

A Discussion Paper on Proposals for the Regulation of Electronic Money Providers

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Financial Supervision Commission Barrantee Oaseirys

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SECTION I

I. INTRODUCTION

The Commission has been charged with the development of a regime to regulate electronic money (“e-money”) providers operating in or from the Island.

Based on analysis of the regulations applying in other jurisdictions and discussions with a number of interested parties, this document sets out the proposed approach to regulation of e-money. We would welcome your comments on these proposals.

At the close of the consultation we will arrange a meeting with interested parties, to discuss the findings and, we hope, agree the way forward.

Subject to your comments on this initial document, the intention is to release a consultation paper during the first quarter of 2007 which will set out the proposed regime in more detail. It is intended that regulations will be progressed through the legislative process in conjunction with the Financial Services Bill and related secondary legislation with a view to implementation early in 2008.

A draft of the Financial Services Bill is to be released for consultation in the near future; you may want to familiarise yourself with its content or participate in the consultation.

It would assist us in our consideration of responses if you could provide comments in answer to the specific questions included. However, we welcome your views on all related issues. A separate document, with space provided for answers to the specific questions and for general comments, will be issued along with the discussion paper; you may find it useful to use this document for providing your response.

It would be much appreciated if we could have your response as soon as possible and at the latest by **2nd February 2007**.

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SECTION 2

2 PROPOSED REGULATIONS

This paper sets out the Commission's proposed approach to the regulation of e-money providers. The Commission's aim is to introduce a regulatory regime which supports consumer and merchant confidence in e-money products while addressing any potential reputational risk that e-money may pose to the Island. The Commission proposes to manage such risks by ensuring issuers of e-money have adequate capital, expertise and systems and controls to manage their business effectively, coupled with restrictions on the activities of the issuer particularly in relation to the investment of money held on behalf of customers. Issuers would also be required to retain suitable records and report on a regular basis on their compliance with the regime.

For each of the key areas, the high-level requirements are listed below, sometimes with more than one possible option. Comments are welcome on any issue connected to e-money regulation, but for each key area there are one or more questions (combined at Section 3) on which we would like your views.

2.1 Regulated activities

The intention is to follow the UK's definition of e-money, as follows:

“E-money is monetary value, as represented by a claim on the issuer, which is:
(1) stored on an electronic device;
(2) issued on receipt of funds; and
(3) accepted as a means of payment by persons other than the issuer.”

All issuers of e-money operating in or from the Isle of Man will need to be licensed by the Commission under the proposed regime.

In relation to holders of banking licences, we propose that the institution be allowed to issue e-money under an extension to their existing licence. We have not yet analysed in detail how the regime would apply in this circumstance and would welcome views as to how this might operate in practice.

It is generally the issuer of the e-money that we will regulate. Where the e-money product is offered to clients through a third party, then the requirements will, subject to certain criteria, apply to the issuer and not the distributor.

Question - *Do you believe a definition of e-money based upon the UK definition would be suitable for Isle of Man based E-Money Providers? In particular:-*

- *Do you think this covers all appropriate E-Money products and services?*
- *Is there a danger that this definition might include products and services that should not be subject to these regulations?*

2.2 Restrictions on Activities

Providers will be restricted to the issuing of e-money and the provision of services closely related to the issuing of e-money. These related activities include the administration of the e-money scheme and the storing of data relating to the creation, redemption and spending of e-money.

Providers will not be permitted to offer any form of credit.

To help maintain the distinction between e-money and deposit taking the UK prevents e-money issuers from applying interest to client balances. The Commission has not settled on an approach to applying interest and this may be linked to the decision on how client money is held (see section 2.5 Capital and own fund requirements).

Questions – Do you have any comments on the restrictions of activities applying to e-money providers?

Do you believe that e-money providers should be permitted to pay interest on outstanding e-money balances?

2.3 Licensing

In considering a licence application the Commission applies its consolidated licensing policy. This policy will be adapted to apply to e-money issuers, but will include, as a minimum, the following requirements.

Fit and proper person

The applicant, and any controller, director, chief executive or manager of the applicant, must be a fit and proper person to carry on the regulated activity and provide the services described in the application. Integrity, competence, and financial standing, plus the structure and organisation of the applicant, are the criteria that will be used to assess the fit and proper test.

Presence on the island

There must be a real, ongoing presence on the island. This presence will generally require that 'mind and management' and the control of key operational tasks are carried out on the island.

The presence on the island requirements does not mean that all activities must be here. Consideration is given to activities being outsourced, including to other group companies, off the island. We would welcome your comments on this.

Systems and controls

The systems and controls in place must be appropriate to the business. In assessing the systems and controls necessary, regard will be taken of the nature of the

business, the diversity of the operations, the territories where the product is used, the volume and size of transactions and the degree of risk arising from activities.

In addition there should be clear and appropriate apportionment of significant responsibilities among the directors and senior managers.

