Feature

KEY POINTS

- The *Re Ipagoo* saga in the English courts had raised questions regarding the protection afforded to customer funds that have been safeguarded by payment and e-money institutions in accordance with e-money and payment services regulations.
- The recent failure of Silicon Valley Bank UK (SVB UK) may have made resolving the uncertainties all the more urgent, but potential chaos for the the Financial Services Compensation Scheme (FSCS) and end customers of the bank's e-money and payment services clients was avoided as a result of the rescue of the bank.
- Keen to address the sorry state of affairs, the UK government and regulatory authorities have been seeking to fix the regime through regulatory reform.

Authors Ferdisha Snagg, George Bumpus and Andreas Wildner

Reforming the UK's e-money and payment services safeguarded funds regimes: better safe than sorry

This article examines the safeguarding requirements for e-money institutions and payment services firms and their treatment under the UK's depositor protection regime, which was recently updated to address the legal uncertainty resulting from the Court of Appeal's decision in the *Re Ipagoo* case and highlights the likelihood of further regulatory reform in this area.

INTRODUCTION

On 10 March 2023, Silicon Valley Bank (SVB), the sixteenth biggest bank in the US, failed. That then precipitated the failure of SVB's UK subsidiary, Silicon Valley Bank UK (SVB UK). At 11:45pm on 10 March, the Bank of England (BoE) issued a statement, which indicated that "absent any meaningful further information" it intended to apply to the court to place SVB UK into "a Bank Insolvency Procedure". A corresponding statement on SVB UK's website stated that the intention was to put SVB UK into insolvency from the evening of 12 March 2023.

The "bank insolvency procedure" (BIP) is a modified insolvency procedure for banks, under Pt 2 of the Banking Act 2009. Its primary objective is for the BIP liquidator to work with the UK's bank depositor protection scheme, the Financial Services Compensation Scheme (FSCS) to ensure that, as soon as reasonably practicable, each depositor who is eligible for FSCS-protection either has their accounts transferred to another bank or receives compensation from the FSCS.

In the end, however, it was announced on 13 March 2023, that the BoE had used its resolution powers under Pt 1 of the Banking Act to write-down SVB UK's Additional Tier 1 and Tier 2 capital instruments, and transfer the shares in SVB UK to a private sector purchaser, HSBC UK Bank plc.

One issue which may have played out if the BoE had proceeded with the BIP, and which was therefore avoided by the resolution, was the eligibility of "safeguarded funds" held by electronic money institutions (EMIs) and payment institutions ("PIs", together with EMIs, "Institutions") with SVB UK for FSCS compensation. As of 10 March, SVB UK held £251m in deposits from Institutions.[1]

This is a question which has always been subject to a degree of uncertainty, but this uncertainty was exacerbated by the decision in *In the Matter of Ipagoo LLP (in administration)* (*Re Ipagoo*).[2]

This article examines the safeguarding requirements under the Electronic Money Regulations 2011 (EMRs) and the Payment Services Regulations 2017 (PSRs) and their treatment under FSCS rules, which were recently amended by the Prudential Regulation Authority (PRA) to address the legal uncertainty resulting from the Court of Appeal's decision in the *Re Ipagoo* case. It also highlights the likelihood of further regulatory reform in this area.

BACKGROUND: SAFEGUARDING REQUIREMENTS UNDER THE PSRs AND EMRs

UK Institutions are required to "safeguard" certain funds, known as "relevant funds", under the EMRs and the PSRs, respectively. For the purposes of the EMRs, "relevant funds" are funds that have been received in exchange for e-money issued by the EMI. For purposes of the PSRs, "relevant funds" include both: (i) sums received from, or for the benefit of, a payment service user for the execution of a payment transaction; and (ii) sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user.

Under both the EMRs and the PSRs, Institutions have two options for how relevant funds may be safeguarded: either via the "segregation" method or the "insurance" method.

