

Financial Services Authority

The Regulation of Electronic Money Issuers

Feedback on CP117

April 2002



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This Policy Statement sets out the views of the Financial Services Authority after considering responses to Consultation Paper 117 – The Regulation of Electronic Money Issuers. It also makes reference to Rules and Guidance contained in the ‘final’ Specialist Sourcebook for Electronic Money Issuers (‘ELM’). This sourcebook has been approved by the Board of the FSA and will come into effect from Saturday 27 April 2002. ELM can be found at our website under ‘Publications’, ‘FSA Handbook of Rules and Guidance’ (www.fsa.gov.uk). The sourcebook should be read in conjunction with the consequential amendments to the FSA Handbook, which include our guidance on the definition of e-money (AUTH App3). These consequential amendments can be found at our website under ‘FSA Handbook of Rules and Guidance’, ‘Legal instruments’.

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It is the FSA’s policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

Context

In December 2001, we published a consultation paper on The Regulation of Electronic Money Issuers (CP117). CP117 invited comments on our proposed approach to the regulation of e-money issuers and our draft rules and guidance. The consultation period closed on 13 February 2002. We received 12 responses to this CP from a wide range of potential electronic money issuers and from the Electronic Money Association ('EMA') which responded on behalf of its 16 members. A response was also received from the Financial Services Consumer Panel. The Annex contains a complete list of respondents. Other than those responses stated by their authors to be confidential, we are making the responses to CP117 available for inspection.

Many of the responses to consultation raised particular concerns on individual schemes. It is neither appropriate nor practicable to deal with individual queries in this Policy Statement. These will have to be explored and decided on a case by case basis. So our guidance is confined to statements of general application.

The fledgling e-money industry has given a generally very positive welcome to our proposed regime on which we consulted them extensively. They have told us that they have in particular appreciated our openness and willingness to listen to them.

Objective

It is the purpose of this Policy Statement to:

- map the proposed changes of policy arising out of consultation on CP117 and to explain the reasons for these changes;

- set out a cost benefit analysis of these proposed changes and show how this affects the cost benefit analysis of the new regime which we published in CP117; and
- show our belief that these proposed changes are compatible with our regulatory objectives and our general duties under FSMA 2000.

Map

(Note: references in the text – for example to ELM 4.3.6 – are to the sourcebook for Electronic Money (Module ELM of the FSA’s Handbook of Rules and Guidance). ELM can be found at the FSA’s website (www.fsa.gov.uk) under ‘Publications’.)

This policy statement has been organised along the lines of CP117. We proceed, in Part 2 below, through all the areas of policy set out in CP117, question by question. In terms of each question asked in CP117, we set out a summary of the responses received plus our reply. In Part 3 below, we set out a cost benefit analysis of our proposed policy changes and, in Part 4, a revised compatibility statement. The following paragraphs summarise the principal changes of policy and rules and guidance that we are proposing to make in consequence of our consultation on CP117.

Definition and Scope

We have amended our guidance on the definition of e-money in order (among other things) to clarify the distinction between e-money and deposit taking (see AUTH App 3).

We have also clarified the rules on issuing e-money at a discount (see ELM 4.4). The rule remains that firms must not issue e-money that has a value greater than its e-money issue price. All e-money issued must be fully backed up by investment in eligible assets as set out in our rules on management of the e-money float (see ELM 3). However, an e-money issuer may wish, for promotional reasons, to sell e-money to the public on terms that the purchaser pays less than its monetary value. It may be possible to do this without contravening our ban on issuing e-money at a discount. You can find the actual rule and guidance on issuing e-money at a discount in ELM 4.4.1 to 4.4.6.

The issue of e-money at a premium is no longer prohibited.

We have also clarified the position on delays caused by the need to clear customers’ cheques (ELM 4.3.6) and delays between payment for, and use of, e-money (AUTH 3.2.19).

We have made a rule banning the issue of e-money that is valid for less than a year (see ELM 6.4.3).

Management of the e-money float

In general, our rules on the management of the e-money float (ELM 3) follow the prescriptive requirements of the European e-money Directive and there is no scope to vary these. We can also confirm that the ban on the payment of interest on e-money is not meant to stop promotional activities such as the giving away of e-money free of charge on first load or loyalty or bonus payments in e-money. The question of payment of interest on e-money is a matter which the European Commission will review in 2005.

Restriction on activities

We have revised our rules on restriction on activities (ELM 4.3.1-4.3.3) to clarify that, in addition to issuing e-money, an e-money issuer may also provide financial and non-financial services closely related to issuing of e-money such as:

- the administering of e-money by the performance of operational and other ancillary functions related to its issuance;
- the issuing and administering of other means of payment; and
- the storing (on behalf of other undertakings or public institutions) of data on the firm's own e-money electronic devices.

Purse limits

We believe that the risks associated with the use of e-money warrant a purse limit. Responding to the arguments made by the industry, we have increased the limit of £250 per purse initially proposed to £1,000 (see ELM 6.9.1). This limit should only be exceeded if:

- there is written acknowledgement by customers that, in the absence of compensation, insolvency of the issuer may lead to a total loss of all e-money in their purses;
- the issuer is capable of blocking the use of a purse that has been reported lost, stolen, damaged or malfunctioning; and
- the issuer ensures the exercise of the redemption right over the monetary value in the blocked purse.

(See ELM 6.9.1 to 6.9.3).

Financial Ombudsman Service (FOS)

E-money issuers will be subject to FOS, but we propose that for the stub period of 2002/2003, they will fall in the minimum bracket where they will pay a nominal flat rate fee of £250. In due course we will consult on the most

appropriate longer term arrangements for incorporating e-money issuers within FOS, with a fee that reflects actual use of FOS by e-money consumers.

Next steps

The new regime is due to come into operation on Saturday 27 April 2002. We will publish our rules and guidance on e-money in a specialist sourcebook (Module ELM of the FSA Handbook of Rules and Guidance). We will make this available at our website (www.fsa.gov.uk) under 'Publications'.

Consequential amendments to other parts of the FSA Handbook of Rules and Guidance, including the guidance of the definition of e-money in AUTH, Appendix 3, will be found at the same place under 'Legal Instruments'. The operation of the e-money Directive in Member States is due to be reviewed by the European Union in 2005 and it is possible that further legislation could be enacted at that time. In the meantime, we will keep the workings of our ELM sourcebook under review.

2 Introduction

(Please note that part two is arranged to follow the order of the chapters of CP117 and the headings below reflect the chapter headings in CP117.)

Question asked in CP117:

Q1: Do you agree with our proposal to incorporate the rules and guidance relating to e-money institutions into a specialist sourcebook (Module ELM of the FSA Handbook of Rules and Guidance) rather than an interim prudential sourcebook? If not what would be your preferred approach?

Summary of the responses received

The people who sent in responses unanimously backed our proposal.

Our reply

We will include our e-money rules and guidance in a specialist sourcebook ('ELM').

3 Definition and scope

Question asked in CP117

Q2: Do you have any comments on the above approach to the definition of e-money?

Summary of the responses received

Many people made a large number of comments, most frequently reflecting concerns of particular application to the person responding. It is not the purpose of this Policy Statement to deal with particular questions that may be settled in bilateral discussions. Only the following points are of more general interest:

1. A clear definition is required of what is meant by electronic device. If a CHIP card is covered and a Magnetic Stripe Card is not, this could lead to a loophole that encourages the use of old technology and deters further technological advance.
2. So as to preserve the prepaid element of e-money, the words 'issued on receipt of funds' should be reinstated.
3. The principle of banning e-money issue at a discount is supported. But for marketing purposes, the following practices are often used:
 - (i) paying a commission to distributors of scratch cards (that is to say sell to them at a discount and top up the float from own funds); and
 - (ii) offering e-money to the public at a discount as a marketing promotion (and again to top up the float from own funds). This can be done by gratuitous offering of pre-loaded value; cash back or loyalty points linked to expenditure; or a combination of the two.