For a better understanding of the Commission's current licensing approach, you should refer to the Commission's Consolidated Licensing Policy (available at: http://www.gov.im/lib/docs/fsc/handbooks/guides/Cis/cis_appendixm1.pdf). You may also find it useful to refer to the Commission's Training and Competence Framework (<http://www.gov.im/lib/docs/fsc/policystatements/tandc0406.pdf>) which sets out the Commission's approach to training and competence at organisation and key person level, and to the Commission's Outsourcing Policy (http://www.gov.im/lib/docs/fsc/policystatements/outsourcing_final.pdf).

Acceptable Use Policy

In addition to the standard requirements, due to the nature of the business, the Commission will expect e-money issuers to have a suitable acceptable usage policy in place. The usage policy should indicate the type of activities for which their product can be used or is prohibited from being used.

Question – Do you foresee any problems with the application of the licensing requirements to the e-money operators?

2.4 Anti-money laundering requirements

We are aware that the UK has varied the standard AML requirements specifically for e-money issuers. In practice the identity of the customer does not need to be verified prior to a transaction taking place. Verification is only required when e-money is redeemed or the total turnover on the account exceeds £5,000.

In addition, the EU's third AML Directive may allow e-money issuers not to apply customer due diligence in certain circumstances. This is likely to be where the total turnover on account or the amount redeemed from an account is below a particular level in a calendar year or, for accounts that can't be recharged, where the maximum amount that can be loaded is below a given amount.

All e-money issuers will be subject to the IOM Anti Money Laundering Code and the FSC's more detailed rules and guidance for licenceholders on Anti-Money Laundering procedures and practice. Effective systems and controls will need to be established and maintained to comply with the requirements.

The provider will need to appoint an individual as Money Laundering Reporting Officer, with responsibility for considering all internal suspicious transaction reports. In addition, the provider has to make sure that adequate resources are given to its compliance function so that processes are implemented and maintained to satisfy the regulations.

The existing Anti Money Laundering requirements are currently being reviewed and are likely to be revised in the coming months. One of the outcomes will be the adoption of a risk based approach. If the regulation of e-money issuers is to proceed, the specific considerations relating to this industry will be taken into account in the development of the new requirements and further consultation will take place on this in due course. The exact timing of this is not known at present.

Questions – Are there expectations as to the anti-money laundering requirements which should be applied to e-money issuers? Would waivers of the type applied in the UK be suitable?

2.5 Capital and own fund requirements

Issuers will be required to have adequate financial resources to support the level and type of business they intend to transact.

One of the key components of any financial resource requirements is the amount of capital that an issuer will be required to maintain. In setting the capital requirements we feel an important factor is how clients' money is held.

One option is for client money to be in a segregated client account, so that the funds are not held on the provider's balance sheet and do not represent part of the provider's assets.

The alternative is for the issuer to treat client money like a deposit so that it becomes an asset of the company. As a result there is a debtor-creditor relationship between the issuer and the customer. This approach carries the additional risk for the client that the client's money would form part of the assets of the provider available to general creditors in the event of the company being wound up. This risk is mitigated where the client's money is held in a segregated client money account.

As a result, where there is a segregated client account and the risk to client funds is therefore deemed to be lower, it is possible to consider a less onerous financial resource requirement. Our view is that with this approach the issuer's position is

comparable to a category 3(b) or 4 investment business licence¹ for which the minimum net tangible assets requirements currently range between £75,000 and £175,000.

As a comparison, e-money issuers in the UK, who are permitted to hold funds as deposits and as such are on the institutions balance sheet, are required to have a minimum initial capital of €1 million and the “own funds” requirements increase proportionately to the value of outstanding e-money (the clients’ money). It is likely that similar limits may be applied in the Isle of Man to e-money providers who wish to hold deposits rather than operate clients’ accounts.

Whilst, the Commission’s preference is for the segregated account approach, it is likely that, even within this approach, there may not be a single limit for capital adequacy. More likely, there will be a tiered requirement based on the size of the company involved – with size being judged on turnover, outstanding e-money and / or the number of employees.

Regardless of the approach adopted, there would be an additional requirement that the issuer will need to hold sufficient liquid funds, at all times, to cover operating expenses for three months.

Questions – *Do you favour a regime where all customer balances are held in a segregated client account rather than “on balance sheet”?*

What level of Minimum Net Tangible Assets do you believe would be appropriate for an e-money provider:

- a) *holding balances in a segregated client account?*
- b) *holding balances on balance sheet?*

Do you foresee any difficulties with the ongoing liquidity requirement?

¹ Category 3 group (b) licenceholders are persons who:

- (a) manage authorised collective investment schemes, and/or;
- (b) manage or administer professional investor funds and/or experienced investor funds, and/or;
- (c) administer managed portfolio managers, and/or;
- (d) act as investment manager with discretionary powers of investment to collective investment schemes, or occupational pension schemes whether the schemes are established in the Island or elsewhere, and/or;
- (e) undertake other investment business apart from that included in categories 1, 2, 3 group (a), 4 and 5.

