management can lead to significant losses

Like banks, non-bank payment institutions (PIs) are vulnerable to cash flow mismatches, reconciliation breaks and intraday liquidity shortfalls. PIs are therefore being urged to enhance governance and risk management controls around liquidity management so they are better equipped to monitor cash movements including intraday flows to mitigate potential shortfalls and avoid the inability to complete client payment transactions. More proactive firms should develop cash flow forecasts using client/counterparty behavioural assumptions to better anticipate cash movements and therefore optimise liquidity using techniques such as agent-based modelling. This can form the basis of liquidity stress scenarios.



Payment firms may be facilitating money laundering, terrorist financing, bribery and corruption

The recent regulatory and media attention on the leakage of US Financial Crimes Enforcement Network ('FinCEN') documents has emphasised why financial crime prevention continues to be a key priority for the FCA. The increasingly digital economy is undergoing a period of significant change and is well-supported by the emerging payments sector, which is a prime target for financial criminals eager to exploit gaps in financial crime prevention controls. Payment firms risk not only their reputation but also their licence to operate. As well as heavy fines, firms can face criminal investigation where their financial crime prevention systems and controls are inadequate or ineffective in mitigating financial crime. Many of the failings across financial crime systems and controls can be attributed to:

- Firms not having an effective business-wide anti-money laundering risk assessment;
- Absence of client risk assessments or assessments with methodologies that didn't include all relevant risk factors;
- A lack of effective and risk-sensitive enhanced due diligence for high-risk clients; and
- Senior management and firms not having adequate oversight of agents, particularly where these operate overseas.

The FCA expects '**senior management to take clear responsibility for managing financial crime risks, which should be treated in the same manner as other risks faced by the business**' and that firms can '**evidence that senior management are actively engaged in the firm's approach to addressing the risks**'. It is therefore clear that Management must remain engaged in the process of managing financial crime risk, thereby supplementing dedicated resources (MLRO/Compliance) as they would with any other critical business area.



Payment firms face significant reputational damage due to insufficient operational risk controls

Businesses and consumers are dependent on reliable payment platforms with robust operational controls. Errors due to lack of control can result in serious reputational damage and significant litigation costs. Recently, Citigroup courted media attention over an operational error which led to a \$900m payment of the bank's own funds to the creditors of a troubled cosmetics company. The operational controls failure which led to the error was caused in part due to manual processes and insufficient four-eye checks prior to payment execution. The bank has since implemented additional controls, albeit at a significant upfront cost that could have been avoided.



Service disruptions are increasingly common due to DoS cyber attacks and lack of business resilience testing

Unexpected system outages, cyber attacks and global payments disruptions are all significant high impact events that many payment firms are ill-prepared against. Firms that do not regularly test business resilience against these scenarios are often at the highest risk and have the lowest survivability under catastrophic economic and market conditions. Testing should include a comprehensive review of business continuity and disaster recovery planning to ensure alternative fail-safe methods for continuing to process payments and minimise losses under adverse conditions.



Ageing infrastructure and manual processes are an indication of firms at high risk

Payment firms operating outdated systems and manual processes tend to be more likely to face significant operational risk losses, given higher burdens on operational staff to compensate for the general lack of automation and high susceptibility to human error due to insufficient systemic data validation controls. Due to the centrality of payment systems, it eventually leads to poor risk decisions based upon inaccurate or invalid payment information, affecting judgement of liquidity risk exposures which rely on transaction level and cash movement information.



Payment firms need to focus on maintaining continuous funding availability

Our experience has found that many non-bank payment firms do not consider how they will continue to fund payment activities under adverse market conditions. Since regulatory pressure is applied more on banks compared to non-bank payment firms, particularly in relation to liquidity and funding adequacy, it has meant less board-level focus on risks which impact solvency and liquidity. Prudent payment firms also focus on contingent funding, such as holding freely accessible cash reserves calibrated against expected intraday volatility, to reduce intraday liquidity risks where conventional sources are unavailable, such as under market-wide liquidity stress.



Wind-down plans are now a requirement for all e-money and payment firms

The recent collapse of Wirecard and Ipagoo has highlighted the extent of the adverse impact on consumers, clients and other market participants when a firm winds down regulated business without sufficient control or adequate planning. The FCA now requires e-money and payment services firms to have wind-down plans in place. Effective wind-down planning aims to ensure firms can cease regulated activities and implement cancelling permissions in an orderly way, with minimal impact on clients, counterparties or wider markets. Planning also helps firms consciously assess resource adequacy to execute an orderly wind-down, although firms will need to calibrate the appropriate trigger point to begin the process. These may range from the point where business becomes non-viable, to when severe risk events crystallise. Firms should assess and mitigate any impacts on consumers, merchants, employees and services providers, although we expect this activity to be difficult to plan in terms of scope and complexity. Assessments should also consider analysis on the ability for counterparties to find alternative providers and required actions to treat customers fairly during the wind down period, consistent with the regulator's expectations.



Uncertainty has been created by Brexit and continuity concerns across EU operations due to lack of equivalence determination

Payment firms will face additional uncertainty as the Brexit transition period ends on 31 December 2020. The ability of UK-based firms to continue to provide payment services in the EU depends on the EU making an equivalence determination regarding the UK's payments firm regulatory and supervisory framework. The provision of equivalence determinations in financial services seems unlikely to be made until wider political progress is seen in UK-EU trade negotiations, and firms risk having very short periods to make new arrangements towards the end of the year. Regulators are urging financial services firms to communicate with clients about options for continued service access, when the transition period ends. Without European equivalence decisions, payments firms face additional complexity in dealing with competent authorities in each member state of their EU-based customers. The Single European Payments Area (SEPA) Credit Transfer (SCT) and SEPA Direct Debit (SDD) rules, with additional data requirements for cross-border transactions to and from third countries, will become applicable to the UK.

PwC has a wealth of experience and expertise across the prudential regulatory and financial risk management disciplines within the Payments sector. Our Prudential Regulations and FS Treasury practice is on hand to further discuss any of the challenges raised in this paper.

If you would like more information, please do not hesitate to get in touch with us.

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2020-10-15_RITM3893986