Some people requested specific guidance to make it clear that such schemes are not to be regarded as issuing at a discount. This is on condition that floats should always be made up to 100% of the e-money

in issue. It is accepted that, if necessary, we could put limits on the scope of such promotion schemes.

4. One person believes that issuers should be allowed to issue at a premium and wants the relevant rule amended to read: [firms]..... ‘may only issue e-money at an amount equal to its face value and for a price at least equal to its face value.’
5. Firms also believe that consumers should be able to spend their e-money at once, no matter how they have chosen to buy it. This implies there will be an element of credit until the e-money issuer receives cleared funds.

Our reply

General

The guidance we have written on the definition of e-money is intended to amplify the meaning of the statutory wording and to indicate in general terms how we will interpret it. We intend this guidance to apply to e-money issuers generally. We have not tailored it to apply to any particular scheme.

We have added a rule to ban issuing e-money that is valid for less than a year.

Specific Points (numbered as above)

1. Our guidance assumes that the term ‘electronic device’ includes ‘old technology’ such as magnetic stripe cards, as well as ‘new technology’ such as chip cards and other digital technology.
2. HM Treasury has now amended the statutory definition of e-money to include the words ‘issued on receipt of funds’, so as to preserve the prepaid element of e-money.
3. The definition of e-money originally proposed in the e-money Directive stipulated that e-money must be ‘issued on receipt of funds of an amount not less in value than the monetary value issued’. So as to prevent schemes escaping regulation as e-money by issuing e-value at a discount, HM Treasury decided to drop the words appearing after ‘issued on receipt of funds’ in this leg of the definition. They propose to leave it to us to introduce a rule specifically banning the issue of e-money at a discount.

As far as the proposed rule on prohibition of issuing e-money at a discount is concerned, one of the key messages coming out of the responses to consultation is that e-money firms would like the ability to sell e-money to their customers at a discount. They accept, however, that all e-money issued to the public must be backed up 100% by float moneys invested in eligible assets. There is a general feeling that in order to foster competition and persuade the public to switch from physical cash to the

new payments mechanism, a monetary inducement of this nature may have to be offered. However, the industry is concerned that the rules as currently drafted appear to prohibit firms from offering a monetary incentive to consumers to use a particular scheme.

In our view, no restrictions should be placed on a firm's commercial decision to offer an incentive to consumers. We have attempted to make the rules on issuing e-money at a discount clear (see ELM 4.4). The rule remains that firms must not issue e-money that has a value greater than its e-money issue price. All electronic money issued must be fully backed up by investment in eligible assets as set out in our rules on management of the e-money float (see ELM 3). However, an e-money issuer may wish, for promotional reasons, to sell e-money to the public on terms that the purchaser pays less than its monetary value. It could do this, for example, by giving away e-money to customers when they first load their purses, as an incentive to get them to start using the product. Alternatively, it could choose to give e-money away pro rata to e-money bought or to the value of goods and services obtained using the firm's own e-money. It may be possible to do this without contravening our ban on issuing e-money at a discount. It is possible that a sum, paid by a third party (such as the issuer's shareholder or another company in the issuer's group) could form part of the issue price of a firm's e-money provided that:

- the sum is paid before the e-money in question is issued;
- the sum is paid to the issuer in payment of part or all of the issue price for that e-money; and
- at the time when the issuer issues that e-money, it immediately applies the sum received towards payment of the e-money issue price of that e-money.

If a firm decides to launch a promotion that involves issuing e-money for less than its monetary value the firm should notify us of its intention and give details about the promotion. Those details should include:

- the type of promotion;
- any other businesses taking part in the promotion;
- the likely amount of the difference between the monetary value of the e-money concerned and its e-money issue price over the life of the promotion; and
- the proposed length of the promotion.

The firm should also keep us informed of changes in its view during the promotion and of any major difference between its projections and the actual outcome.

4. The issue of e-money at a premium is no longer banned. If issuers wish to issue e-money at a premium, that is to say issue less e-money than the funds received for it, then this is a commercial matter and not an issue for our Rules and Guidance.
5. Our guidance on the issue of e-money now states that if a person buys e-money from a firm and pays for it by cheque (so that the firm does not immediately receive value for it) that does not amount to the granting of credit by the firm.

Question asked in CP117

Q3: Is the guidance on definition set out in Annex 3 to this CP clear and adequate?

Summary of the responses received

General

As with question 2, many people raised specific concerns about the definition of e-money and our guidance on this. However, we are not going to expand our guidance to cover each individual query from each individual who sent in a response to our CP. Our guidance is intended to apply across the board. A general comment was also made that some more thought may need to be given to new developments such as mobile payments and youth products.

Our reply:

General

We have expanded our guidance to try and clarify where we see the distinction lying between the definition of e-money and the definition of a deposit.

We may issue more detailed guidance on e-money purses held on mobile phones later, where telecom-specific issues arise. We have no plans to do so now. The same approach applies to youth products aimed at the under-18 market. Our regulatory objective relates to consumer protection in general and our rules and guidance follow this. We will be keeping our regime under review but do not intend to issue specific rules or guidance on youth products unless a particular issue, arising out of the marketing and sale of such products, gives cause for concern.

Specific issues:

Having said that, some specific points require a response. These are set out below, together with our responses.

There was a general welcome for our guidance, but people made the following points:

1. A distinction is sought (by way of guidance) between withdrawal of cash at ATMs which constitutes a redemption of e-money and the purchase of foreign currency at ATMs (usually done abroad).
2. Explicit guidance is also sought that server based account systems are a technologically legitimate means of storing e-money. Any similarity between this technology and what the banking industry uses should not in itself lead to suggestions of deposit taking.
3. A distinction is sought between non-compliance with 'immediate issuance' and operational delays due to:
 - late activation of scratch cards by consumers after the issuer has received their funds; and
 - security, anti-fraud or anti-money laundering procedures by e-money firms

so as to avoid classification as deposit taking.

4. One person has suggested amending paragraph 3.3.8 to read:

'E-money is an electronic payment product. E-money may, in some systems, be transferred from device to device while it is in issue or the device may be used, in some systems, to effect payment to a person other than the issuer but the value representing the e-money must be held electronically at all times and payments to other persons representing a drawdown of that value must always be effected electronically.'
5. Some people said that they could foresee scenarios where there is a time lapse between purchase of the e-money and activation of the e-money card. This period needs to be strictly limited so as to prevent creating the impression that a deposit has been taken. Just including an expiry date on the e-money would satisfactorily limit the time period.
6. As regards the transitional provisions, it should be sufficient that an e-money issuer should be established in the UK after 27th April 2002: being required in addition to locate its Head Office here (or the EEA) would be inequitably burdensome.

Our reply:

1. There may be a valid distinction here but this will depend on the detailed characteristics of each individual scheme. Scheme promoters and their professional advisers should consider the implications of the e-money definition for their own business models.