Under the segregation method, Institutions may safeguard relevant funds in one of two ways, either: (i) place the relevant funds in a separate account that they hold with a credit institution (a Safeguarding Bank) authorised under the Financial Services and Markets Act 2000 (FSMA) or the BoE; or (ii) invest the relevant funds in secure, liquid, low-risk assets (relevant assets) and place those assets in a separate account with an authorised custodian.

Both regulations further specify particular segregation obligations: an account in which relevant funds or relevant assets are placed must only be used for holding such funds or assets (or proceeds arising from the insurance option) and must be designated as an account which is held for the purpose of safeguarding relevant funds or relevant assets in accordance

Biog box
Ferdisha Snagg is counsel at Cleary Gottlieb Steen & Hamilton LLP, specialising in UK financial services regulation. Email: fsnagg@cgsh.com

with the respective regulation. Moreover, no person other than the relevant Institution may have any interest in or right over the relevant funds or the relevant assets placed in an account (except as provided otherwise in the respective regulation).

Under the insurance option, Institutions must ensure that relevant funds are covered by an insurance policy by a FSMA-authorised insurer, or by a guarantee from such an insurer or a FSMA-authorised credit institution.

Together, any relevant funds and assets (and any proceeds of an insurance policy or guarantee) constitute the "asset pool".

NATURE OF SAFEGUARDED FUNDS

Both the PSRs and EMRs provide that, where there is an "insolvency event" in relation to an Institution (eg a winding-up or bankruptcy order or entry into administration), the claims of Institutions' customers (ie of e-money holders and payment service users respectively) are given priority over the claims of all other creditors of the relevant Institution. The regulations further provide that, subject to specific exemptions, no right of set-off or security right may be exercised in respect of the asset pool until all the claims of Institutions' customers have been paid.

The legal effect of these insolvency event provisions was considered in detail by the Court of Appeal in *Re Ipagoo*.

Ipagoo LLP (Ipagoo) was authorised by the Financial Conduct Authority (FCA) to issue e-money under the EMRs and provide certain payment services. Ipagoo subsequently became insolvent and went into administration. As noted by the court, there appeared to have been serious non-compliance with the EMR safeguarding requirements; so much so that it was not possible to determine whether any relevant funds were safeguarded in the manner required by the EMRs. For that reason, the joint administrators applied to the court for directions how to distribute funds held by Ipagoo. The FCA intervened at the administrators' invitation.

The two main questions to be determined were: (i) whether, by virtue of the framework set up by the EMRs, the relevant funds were held by Ipagoo on a statutory trust; and (ii) whether, in circumstances where the relevant funds had not (or only partly) been safeguarded, Ipagoo's customers' priority claims should extend to Ipagoo's general estate, to make up for the shortfall in the asset pool.

Agreeing with the judgment at first instance, the Court of Appeal held that the relevant funds were *not* held on trust. Instead, customers had "priority claims" in respect of the asset pool. This means that, despite the absence of a statutory trust, there was a statutory right for customers to be paid relevant funds in priority to other creditors in respect of the asset pool. In relation to the second issue, the court held that the asset pool included a sum equal to all relevant funds which ought to have been but may not have been safeguarded.

This was based on a careful interpretation of the requirements under the EMRs, construed against the background of Directive 2009/110/EC (EMD) which the EMRs implemented. One of a number of factors in respect of the first finding was that, whilst the EMD specifically creates rights superior to other creditors' in an insolvency event, imposing a trust structure on such assets would result in more extensive rights than that, and the purpose of the relevant provisions in the EMD was not to create such rights.

Prior to the *Re Ipagoo* case, the FCA's position had been that relevant funds were held on trust, which in the FCA's view was necessary to ensure an adequate level of customer protection.