Category 4 licenceholders are persons providing administrative services to managers of authorised and/or international collective investment schemes including experienced investor funds and professional investor funds.

(for full details refer to the Financial Resource and Compliance Requirements Code available at: http://www.gov.im/fsc/handbooks/guides/Investment_Business/pdf/IB_appendix%20C1a.PDF)

2.6 Management of client money

Providers will be expected, at all times, to hold low risk assets equal to the value of the total outstanding e-money.

There will be a requirement to hold sufficient liquid funds to satisfy redemption needs. This will permit the investment of a proportion of the client money in longer term assets. Issuers will have to demonstrate that the liquidity profile of the client money holding is suitable to meet predicted redemptions, evidenced by historical data.

Issuers will need to have procedures in place to limit their exposure to foreign exchange risks. In the absence of significant own funds holdings, the issuer will be expected to review and remove any exposure on a regular basis.

The e-money issuer will be required to manage the investment of client money to ensure that it does not have a large exposure to a single institution.

Should the value of the client float fall below the value of total outstanding e-money the provider will be expected to meet the shortfall from its own funds.

Question – Do you have any views on the types of assets or on the approach to treasury management that should be permitted for management of client money?

2.7 Record keeping

A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system

The issuer will be expected to maintain records evidencing the history of a customer's account including a full audit trail of all transactions. The records will need to be retained for a period of at least six years.

The customer verification evidence, required to satisfy anti money laundering requirements, will need to be retained for at least six years after the termination of the relationship with the client.

Questions – Are the proposed record keeping requirements likely to pose any problems for e-money providers?

Is there any other data on which you feel e-money providers should be required to maintain records?

2.8 Reporting requirements

Each issuer will be expected to provide audited financial accounts annually.

In addition, the Commission will require management accounts and a compliance statement to be submitted quarterly. The management accounts should include details of investments, client money balances and liquid capital. There should also be comment on compliance with the regulations, with any breaches reported and details of the actions taken or being taken to eliminate them.

The client account should be reconciled on a routine and regular basis. The quarterly reports should evidence the regular reconciliations and provide details of significant outstanding items based on value and age.

Question – Do you have any comments on the proposed frequency and content of the reporting requirements?

2.9 Systems

Due to the heavy reliance on computer systems, the Commission will require independent verification that the systems provide security against fraud, are robust enough to maintain availability and deliver functionality in line with client agreements.

To achieve this, the issuer must supply a report from their auditors, or a similar source approved by the Commission, on system suitability. This will be required for the licence application, on an annual basis and when there are major changes to systems.

Question – Is the proposed approach to system verification suitable? Is there an alternative approach that you feel is preferable?

2.10 Redeemability

An issuer will be expected to redeem at par any e-money issued on request of a customer, subject to a minimum redemption value of £10 or currency equivalent.

Any e-money issued must be valid for a minimum of one year from the date of issue.

Question – Do you have any comments to make in relation to the redeemability of e-money?

2.11 Licence Fees

Fees will be levied by the Commission for applying for a licence and on an annual basis. The level of fees will be confirmed at a later stage.

SECTION 3

3. SUMMARY OF QUESTIONS

The following is a full list of the questions contained in the body of the paper:

Question 1 – Section 2.1

Do you believe a definition of e-money based upon the UK definition would be suitable for Isle of Man based E-Money Providers? In particular:-

- Do you think this covers all appropriate E-Money products and services?
- Is there a danger that this definition might include products and services that should not be subject to these regulations?

Question 2 – Section 2.2

Do you have any comments on the restrictions of activities applying to e-money providers?

Question 3 – Section 2.2

Do you believe that e-money providers should be permitted to pay interest on outstanding e-money balances?

Question 4 – Section 2.3

Do you foresee any problems with the application of the licensing requirements to the e-money operators?

Question 5 – Section 2.4

Are there expectations as to the anti-money laundering requirements which should be applied to e-money issuers? Would waivers of the type applied in the UK be suitable?

Question 6 – Section 2.5

Do you favour a regime where all customer balances are held in a segregated client account rather than “on balance sheet”?

Question 7 – Section 2.5

What level of Minimum Net Tangible Assets do you believe would be appropriate for an e-money provider:

- a) holding balances in a segregated client account?
- b) holding balances on balance sheet?

Question 8 – Section 2.5

Do you foresee any difficulties with the ongoing liquidity requirement?

Question 9 – Section 2.6

Do you have any views on the types of investments or on the approach to treasury management that should be permitted for management of client money?

Question 10 – Section 2.7

Are the proposed record keeping requirements likely to pose any problems for e-money providers?

Question 11 – Section 2.7

Is there any other data on which you feel e-money providers should be required to maintain records?

Question 12 – Section 2.8

Do you have any comments on the proposed frequency and content of the reporting requirements?

Question 13 – Section 2.9

Is the proposed approach to system verification suitable? Is there an alternative approach that you feel is preferable?

Question 14 – Section 2.10

Do you have any comments to make in relation to the redeemability of e-money?