2. Our guidance says that a product does not cease to be e-money merely because the scheme is based on an electronic account that the user can access remotely. So monetary value issued under an account-based scheme can be e-money. However, it is necessary to draw the line between where an account-based scheme constitutes e-money and where it represents a deposit taking arrangement (which would require a deposit taking permission). Our guidance makes the following points as relevant to where the line should be drawn between the two activities:
 - e-money is a purely electronic product. So if it is kept in an account that can be accessed by non-electronic means (such as an account where cheques are allowed to be drawn) that points to its being a deposit rather than e-money;
 - a product that is only designed to be used for making payments of limited amounts and not as a means of saving (such as an account where no interest is payable or where there is a limit to the time that value may remain on an account) is likely to be seen as e-money rather than a deposit; and
 - additional features (overdrafts, direct debit arrangements) point towards deposit taking.
3. The delay between making payment for the e-money and its use by the holder does not make the payment for the e-money a deposit. This is because the means of spending the e-money is put into the hands of the purchaser when he or she buys the e-money card. Article 9A of the Regulated Activities Order makes it clear that a sum is not a deposit if it is immediately exchanged for e-money. This means that if a customer pays for e-money but the e-money is not issued until later, that initial payment will be a deposit as long as the payment comes within the definition of deposit in the Regulated Activities Order. However, the delay caused by the need to clear a cheque received as payment for e-money does not make the payment for the e-money into a deposit.
4. We have changed this guidance to read ‘the value is held electronically and payments using the value are made electronically’.
5. The delay between payment for the e-money and its use by the holder does not make the payment for the e-money a deposit. This is because the means of spending the e-money is put into the hands of customers when they buy their e-money cards.
6. Our guidance on transitional provisions reflects what is laid down in the Regulated Activities Order. We do not have the power to vary this.

Question asked in CP117

Q4: Are there any issues on which you require further guidance?

Summary of the responses received

1. How does this definition fit with the Electronic Signatures Directive?
Could there in future be a situation where digital certifications are used as a form of e-money? Whilst digital certificates are not intended to be used as a means of payment, the potential for this could exist.
2. The Financial Law Panel mention e-money in their December 2001 Discussion Paper entitled 'e-commerce – review of legal implications – substantive legal issues' (p23). Are e-money transactions considered to be barter? If so, most consumer protection legislation will not apply to purchases made with e-purses.
3. People requested more guidance on whether systems that are designed to let the customer obtain foreign currency from ATMs should fall within the definition of e-money. It is argued that this is a purchase of foreign currency and not simply a withdrawal of cash. So we should amend the second sentence of 3.3.1 to read:

'Thus prepaid monetary value that only allows the holder to withdraw cash from an ATM in the same currency as the original payment is not e-money'.

Our reply

1. We have not attempted to construct guidance covering hypothetical situations or possible future technological developments. However, we shall keep our rules and guidance under review as the market for e-money develops and the technological possibilities for using and storing it expand.
2. We cannot comment on this issue. The question posed is too general in its nature and it is for the Courts, not for us, to decide whether or not e-money payments are barter.
3. This issue relates to a potential e-money scheme of a particular design that offers only a very narrow range of services. It is therefore too specific in nature to merit general guidance in our rules. It will be for the directors of individual schemes who believe they have a problem to investigate whether the product they are offering does or does not constitute e-money.

4 Regulatory processes

Question asked in CP117

Q5: Do you consider that our proposed use of our supervisory tools is appropriate and proportionate?

Summary of the responses received

Responses to CP117 indicated that people regard our proposals as appropriate and proportionate. The wish was also expressed that the regime should continue to be light touch. However, people accepted that there should be a means for dealing with issues of concern as soon as these arise. However, the point was also made that the on-line nature of many e-money products lends itself to a distributed infrastructure, where parts of systems may be hosted overseas. Appropriate systems and controls will be put in place and outsourcing arrangements will reflect our requirements but people sought comfort that this would not have an adverse impact on supervisory requirements. People accepted that we may wish to examine such outsourcing arrangements individually.

Our reply

We will hold the individual issuer responsible for compliance with our rules. It will not be an excuse for failure to comply to say that this was caused by the issuer's inability to control events in overseas or outsourced parts of its operations. Issuers considering outsourcing or expatriating any part of their operations would be well advised to discuss the matter with their supervisors before hand.

Question asked in CP117

Q6: Do you agree with our proposals for financial reporting and provision of information by e-money issuers and with the make up of the forms contained in Annex 5?

Summary of the responses received

People thought that the proposals and the forms were acceptable and prudent. However, one person preferred annual to semi-annual returns.

Our reply

The e-money Directive makes it clear that e-money issuers are obliged to submit returns showing their compliance with the rules on capital and investments ‘not less than twice each year’.

5 Prudential requirements

Question asked in CP117

Q7: Do you agree with our suggested definition of own funds and with our proposals for setting capital requirements for e-money issuers?

Summary of the responses received

People thought that the proposals were generally acceptable, subject to one or two reservations. First, the criteria for imposing more onerous capital requirements should be transparent and set out in the guidance. Such criteria should not discriminate in favour of some technological systems at the expense of others. However, people accepted that the technology must be able to meet legitimate security and risk concerns. There is also a feeling that expressing own funds in Euro increases complexity and may require e-money issuers to hedge a regulatory FX risk. Capital requirements would be better expressed in sterling.

Our reply

All e-money issuers will be subject to Threshold Condition 4 which requires authorised firms to have adequate resources. Our rules for e-money issuers do not allow us to impose higher capital requirements than the 2% (of outstanding e-money liabilities) specified in the Directive. We shall, however, be shortly consulting on our future policy on individual capital adequacy standards. There are two possible elements to this:

- Each authorised firm might be required to address business and systems and controls risks not adequately captured in the minimum capital requirements. Any additional capital requirement arising from this review would be decided on the basis of self-certification.
- We might impose an additional capital requirement in response to specific systems and controls related concerns or for exceptional business risks not

adequately captured in the basic capital requirement. Our capital requirements would apply to all e-money firms irrespective of the technology that they use.

The rules require an e-money issuer to hold a minimum capital of €1 million if its base currency is in Euro. If its base currency is in another currency, then the minimum capital held should be the equivalent of €1 million expressed in that currency. The e-money Directive does not permit capital requirements to be expressed in currencies other than the Euro.

Question asked in CP117

Q8: Do you agree with the suggested range of eligible asset items for the investment of the e-money float?

Summary of the responses received

People generally supported the proposed range of assets but made the following points:

1. There was concern that the maximum allowed maturity of any asset should be restricted to one year. The industry believes that more flexibility should be allowed in terms of maturity (that is to say maturities of greater than one year should be allowed). This is so that risk can be better managed by diversification and so that maturity of assets can be matched with the cashflow demands of the business. This could be determined by using historical data.
2. The degree of default risk within ‘the range of what is normal’ cannot easily be measured. It is suggested that acceptable default risk should be measured by using credit ratings (minimum rating of ‘A’ should be appropriate).
3. ‘Sight deposits’ could be expanded to include money market deposits with Zone A credit institutions of a range of maturities up to one year to aid asset/liability management. Such deposits yield a higher return. Clarification on use of these is requested.

Our reply

1. The purpose of imposing a limit on the maturity of eligible assets is to ensure that e-money issuers are, as far as possible, protected against the perils of interest rate volatility. Without historical data it is not possible at present to develop a more flexible regulatory approach. We intend to keep our policy under review and are prepared to allow for more flexibility if empirical evidence suggests that it is prudent to do so, in the light of a better understanding of issuers’ exposure to interest rate risk and their ability to manage it.

2. The phrase ‘degree of default risk which is comparable.....’ is a copy-out of the relevant provision in European legislation. It is intended to guide e-money issuers, in determining their investment policy, towards assets of comparable quality and risk to those issued by multilateral development banks, regional governments and Zone A credit institutions. It aims to do this without at the same time unduly restricting the flexibility that European legislation allows in this respect. E-money issuers should exercise prudent judgement in making their investment decisions. We will keep our policy under review and will provide further guidance if deemed necessary.
3. The e-money Directive does not allow us to expand the range of eligible assets to include money market deposits.

Question asked in CP117

Q9: Do you agree with our proposals on liquidity for e-money issuers?

Summary of the responses received

There was general support for our liquidity proposals although one person commented that there should be flexibility for waived firms.