IMPACT OF *RE IPAGOO* ON DEPOSITOR PROTECTION

The FSCS pays compensation under certain circumstances to customers of UK financial services firms if the firm is unable, or likely to be unable, to pay claims against it. Rules on when the FSCS pays compensation in respect of deposits held by FSMA authorised credit institutions are set out in the Rulebook of the PRA, which specify that FSCS compensation (of up to £85,000) in respect of an eligible deposit is generally only payable to the depositor (ie the accountholder), subject to certain exceptions such as where another person is "absolutely entitled" to the eligible deposit.

Not only did the position of the Court of Appeal in *Re Ipagoo* upset the conventionally accepted analysis of the legal nature of safeguarded funds (as trust funds), it created ambiguity over the question of whether the end customers of an EMI or PI had an absolute entitlement to the safeguarded deposits and were therefore entitled to FSCS compensation in the event of the failure of the Safeguarding Bank (FSCS protection is not available in the event of a failure at the level of an Institution, since Institutions are not banks).

The PRA's Depositor Protection Rule 6.10 provides that the cases in which a person is absolutely entitled to the eligible deposit include where they are a client in respect of money which the account holder is treating as client money of the person in accordance with FCA rules, the SRA Accounts Rules 2011 or an equivalent regime. The safeguarding regimes under the EMRs and PSRs are, arguably, "equivalent regimes" to the FCA's client money rules under its Client Assets Sourcebook (CASS). The "priority claim" analysis employed by the court in *Re Ipagoo*, is not entirely unanalogous to the position resulting from a trust for these purposes: both priority claimants and trust beneficiaries could be said to have an "entitlement" to the relevant funds – albeit that for a priority claimant the entitlement is not a beneficial interest. Nonetheless, these arguments are not free from doubt.

REGULATORY CLARIFICATION

In its consultation paper on Depositor Protection (Consultation),[3] the PRA acknowledged the uncertainty caused by *Re Ipagoo* and the risk that the FSCS could not provide compensation to end customers if a Safeguarding Bank were to fail, which, it noted, was not the intention of the original policy of the Depositor Protection rules.

It therefore proposed to address the disruption caused by *Re Ipagoo* by amending its rules to ensure that FSCS depositor protection was available to eligible customers of an Institution in respect of their relevant proportion of safeguarded funds should the Safeguarding Bank holding the safeguarded deposits fail. Notably, its proposals included

Biog box

George Bumpus is an associate at Cleary Gottlieb Steen & Hamilton LLP, specialising in UK financial services regulation. Email: gbumpus@cgsh.com

Andreas Wildner is a associate at Cleary Gottlieb Steen & Hamilton LLP, specialising in UK and EU financial services regulation, ESG matters and financial sanctions advice. Email: awildner@cgsh.com

that end customers of an Institution should, potentially, each receive compensation up to the £85,000 limit.

Crucially, the PRA's approach was not to amend the Depositor Rule 6.10 to add EMI or PI customers as a category of persons with absolute entitlement (which, we expect, it might have had to do if the UK were still part of the EU). Instead, the PRA employed the concept of "priority creditors", providing for a bespoke set of pay-out rules for such persons. In particular, under the amended rules each end customer would need to be eligible for FSCS protection under the PRA's pre-existing eligibility requirements, meaning that not all customers would be entitled to receive FSCS compensation. End customers would also not be eligible for protection if they were unidentifiable (eg in the case of an EMI customer where the e-money was anonymous) or could not be verified under anti-money laundering rules.

For the Safeguarding Bank, the safeguarded deposits would fall under the "exclusions view" file (and be recorded as a safeguarded deposit) for the purposes of the PRA's "single customer view" requirements under the Depositor Protection rules in the PRA Rulebook. However, as the PRA cannot make rules requiring Institutions to maintain up-to-date customer details, the PRA also proposed to amend the rules to allow the FSCS additional time to effect a pay-out in respect of safeguarded funds in the event of a delay.

