NEW UK INSOLVENCY REGIME FOR PAYMENT INSTITUTIONS AND ELECTRONIC MONEY INSTITUTIONS

Date: 11 May 2021

UK Restructuring & Insolvency Alert

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EXECUTIVE SUMMARY

On 26 April 2021, draft Payment and Electronic Money Institution Insolvency Regulations (Regulations) were brought before the UK Parliament for approval. They will introduce a new special administration regime for insolvent payment institutions (PIs) and electronic money institutions (EMIs). The key purposes of the Regulations are to ensure that in the event of an institution's insolvency (i) funds are returned to customers quickly and (ii) shortfalls in the amounts returned are minimised. Since 2018, six PIs and EMIs have entered insolvency but only one has returned customer funds. The Regulations are therefore considered necessary to give certainty to those looking after insolvent institutions (the special administrators) and to avoid having to go to court for further directions and so expedite returning customer funds.

INTRODUCTION

As customers become more digitally inclined, they have started using PIs and EMIs in ever-greater numbers to access their salaries and make virtual payments. The main difference between PIs and EMIs versus traditional banking institutions is that PIs and EMIs do not take deposits. However, PIs and EMIs can make credit and debit payments, and EMIs can issue electronic money (e.g., on a prepaid card).

Insolvent PIs and EMIs enter into a special administration regime by court order and the grounds for applying for such an order depend on the type of creditor making the application. In general, the creditor must show that (i) the PI or EMI is (or is likely to become) unable to pay its debts or (ii) it is fair or in the public's interest to put the PI or EMI into special administration.

There are three objectives to special administration, and it is in the appointed special administrator's discretion to choose which objective to prioritise (though each objective must be tried and the order of prioritisation stated upon commencement of work). However, if the Financial Conduct Authority (FCA) considers it necessary to protect the stability of the UK financial system or to maintain public confidence in such systems, it may give the special administrator instructions to prioritise one objective over another.

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OBJECTIVE 1

The objective likely to be prioritised by special administrators is to return customer funds as soon as reasonably practicable. In the normal course, PIs and EMIs should be ring-fencing customer funds from the remainder of their assets (known as the “safeguarding” requirements). Upon appointment, the special administrator should take stock of what funds are ring-fenced and what funds should be ring-fenced and reconcile the two. While doing this, the special administrator must not interrupt payments to payment system operators. Reconciliation will not apply to any funds that were transferred after special administration commenced. These funds should simply be returned to the customer less any costs for doing so.

If any funds are covered by insurance policies or third party guarantees, the special administrator should ensure these are realised without delay and deposited into the relevant account.

In order to facilitate prompt return of customer funds, the special administrator may set bar dates for submitting claims. A soft bar date would encourage timely submission while a hard bar date indicates an absolute cut-off time for submissions. Notice must be given for each date to anyone the special administrator reasonably identifies as having a claim, and a hard bar date needs court approval.

OBJECTIVE 2

The second objective is to ensure timely engagement with payment system operators, the FCA, the Bank of England, and HM Treasury (the UK government's economic and finance ministry). The special administrator will work with the payment system operators to resolve problems arising out of the special administration and to facilitate the prompt transfer, settlement, or cancellation of payments (as applicable). The special administrator will also work with the above-mentioned authorities to ensure customers are adequately protected and there is minimal disruption to the market. For the purposes of this objective, “work with” includes complying with written requests and allowing access to the facilities or staff.

OBJECTIVE 3

Objective 3 is to either (a) to rescue the PI or EMI as a going concern or (b) to wind it up, if in the best interests of the creditors. This can be done by either going through the traditional winding up process or by transferring all or part of the property, rights and liabilities, and all or some of the relevant funds to another institution so that essentially the transferee becomes the PI or EMI. Note that such transfer will also satisfy Objective 1. In order to make a transfer from an insolvent institution to a solvent institution:

(a) the special administrator should believe that customers will have access to their funds as soon as reasonably practicable after the transfer;

(b) there is an undertaking that current funds and any future funds will be ring-fenced; and

(c) within 14 days, all customers or agents of the PI or EMI or any distributors of the EMI will receive a notice indicating that the funds are ring-fenced in accordance with (b) above.

In order to expedite the process, any such transfers will automatically have the underlying contracts novated to the transferee.

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If a transfer will only occur for part of the PI's or EMI's business, the special administrator must be satisfied that the customer would receive the same or more return by entering into the transfer.

CONTINUING SUPPLY

It is likely that prior to the special administration commencing, the PI or EMI would have entered into supply agreements to facilitate the transactions contemplated by their business models, including:

- services relating to ring-fencing customer funds;
- hardware and software;
- financial data and data processing;
- infrastructure allowing electronic communication; and
- secure networks.

When special administration is commenced, the supplier must continue to supply under the terms of their agreement unless (i) the special administrator consents to the termination, (ii) the supplier remains unpaid for more than 28 days, or (iii) the supplier has received permission from the courts. It is important to note that payment system operators do not fall within the definition of suppliers.

OTHER CONSIDERATIONS

Insolvency event: The Regulations will amend the Payment Services Regulations 2017 and the Electronic Money Regulations 2011 so entry of a PI or EMI into special administration will automatically constitute an "insolvency event" under the PI's or EMI's existing contracts.

Costs and shortfalls: If there is a shortfall in ring-fenced funds to be distributed, the cost will be borne pro rata by all customers. However, any breaches to the safeguarding requirements will be borne by the insolvency estate. If a customer is also an unsecured creditor, they have a right to proceeds via the usual unsecured creditor process in addition to those funds ring-fenced. If an EMI has two asset pools, these may not be set-off against each other.

The FCA: The FCA's powers under Part 24 of the Financial Services Act 2000 will be extended for special administration meaning that the FCA will have the same rights in the administration process as it has for other regulated institutions, such as speaking at creditor meetings and participating in court proceedings.

Small institutions: Small PIs and small EMIs are not required to ring-fence customer funds (only with respect to payment transactions unrelated to the issuance of electronic money) but they can voluntarily choose to do so. Objective 1 will not apply to small PIs that did not choose to ring-fence funds when entering special administration; similarly it will not apply to customer funds for unrelated payment transactions that small EMIs did not choose to ring-fence when entering special administration. However, small institutions will still be caught by Objective 2 and Objective 3. Small PIs and EMIs are "registered" as such by the FCA (and subject to a lighter regime than "authorised" PIs and EMIs). To be so registered, small PIs and EMIs must meet specific conditions. For example, the total amount of payment transactions executed over the preceding 12 months (averaged monthly) must not exceed €3,000,000 (for a small EMI, this refers to transactions unrelated to the issuance of

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electronic money); in addition, for a small EMI, its total business activity must not generate more than €5,000,000 average outstanding of electronic money.

CONCLUSION

The Regulations will provide some clarity for those dealing with the fall-out from the failure of a PI or EMI. As the number of these institutions proliferates, then dealing with the failures in the payment industry will be just as important as lauding the success of those gaining market share. This will hopefully give consumers confidence to use these institutions on a wider scale.

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