Our reply:

Our rules on liquidity do not apply to waived firms.

Question asked in CP117

Q10: Do you agree with our definition of ‘sufficiently liquid’ set out in paragraph 6.28 above?

Summary of the responses received

There was general support for this definition. However, people felt that the use of money market deposits should be allowed as these are highly liquid, deposit terms can if necessary be broken at short notice (although a cost is involved) and reasonable returns can be expected. Again a request was made for flexibility for waived firms.

Our reply:

As stated earlier, the e-money Directive does not allow us to extend the range of eligible assets to money market deposits.

Our rules do not apply to waived firms.

Question asked in CP117

Q11: Do you agree with our proposed limitations on foreign exchange exposures for e-money issuers?

Summary of the responses received

People generally agreed with our views but one person stated that these proposals should not apply to firms which only issue in sterling or in Euro.

Our reply:

Our limitations on foreign exchange exposure apply, without exception, to all e-money issuers that invest funds in a currency other than the one in which their issued electronic money is denominated. The fact that a firm may only be issuing electronic money in sterling or in Euro makes no difference to the application of these rules. It is clear, however, that where liabilities and assets are denominated in the same currency there is no foreign exchange exposure.

Question asked in CP117

Q12: Do you agree with our proposals for limiting interest rate risk?

Summary of the responses received

Opinions are mixed on this point. One person expressed the view that these proposals seem unduly restrictive and inconsistent with a light touch approach. Others expressed broad agreement (at least until the 2005 review) with the proposals subject to two cautions:

1. the words 'or any similar sum' cause concern. Loyalty points or cash may be awarded based on use of the purse. Such promotions would not cause interest rate exposure. They would be limited in individual and aggregate value and in time period of promotion. Firms would finance the costs from working capital. So the wording should be 'any similar sum which has the effect of creating an interest rate exposure'. Alternatively there should be a rule exempting promotional offers from the ban; and
2. given the prohibition on the payment of interest, e-money issuers should be allowed to buy fixed and floating rate assets as needed to meet their prudential management obligations without restriction. Moreover, the limitation of one year on fixed rate assets should be revisited at a later stage with a view to allowing some flexibility for mature e-money issuers with significant experience of the market and the ability to manage interest rate risk in a more sophisticated manner.

Our reply:

1. We are not proposing to amend our rules. However, our revised guidance makes clear that the ban on paying interest is not meant to stop promotional activities, such as where some e-money is given away free, on first load, or where e-money is given away free by way of bonus or loyalty payments.
2. The ban on interest payments removes the risk that there could be a mismatch between the liabilities and the asset side. However, interest-bearing assets are still exposed to adverse movements of market rates. Where the market value of the asset falls below the initial cost, an issuer may not be able to meet the prudential requirement of full backing of the issued e-money by eligible assets. The restriction of investments to assets with a residual maturity of one year or less – in the case of fixed rate assets – and a resetting of the interest rate within one year or less – in the case of floating rate assets – contains this risk. We shall be keeping our policy under review and may allow for more flexibility in the light of experience gained over time. We believe that the one year limitation is correct at the present time but we can, if need arises, deal with the issue again in 2005, when the European Commission reviews the e-money Directive.

Question asked in CP117

Q13: Do you agree with our large exposure requirements?

Summary of the responses received

People in general agree with our proposals. However, there is a request to extend the exemption to include zero-weighted assets of a maturity greater than one year.

Our reply:

All zero-weighted assets are exempt from the large exposure requirements regardless of their maturity.

Question asked in CP117

Q14: Do you agree with our proposals for hedging market risk?

Summary of the responses received

While comments are generally supportive, some people looked for more flexibility in achieving the required level of hedging of risk. In particular, hedging should be allowed using contracts of a maturity of up to one year and the use of interest rate derivatives is also sought. Confining use of derivatives

only to situations where ‘full elimination of these risks is intended’ is unrealistic and it may be more prudent to allow hedging at other levels.

Our reply:

Our rules on hedging market risk are designed to comply with the specific requirements of the e-money Directive. There is no scope to vary these.

General comment on the matters covered in questions 8 to 14 inclusive

One person made a general point in response to questions 8 to 14 inclusive. This is that any product that relies for a significant part of its economic viability on float income can ill afford the reduction in yield implied by tight investment restrictions, especially during a period of low interest rates. So they said that we should have some discretion to remove or relax restrictions on float management in cases where the product is backed:

- by a guarantee from a reputable third party such as a clearing bank or other fully authorised credit institution; and/or
- by acceptance marks such as VISA/Mastercard which impose quite onerous risk management requirements on their issuers.

Where an issuer’s existing investment policy is already bound in this way, applying different standards for the e-money float will create inefficiencies and threaten competitive viability.

General FSA response to responses to questions 8 to 14 inclusive.

The e-money Directive does not give us any discretion to remove or relax restrictions on float management.

Question asked in CP117

Q15: Do you agree with our proposed approach to consolidated supervision?

Summary of the responses received

Nobody made any significant comments on our proposals, although one person believed that it was premature to express a view at the present time.

Summary of the comments received regarding the proposed rule on limitations of activities

The industry strongly opposed our proposed rules on limitations of activities. It was held that limitations beyond those imposed by the e-money Directive were unwarranted.

Our reply:

The restrictions initially proposed were inadvertently drafted so as to exclude some activities that are permissible under the restrictions of the e-money Directive. We have now incorporated the Directive's provisions in our rules to the effect that, besides issuing e-money, an e-money issuer may also provide financial and non-financial services closely related to issuing e-money such as:

- the administering of e-money by the performance of operational and other ancillary functions related to its issuance;
- the issuing and administering of other means of payment; and
- the storing (on behalf of other undertakings or public institutions) of data on the firm's own e-money electronic devices.

6 Management, systems and controls

Question asked in CP117

Q16: Do you agree that the Approved Persons regime should apply to all e-money issuers on the basis outlined above?

Summary of the responses received

Most people said ‘yes’ although the caution was made that the Approved Persons regime should be applied proportionately.

Our reply:

We have said in our CP that we will apply this regime proportionately and are committed to do so.

Question asked in CP117

Q17: We would welcome your views as to the implications of the apportionment and oversight requirements of SYSC and the approved persons regime for management and organisation of e-money issuers.

Summary of the responses received

Most people felt that these requirements should cause no problems. However, the point was made that for e-money issuers with only a few staff, the proposals are onerous. So we should view each application on a fit for purpose basis so as to achieve proportionate application of SYSC.

Our reply:

We made it clear in CP117 that the manner in which the apportionment and oversight functions are administered should be clear and appropriate. This applies equally to a small firm with few staff as it does to a much larger firm. However, what is required for a small firm in terms of personnel and systems

will be much simpler and less resource-intensive than what will be required for a larger and more complex firm. Management organisation, systems and controls must obviously be proportionate to the size and complexity of the risks that the firm is trying to manage.

Question asked in CP117

Q18: Do you support the application of SYSC to all e-money issuers on the basis described above?

Summary of the responses received

Most people said yes, SYSC can be applied to all types of e-money issuer and a level playing field with other firms should be maintained. Regulation should be kept light touch.

Our reply:

We agree with this view.

Question asked in CP117

Q19: Do you agree with the approach to common standards outlined above?

Summary of the responses received

Most people said yes. They welcomed this approach but it should also be applied to waived firms. There are real risks of counterfeit e-money and the failure of a waived firm could have knock-on reputational consequences for authorised firms as well. So all issuers should be encouraged to participate in the industry standards round table. The point is made that no credit institutions are members of this, so there might not be a level playing field.