In the event of the failure of the Safeguarding Bank, the FSCS would be able to pay compensation either:

- into a new safeguarding account of the Institution, provided the Institution is not subject to a formal insolvency procedure and the FSCS is satisfied that each eligible end customer would be in no worse position than if the compensation was paid directly; or
- directly to the eligible end customers of the Institution or to another person as directed by the end customer, if there has been an insolvency event at the Institution.

In a policy statement published on 29 March 2023,[4] the PRA announced that it had brought in the proposed changes (with certain minor edits relative to the proposals as set out in the Consultation), effective as of 12 March 2023 – a little earlier than perhaps expected given that final rules were scheduled to be published in "H1 2023", according to the UK regulators' February 2023 regulatory initiatives grid.[5] The effective date of the policy statement is interesting since this was the date on which it had been expected that SVB UK would have entered into insolvency, had the BoE gone ahead with the BIP, and perhaps this was intended to clarify the position and facilitate the FSCS pay-out for SVB UK. How this may have played out in practice, though, is not certain.

FUTURE REGULATORY DEVELOPMENTS

HM Treasury too has been concerned by the ambiguity surrounding the safeguarding regime and the potential for it to result in cost, delay and risk of consumer harm in insolvency situations. In its January 2023 review and call for evidence on the PSRs (PSR Review),[6] HM Treasury stated that the UK government's proposed future regulatory framework would lend itself to transferring to the FCA responsibility for developing and delivering the safeguarding regime for payments and e-money (within a framework set by the government and Parliament). In HM Treasury's view, adopting this approach would enable the safeguarding regime to benefit from greater regulatory agility.

Furthermore, while acknowledging that *Re Ipagoo* clarified the mechanics of the current regime, the PSR Review signals HM Treasury's clear preference for the FCA's CASS rules, under which safeguarded funds are held on trust.

Accordingly, while the specifics of the future safeguarding regime for Institutions would be subject, first, to the replacement framework established by Parliament and HM Treasury and then to consultation by the FCA, HM Treasury's favourable comparison of the CASS regime to the unfortunate state of the current safeguarding rules, in light of *Re Ipagoo*, suggests that it would be supportive of a regime that follows a similar model.

Indeed, both the government and the FCA seem to support a trust-based regime not only because it promotes clarity in insolvency contexts: HM Treasury, for example, highlighted that the CASS statutory trust regime imposes on Institutions fiduciary duties; and, in its appeal against the first-instance decision in *Re Ipagoo*, the FCA argued that imposing a trust was necessary to ensure adequate customer protection (eg to enable customers to trace relevant funds into the hands of third parties, where an Institution wrongfully dissipated such funds).

If this approach is pursued, the PRA would likely need to make at least technical amendments to its Depositor Protection rules, though we would not expect a departure from the overall policy approach of the new rules. ■

1 See the letter from the Governor of the Bank of England to the Treasury Committee, dated 22 March 2023: https://committees.parliament.uk/publications/34533/documents/190168/default/

2 [2022] EWCA Civ 302: https://www.bailii.org/ew/cases/EWCA/Civ/2022/302.html

3 The PRA's consultation paper on Depositor Protection (CP 9/22): https://www.bankofengland.co.uk/prudential-regulation/publication/2022/september/depositor-protection

4 The PRA's policy statement on Depositor Protection (PS 2/23): https://www.bankofengland.co.uk/prudential-regulation/publication/2023/march/depositor-protection

5 https://www.fca.org.uk/publications/corporate-documents/regulatory-initiatives-grid

6 The PSR Review: https://www.gov.uk/government/consultations/payment-services-regulations-review-and-call-for-evidence

Further reading:

- Take it on trust: "relevant funds" under The Payment and Electronic Money Institution Insolvency Regulations 2021 (2021) 8 JIBFL 566.
- Case Analysis (2022) 5 JIBFL 354.
- Lexis+® UK: Segregation obligations in Electronic Money Regulations 2011 held not to create trust (*Re Ipagoo LLP*).