Our reply

As mentioned before, we will have no power to apply any section of our Handbook to waived firms. The only rules that we impose on such firms will be rules on the supplying information. Any industry round table or trade association and any guidance made by any such body can only operate on a voluntary basis and cannot be made the subject of disciplinary or enforcement action by us. As regards the level playing field argument, we expect credit institutions that issue e-money to comply with the risk management requirements according to SYSC to the same high standards as e-money issuers. It is not our intention to apply risk management requirements more leniently to credit institutions.

7 Disclosure requirements, purse limits and redeemability of e-money

Question asked in CP117

Q20: What are your views on our proposed use of purse limits as a protection for consumers and a defence against money laundering?

Summary of the responses received

People commented extensively upon this question. A lot of people thought that our proposed use of purse limits was misplaced and inequitable.

On consumer protection, it is felt that as with physical cash, consumers should take the risk if they lose their purses. Consumers can best deal with the event of accidental loss of a purse by only storing limited amounts in it and by looking after it, just as prudent consumers already do with physical wallets. Purse limits should be set individually by negotiation between consumer and issuer. The risk of failure of the issuer is best dealt with through the prudential regime in rules for capital, liquidity and investments.

It is also argued that the average value of cash transactions is greater in mainland Europe. So low UK purse limits would be inconsistent with a level playing field across Europe. In any event, many EU member states are not proposing to introduce any purse limits. When the e-money Directive talks about e-money being used for payments of 'limited amounts' it does not mean 'small amounts'. Finally purse limits would be super-equivalent to the e-money Directive.

We should keep the exemption for account based schemes.

On money laundering, people argued that in any event, money launderers will prefer to use physical cash and are only likely to target e-money systems that permit loading of purses from cash (that is to say primarily those which operate through scratch cards sold through corner shops). Some people also argued that systems can be developed to detect and record suspicious transactions and patterns of use. For person to person (non-centrally

accounted) transactions, the placement of turnover (or velocity) limits on individual purses can limit the cumulative total transfers possible in each purse. Purse limits would not in any event deter the division of large sums into very small amounts among lots of purses. The greater flexibility and usefulness of e-money to consumers must not be compromised or sacrificed but on the other hand, e-money systems enable greater detection of money laundering than is possible for physical cash. Limiting purse sizes provides no mitigation against a system that breaks large amounts down into lots of much smaller amounts. Where schemes are accounted, suspicious transactions can be detected. Where the schemes are unaccounted, turnover (or velocity) limits are more effective protection than purse limits. Moreover purse limits restrict the utility of e-money to honest consumers.

Finally, money laundering controls for e-money should be applied equally to both bank and non-bank issuers of e-money.

Our reply:

Our proposed purse limit is intended to protect consumers and contain the dual risk of financial loss due to failure of the issuer and loss, theft, damage or malfunction of the purse or the device that gives access to the purse. Imposing a purse limit can send out a message to consumers that holding e-money is riskier than holding physical cash because an e-money issuer could fail. Together with the requirements for disclosure of risk warnings by issuers it raises the awareness of consumers and helps to promote an informed and considerate use of e-money. The purse limit also reinforces the notion that e-money is intended to be used in place of coins and notes and as a means for retail payments of limited amounts. However, we accept that purse limits are only one of several possible weapons in the fight against money laundering and only one of several possible means of consumer protection.

Question asked in CP117

Q21: Do you agree that £250 is an appropriate limitation on the capacity of electronic purses?

Summary of the responses received

Two people argued for lower purse limits, say £50-100. However most people felt that purse limits should be left to the market to decide but that if we wished to have a rule on the matter, this should set the limit at a higher level, say £1000. Waivers should be available where a particular firm can show a business case that can convince us of the need for an even higher limit and appropriate safeguards can be put in place.

One example quoted concerned electronic purses used for travel purposes. Average initial load for such cards sold by one firm in 2001 was £1,170.

Our reply

We intend to increase the purse limit originally proposed from £250 to £1,000 (or the equivalent figure in another currency). This limit will be uniformly applicable to all e-money issuers. Issuers could offer purses subject to higher limits only if:

- there is written acknowledgement by customers that, in the absence of compensation, insolvency of the issuer may lead to a total loss of all e-money in their purses;
- the issuer is capable of blocking the use of a purse that has been reported lost, stolen, damaged or malfunctioning; and
- the issuer ensures the exercise of the redemption right over the value in the blocked purse.

Question asked in CP117

Q22: Do you agree that the above proposals form an adequate basis for protecting consumers of e-money?

Summary of the responses received

People sent many varied responses of which the most significant are summarised below.

On redeemability:

- A three business days' limit for redemption does not give enough time for normal electronic transfers made by BACS. Five business days would be more realistic. The limit should also be subject to reasonable clearing and settlement cycle delays as well as delays caused by the performance of risk management and other operational and fraud prevention checks before redemption (or where there are reasons for suspecting criminal activity and investigation is being undertaken).
- Two people believe that it is unduly restrictive to insist on redemption in the e-money's denominated currency. They think that customers should be able to redeem cash on their cards in local currency where it is more efficient for them to do so. They argue that our position in rule 6.3.3 is super-equivalent to the e-money Directive. We should therefore either delete this rule or else add the words 'or in the currency of the country where the holder is located at the time of redemption.' An issuer should not take a foreign exchange risk with the float but a second transaction

should be permitted to allow a payout in US dollars to a sterling purse holder, if desired.

- To prevent fraudulent redemption, there is a need for authentication and identification checks.

Our reply:

Holders should have the right to receive the proceeds from redeeming their e-money in the currency in which the e-money is denominated. They should also have the right to have the proceeds paid immediately in banknotes or coins or by transfer to a conventional bank account. When we say ‘immediately’, we mean that the firm must give the necessary payment instructions as soon as the firm has completed any checks that are reasonably required to prevent money laundering or fraud, or to check whether the holder of the e-money is a person who is entitled to redeem it. We shall amend the rule to require the firm to ensure that the funds should reach the holder’s account within five (as opposed to three) business days of the day on which the firm gave the payment instructions (except where this is prevented by factors outside the firm’s control).

However, our rules do not require a firm to redeem e-money in a way that the holder does not want. So if the holder wants the e-money redeemed in a different currency, the firm may redeem the e-money in that currency if it wishes to do so. Similarly the holder may ask the issuer to redeem in a different way from paying in banknotes or coins or by transfer to a conventional bank account. This also means that a firm may allow a holder of e-money issued by the firm to buy a currency other than the one in which the e-money is denominated through an automated teller machine.

A firm is not at fault if the redemption moneys do not reach the customer’s account due to failure outside the firm’s control by any third party that is involved in the funds transfer.

An exception to the duty to redeem has been acknowledged in circumstances where the scheme has given due notice that the e-money ceases to be valid after the expiry of a specified period. We have added a new rule that says that a firm must not issue e-money that is valid for less than a year.

The duty to redeem assumes that the person asking for redemption is able to present or make available the e-money for redemption. Where, however, a customer loses his or her card, our rules do not require the firm to reimburse the holder or redeem that e-money for him or her. However, this exception does not affect any other duty the firm may be under.

In CP117, we proposed a rule (6.5.2) that says that a firm must ensure that the exercise of the redemption right will not be unreasonably difficult for

anyone entitled to receive it. To make this clear we have also now said by way of guidance that this rule is not broken if the firm does not allow e-money to be redeemed at each ATM at which people may withdraw cash by using e-money issued by the firm. So a UK e-money issuer may allow users of its e-money to withdraw cash from ATMs abroad, but not offer the redemption right at those machines abroad.

It is the e-money Directive that states that the charge for redemption can never exceed €10.

On information disclosure:

Summary of responses received:

One person asked us to make clear what is meant by the words ‘in writing’ in the case of our requirements for information disclosure.

Our reply:

By the expression ‘in writing’ we mean a document in legible form and capable of being reproduced on paper, irrespective of the medium used. So the information does not have to be issued by the firm in the form of a physical document.

Question asked in CP117

Q23: What alternative suggestions would you make for protecting consumers against those areas of risk that they are not best suited to manage themselves?

Summary of the responses received

In general people felt that the proposed regime of consumer protection was robust. However, the industry fears that the activities of rogue issuers could cause much reputational damage. People also expressed the concern that e-money will be comparatively under-regulated in terms of advertising. Most other forms of financial advertising have some form of code to comply with.

It was felt that the best safeguards are to encourage bona fide e-money issuers to implement industry guidelines and to advertise their affiliation to the Electronic Money Association. A second risk is a lack of consumer understanding which is best tackled by consumer education and information provision.

Another suggestion was that issuers should adopt a code of conduct covering consumer rights. This would be drawn up by the Electronic Money Association and applied to Part IV permission holders and waived firms.

Our reply

Consumer protection is one of our four regulatory objectives and we have tried to ensure that our regime of rules and guidance meets reasonable consumer aspirations in the light of the perceived risks to consumers posed by e-money.

Apart from our rules on providing information to us, our rules will not extend to certified small e-money issuers (that is to say *waivered* firms in the language of the e-money Directive). We shall not have powers of enforcement and discipline over such firms except where they fail to observe the rules on information provision.

HM Treasury has confirmed that it will exclude electronic money issuers from the remit of the Financial Promotions Order. So e-money issuers will at most be subject to general Advertising Standards Authority rules to ensure that all their advertising is 'legal, decent, honest and truthful'. However, application of our Principles for Businesses means that if the quality of an e-money firm's communications with its customers was so consistently bad as to call into question the probity of the firm, its senior management or both, we would be obliged to take action against it.

Membership of the Electronic Money Association is voluntary as is compliance with any code of conduct or other guidelines that it may issue. These matters would not be for the us to police or enforce.

Our Consumer Education Department will be considering what it should do to promote consumer understanding of e-money and the risks that attach to it.

8 Compensation and complaints handling

Question asked in CP117

Q24: Do you agree with our proposal that e-money issuers should be brought within the Compulsory Jurisdiction of the FOS?

Summary of the responses received

Our CP did not state the costs of joining the FOS and we did no cost benefit analysis of applying the FOS to e-money issuers because there was no evidence available on the likely level of complaints that would be received. Responses to this question fell into two categories. On the one hand, some people felt that there should be an independent complaints handling forum, but that the indicative costs of the FOS were too expensive. On the other hand, some people felt that an independent complaints handling forum of any description was unnecessary at this stage. This position should be reviewed in 2005 when the results of the European Commission's review of bearer protection measures become available.

People took particular exception to the suggestion that e-money issuers should be placed together with deposit takers for the purposes of calculating the fees they should pay for membership of the FOS. Unlike bank accounts, e-money accounts would tend to proliferate at a fast rate, especially as new schemes started to market the new product extensively. Card based schemes, in particular, are likely to use promotional campaigns that result in the mass marketing of large numbers of cards. Many of these new 'accounts' would either remain dormant or would be used only infrequently and for small amounts. A telecoms operator would be offering the potential to make electronic cash transactions to all of its customer base, a figure that could run into millions of users. Based on existing tariff rates, it is estimated that a small scheme (100,000 users and 10 complaints each year) would have to pay £5,173 each year. A large scheme (10 million users and 100 complaints each year) would have to pay £193,300 each year. Complaints are likely to involve

comparatively small sums of money so it was felt worthwhile considering a lower fee in respect of adjudication.

The case fee (£360) is held to be out of all proportion to the typical values of e-money that may be the subject of consumer complaints.

The industry's concerns might be eased if a different fee block of the FOS could be applied to them. Alternatively, the industry could set up its own disputes resolution procedures (for example it could set up a scheme run under the Chartered Institute of Arbitrators) which would be much cheaper. What's more, utility and telecommunications companies may already have existing payments related complaints procedures and people thought that it was desirable to avoid duplication.

Our reply

Our conclusion is that e-money should in principle be included in the FOS. If excluded, it would be the only regulated consumer financial product that was not covered by the FOS.

So we propose that e-money issuers should be included in the FOS in the fee block for deposit takers, but initially in the minimum bracket where they will pay a nominal flat rate fee of £250. This arrangement would operate for the stub period of 2002/2003. Before the end of this financial year, we would consult on the most appropriate longer term arrangements for incorporating e-money issuers within the FOS. The aim would be to arrive at an annual fee that reflected actual use of the FOS by e-money holders.

9 Small e-money issuers

Summary of the comments we received on our proposed approach to small e-money issuers

People made a number of comments on, and requested a number of changes to, the conditions small e-money issuers will have to meet in order for them to gain exemption from our regime for authorised e-money issuers.

Our reply

We cannot comment on these issues, all of which relate to requirements of the amended Regulated Activities Order. We cannot vary these requirements, or modify them in any way, by our rules or guidance.

It should be noted that in exercise of extended powers which the amended Regulated Activities Order gives us, we have:

- extended the rules on actions for damages and private persons now also have the right to take action for damages in respect of contravention of rules that apply to small e-money issuers;
- redrafted the rules on reporting in the case of breaches of conditions; and
- incorporated a rule that allows for the use of skilled persons to verify compliance with conditions.

10 Fee-raising proposals for e-money issuers

Question asked in CP117

Q25: Do respondents agree with the proposal for determining the fee tariff?

Summary of the responses received

People thought that both the approach to determining fees and the suggested level of tariffs was generally acceptable, although they chose to reserve more detailed comment until we had published the proposed fee scales for 2002/2003. In principle, people felt that there should be no difference between fees charged to new entrants and fees charged to existing firms of comparable size and complexity.

Our reply:

People may misunderstand the basis on which we levy fees. We explained this in CP117, but, for the avoidance of doubt, we repeat it here. We intend application fees, which by definition new firms pay, to cover the costs of processing applications and authorising new firms and are therefore these are payable whether the firm is authorised or not. All firms, once authorised, pay periodic fees each year, and we intend these to cover the bulk of our funding needs. Because the two types of fee cover different things, they will inevitably vary from each other. It is also a fundamental principle that the periodic fees which firms pay are mainly to be determined by the risk that organisations in that fee block are perceived to pose to our ability to meet our statutory objectives. This perceived risk is the key determinant in our allocation of supervisory resources.

Question asked in CP117

Q26: Do you agree with the proposal for a minimum fee and, if so, at what level should the minimum fee be set for e-money issuers?

Summary of the responses received

In general, people felt that the proposed application and minimum periodic fees were acceptable as was the incremental periodic payment based on additional liabilities.

Our reply:

We are happy to learn that people consider our proposed minimum fee arrangements to be acceptable.

Question asked in CP117

Q27: Do you agree that applicants should meet the regulatory costs of processing their applications and if so do you agree with a proposed fee of £5,000 (for non-complex applications)?

Summary of the responses received

People accept the principle that applicants should meet the costs of processing their applications. The level of £5,000 is acceptable, but some people are concerned about the description of 'non-complex applications,' the worry being that some applications might be found to be complex. In such a case, people asked what the resultant costs would actually work out at. People require further clarification as to how the fee varies with the type of application made.

One person felt that applicants should pay, but that £5,000 seems excessive. Since the experience of processing the initial applications will provide us with a useful learning curve, it was argued that they should be free for 12 months from 27 April 2002.

Our reply

Since our rules require e-money issuers to restrict their business activities to the issue of e-money and the 'provision of closely related services' we do not think that any of their applications for Authorisation could be construed as 'complex'. As long as all applicants supply the information requested in the information pack promptly, the application process should not prove unduly onerous. The main risk to applicants of not providing full information promptly is that the processing of their application will be delayed.

The £5,000 is a flat rate application fee payable by all applicants who are deemed to be 'non-complex'. It follows that some will feel that it represents good value for the work undertaken to process their case whereas others will feel that it is excessive. That is the nature of fixed rate fees. It is not our policy to offer concessionary rates to those who may deem themselves to be 'guinea pigs' for the application process.

11 Cost benefit analysis

Question asked in CP117

Q28: Comments are invited on the cost benefit analysis set out above.

Summary of the responses received

There were no general comments other than those specified in the answers to questions 29 and 30 below.

Our reply:

We deal with the matters raised below.

Question asked in CP117

Q29: Do you agree with this cost benefit analysis?

Summary of the responses received

In general people supported our cost benefit analysis. However, the costs to the industry arising from the application of the FOS raise concerns. One person with considerable experience of systems development costs commented that the CBA seemed fair within a tolerance of +/-20%. However, it also stated that development costs for the industry should be nearer £800,000-900,000 rather than the figure of £500,000-550,000 quoted in the CP. The costs associated with purse limits were also 'unlikely to be minor'. One person made the point that the potential costs of complying with the new regime should not be underestimated as firms may have spent a lot of money developing systems, procedures and rules of governance that will have to be replaced, so as to comply with the new regime.

Our reply

We acknowledge the industry's concerns over the potential costs to e-money issuers of FOS membership on the same basis as deposit takers. We have attempted to deal with these concerns through our proposals set out in response to question 24 above.

Our estimate of the costs to the industry of complying with the new regulatory regime was based on the information available to us at the time and after consultation with the industry. Without any empirical evidence on the likely compliance costs associated with our new regime, including purse limits, we have not been able to firm up these estimates.

In CP117, we said that we did not believe that the cost of purse limits (in terms of the systems modifications required to monitor and enforce them) would create anything other than minor additional costs for firms. We may have underestimated the actual cost implications and one person commented that our statement was yet to be proven 'particularly where large numbers of purses are already in circulation.' However, we are unaware of any scheme with 'large numbers' of operational e-purses in the UK at the present time and, in the absence of any evidence, it is difficult to quantify the costs of necessary systems modifications.

Question asked in CP117

Q30: Are there any areas where you believe significant costs or benefits have been overlooked or have not been evaluated properly? Please provide details.

Summary of the responses received

In general people felt that no significant issues appeared to have been omitted.

12 Compatibility Statement

Question asked in CP117

Q31: Comments are invited on this statement of compatibility with our regulatory objectives and with our general duties under the Act.

Summary of the responses received

In general people felt that the approach we had taken in CP117 appeared to be wholly in keeping with our regulatory objectives. However, some people said that the rider to our third regulatory objective, namely that consumers should take responsibility for their own decisions (Financial Services and Markets Act 2000, section 5 (2) (d)) means that purse limits are unnecessary. Some people also said that allowing differential purse limits (as between card-based and account-based schemes) will distort competition between different e-money issuers.

Our reply

It is true that one of the factors that underpins our regulatory objective of consumer protection is the general principle that consumers should take responsibility for their own decisions. However, we must also have regard to the need to secure the appropriate level of protection for consumers. This includes the differing degrees of experience and expertise that different consumers and groups of consumers may have of different kinds of regulated activity. As far as electronic money is concerned, we accept the fact that it is a product that may well be used by, among others, those who do not have the use of credit cards, in other words the financially excluded and under-18s. In the absence of a compensation scheme or any other specific measures for consumer protection, we have decided to increase the purse limit from £250 to £1,000, as described in our reply to the consultation in Chapter 7 of this Policy Statement. The whole issue of consumer protection measures is one of the matters that the European Commission is mandated to review in 2005.

Between now and then, we will monitor how e-money take-up progresses and review our policy in the light of this and the Commission's forthcoming proposals.

Question asked in CP117

Q32: Do you agree with this assessment of the compatibility of the proposals in this CP with our general duties as outlined above? Where you disagree, please explain why.

Summary of the responses received

Subject to the cautions made in answer to question 31 above on the subject of purse limits, it was generally felt that our proposals are in line with our stated regulatory objectives and strike a good balance between regulatory oversight and business freedom. It was stated that our regime compares well with those developed elsewhere in Europe.

Our reply

We are encouraged to learn that our proposals are considered balanced and proportionate.

Cost Benefit Analysis of the Policy modifications introduced in this Policy Statement

Subject to the matters discussed below and our response to comments received on the initial cost benefit analysis in CP117 and set out in Chapter 12 above, we believe that our original cost benefit analysis remains valid as at the date of publication of this Policy Statement.

The following changes to the regime, proposed in this Policy Statement, require us to revise our initial cost benefit analysis. This need arises either because we consider the changes to our policy to be significant or because of their potential implications in terms of significant costs or benefits that may arise. These are:

- the increased purse limit;
- the approach to bringing e-money issuers into membership of the Financial Ombudsman Service ('FOS');
- the rules on actions for damages;
- the additional guidance on issuing at a discount;
- the revision of limitations of activities; and
- the ban on short-term validity.

Our analysis relates the likely costs and benefits arising from the above changes to the analysis provided in Chapter 14 of CP117 of costs and benefits of our initial proposals. Our CBA is also a comparison between the overall position after making of the amended rules and guidance and the overall position before the rules and guidance were made.

Purse limits

The move from the purse limit of £250 initially proposed to a limit of £1000 allows issuers to realise additional commercial benefits by offering more attractive e-money products. It will help e-money to compete with cash and

other electronic means of payment (such as debit and credit cards). Increased competition is likely to lead to the provision of electronic payment products that are better tailored to meet consumer demands. Consumers will also benefit from the additional freedom and convenience that an increased purse limit gives. They will be able to dispose of higher amounts of e-money without having to resort to the holding of multiple purses, which could expose them to increased risks of loss or theft. On the other hand, the higher purse limit should save issuers the expense of issuing multiple purses.

There are also risks associated with these benefits. The full amount of e-money held on the purse will be exposed to potential loss if the issuer fails or if there is loss or theft of, or damage to, the purse (or the device that gives access to the purse). In the absence of compensation, consumers are fully exposed to loss arising out of the failure of the issuer, which could particularly disadvantage the financially excluded. For them, e-money may represent the only alternative to the use of cash. Finally, we believe that higher purse limits are likely to be less effective in reducing the attractiveness of e-money to money launderers.

In our view these important drawbacks are outweighed by the potential benefits of an increased purse limit for both consumers and the e-money industry. Since consumers have the choice not to use e-money or to carry with them only limited amounts, it would appear unjustified to impose a low purse limit upon them and the industry. Such a restrictive course could jeopardise the prospects of the fledgling e-money market in the UK. The absence of purse limits in the proposed regulatory regimes of most other European countries also suggests that we should at least be prepared to ease the constraints that we initially proposed.

In CP117 we said that there are costs and benefits involved in setting purse limits but have not been able to quantify these. As a consequence of the move from a £250 limit to a £1000 limit the balance of costs and benefits has changed. As for the initial analysis it would be unreasonable and potentially misleading to try to provide estimates of the additional benefits and costs associated with the higher limit. This is because it is not possible to attach a figure to subjective benefits like convenience and in any event, without knowing the likely level of take-up of e-purses, we cannot say how many people will be affected.

The changes to the exemption rule which we initially proposed are limited. Our rules now require that where purses are to have a limit exceeding £1000, this should be made subject to the customers' written acknowledgement that, in the absence of compensation, insolvency of the issuer may lead to a total loss of the e-money in their purses. Under the initial proposals issuers were required to provide information to customers on these and other risks. The additional costs of obtaining a written acknowledgement of risk (which could

be obtained online) appear to be limited although probably not negligible for existing customers. It is difficult to quantify costs that may arise in addition to the costs associated with our initial proposals. In any case, it is our view that they are outweighed by the benefit of consumers' full awareness of risks.

The implementation of purse limits may necessitate systems modifications. However, the move to an increased purse limit of £1000 does not appear to have any additional cost implications except to the extent that some issuers may have already installed systems to impose a £250 limit. We are not aware of any firms that require to undertake such systems work and since our move comes in response to representations made by the e-money industry during consultation, it is unlikely that much, if any, such work has yet been undertaken.

Finally, we look at the CBA of our revised proposal on purse limits in comparison to the position which currently exists before our regime is introduced, that is to say the absence of purse limits. In summary, the rules on purse limits may require firms to spend money on systems adjustments to implement our rules if they were not already proposing to introduce purse limits themselves. These costs could differ markedly from firm to firm. As we said in CP117, we do not believe these rules will create anything other than minor additional costs for firms and we believe that the same statement can continue to be made about our revised proposal on purse limits. As far as consumers are concerned, the £1,000 purse limit (as opposed to no purse limit) means that their maximum theoretical losses can be capped for the first time. One of the principal reasons for introducing a purse limit was to send a signal to consumers that, in the absence of a compensation scheme, they could lose all the value in their e-money purse if the issuer were to fail. How much money a consumer loads in his or her purse is, however, a matter of personal choice.

E-money issuers and the Financial Ombudsman Service (the FOS)

In the absence of regulation, holders of e-money would only benefit from any disputes resolution procedures that might have been put in place by individual issuers. Alternatively they might have benefited where an issuer agreed to go to, and be bound by, independent arbitration. Individual issuers would have had the choice of whether or not to incur the expenditure involved and, to a degree, how much expenditure to incur in establishing a disputes resolution procedure.

In CP117, we said that it is impossible to give any meaningful estimate of the costs of applying the FOS and of having internal complaints mechanisms. This is because there is no evidence available at present as to what the likely level of complaints from holders of e-money will be. It is, however, possible to devise scenarios of what costs might amount to where e-money issuers were included in the FOS in the deposit takers block on the standard basis. Under this option they would pay fees on a sliding scale according to the number of accounts they operated and the number of complaints they received. Thus a small scheme with

100,000 accounts and 10 complaints per annum would incur a charge of £5,173. A large scheme with 10 million accounts and 100 complaints per annum would incur a charge of £193,300. In other words the range of costs could be large and, in certain circumstances, their total could be substantial.

As an alternative to including e-money issuers in the FOS on the standard terms, we are proposing to include them in the FOS for the remainder of the year 2002/2003 in the deposit-taking band but on the basis of a flat rate charge of £250 each. This represents a saving on the original proposal in almost any event. However, since we did not quantify the costs of participating in the FOS in CP117, our new proposals would actually inflate the estimate of identifiable costs to the industry appearing in the table in paragraph 14.94 of CP117 by £3,000 on the basis used therein that there would be 12 authorised e-money issuers.

The case fee chargeable to consumers who bring a complaint to the FOS remains unchanged at £360 per case.

There are benefits to consumers in having guaranteed access to an independent disputes resolution mechanism. This access may in turn increase their confidence in using e-money which could increase usage which would in turn benefit the industry. We also believe that including e-money issuers in the FOS could give UK issuers a competitive edge over overseas issuers with no independent disputes resolutions procedures.

We believe that the possible anti-competitive effects arising out of including e-money issuers in the FOS on the basis described here are unlikely to be significant. Moreover, we believe that the costs likely to be generated by the effort to devise a more appropriate fee would far outweigh the benefits of alleviating or eliminating those anti-competitive effects.

We will consult at a later stage on the basis on which e-money issuers are to participate in the FOS for 2003/2004 and subsequent years.

Actions for damages

In exercise of extended powers given to us by the amended Regulated Activities Order, we have amended our rule that allows consumers to take action for damages arising from rule breaches by issuers. Private persons now also have the right to take action for damages due to contravention of rules that apply to small e-money issuers (the rules in ELM 8). We believe that the strengthening of the legal position of consumers also with regard to small e-money issuers is likely to provide additional benefits for both consumers and the e-money industry. It is likely to help promote confidence in the e-money market and acceptance of e-money as an attractive alternative to other means of payment that benefits from a safe legal environment. The extension to small e-money issuers does not have any cost implications.

Issuers that comply with our regime will not incur any additional costs. The potential benefits cannot be quantified at present in any meaningful manner.

Issuing electronic money at a discount

In the light of responses received during the consultation we introduced guidance to the effect that e-money issuers are allowed to sell e-money to consumers at a discount. This guidance clarifies that the selling of e-money at a price below its face value for promotional purposes does not contravene the prohibition of issuing e-money at a discount, provided that a third party makes up the difference between the selling price and the face value. We stated in our initial cost benefit analysis that the prohibition of issuing at a discount which at the time we thought would also exclude any selling of e-money at below its face value would result in potential opportunity costs, which, however, were difficult to quantify. The commercial freedom for issuers to conduct promotion campaigns and offer a monetary inducement in line with the newly introduced guidance represents a significant benefit compared to the position taken in CP117. It also offers more choice for consumers. It should help the take-up and acceptance of e-money by consumers and promote competition between e-money and other means of payment. There are no additional costs arising from what amounts to the grant of greater freedom. Trying to quantify the potential benefits would be unreasonable and potentially misleading.

Revision of restrictions on activities

We have revised our rules on the restriction on e-money issuers' activities. The purpose of this revision was to extend the range of permissible activities to the full scope allowed under the e-money Directive. The initially proposed restrictions inadvertently excluded some activities that are permissible under the e-money Directive. We have now incorporated the Directive's provisions in our rules to the effect that, in addition to issuing e-money, an e-money issuer may also provide financial and non-financial services closely related to issuing e-money such as:

- the administering of e-money by the performance of operational and other ancillary functions related to its issuance;
- the issuing and administering of other means of payment; and
- the storing (on behalf of other undertakings or public institutions) of data on the firm's own e-money electronic devices.

We have stated in CP117 that the prescriptive rules on limitations of activities impose a substantial opportunity cost on e-money issuers. This statement remains valid. Our revised rule imposes no new costs but does allow issuers to exploit other possible sources of income within the limits set by the e-money

Directive. These additional sources of income rather than creating further risks assist the financial viability and soundness of businesses and thus mitigate the risk of failure of issuers. It would be unreasonable and potentially misleading to try to quantify the additional benefits.

New ban on short term validity

We have introduced a new rule banning the issue of e-money having a validity of less than one year. We have undertaken extensive consultation but we are not aware of any e-money businesses that are contemplating the issue of e-money with its validity restricted in this way. So it seems very unlikely that there will be any additional costs associated with the introduction of this rule. It may, however, be of some benefit to consumers who might otherwise have found themselves with unusable e-money in their purses which they were not able to redeem. Additional benefits that may be gained from this rule cannot be quantified in any meaningful manner.

Revised Compatibility Statement

In CP117 we included a statement demonstrating that our proposed regime of prudential supervision for e-money issuers was compatible with our regulatory objectives and our general duties under FSMA 2000. We also demonstrated why we believed that our proposals formed the most appropriate way for the FSA to meet its regulatory objectives. We believe that the revised proposals described in this Policy Statement do not alter the validity of the compatibility statement contained in CP117.

List of respondents to CP117

The following organisations sent in written submissions to CP117:

The Abbey National Group

Electronic Money Association

Financial Services Consumer Panel

GE Capital Global Consumer Finance Limited

London Investment Banking Association

Mondex UK Limited

One 2 One Personal Communications Limited

Orange (not for publication)

SmartCities Consortium

Transport Card Forum

Travelex Global and Financial Services Limited

Ulster Bank Limited

VISA International