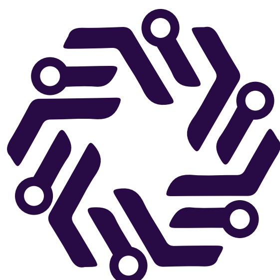

Capital requirements

A series of guides addressing the subject of governance arrangements for UK authorised Electronic Money Institutions ("EMI") and Payment Institutions ("PI").

Guidance is provided for firms and is not intended as legal advice.

Guide 1: Overview of capital requirements

Background

UK authorised EMI and PI businesses must adhere to the regulatory requirements defined in the Electronic Money Regulations 2011 ("EMR") and the Payment Service Regulations 2017 ("PSR") as well as associated guidance from the UK's Financial Conduct Authority ("FCA").

The EMR and PSR require firms to maintain a certain level of capital as a condition of the firm's authorisation as well as on an ongoing basis in order to remain authorised. The initial and ongoing capital requirements differ depending on whether the firm is an EMI or a PI.

Initial capital requirements must be demonstrated as part of an application for authorisation and the ongoing capital requirement (also referred to as the "Own Funds" requirement) will need to calculated in accordance with methods defined in the EMR and PSR.

The capital held by a firm will need to be monitored on an ongoing basis to ensure that the Own Funds requirement is not breached.

The Importance of Regulatory Capital

Capital is required to be held as a buffer, to help absorb unexpected losses, or losses arising if a firm is wound up. Holding sufficient regulatory capital is important for several reasons. First and foremost, it acts as a buffer against unexpected losses. In the event that a firm experiences a decline in its assets or an increase in its liabilities, the capital that it holds can help to absorb those losses and prevent the firm from becoming insolvent. This helps to maintain the stability of both the firm and the broader financial system and thereby help maintain overall market confidence.

The Own Funds requirement increases as the level of business activities increases, e.g. the more e-money that is issued, or the greater the number / value of payment transactions processed, the higher the Own Funds requirement will be. Since the capital held by an EMI / PI typically (in most cases) represents the 'size' of its Balance Sheet, increased activity

dictates a larger Balance Sheet. Firms' that hold sufficient regulatory capital are also in a better position to withstand unexpected events such as natural disasters, cyber-attacks or other types of operational risks – this should be factored into the firm's Wind Down Plan. Holding the required level of capital therefore reduces the overall risk of the business and, in particular, regulatory risk.

What does 'capital' comprise?

A firm's capital resources, i.e. the capital that it holds, typically comprises:

- Capital instruments (e.g. Issued Share Capital)
- Share Premium; and
- Retained earnings (e.g. Profit & Loss Reserves).

These items would essentially represent the bottom half of the firm's Balance Sheet. A profitable business will have an increasing Profit & Loss Reserve, due to the generation of profits that are retained in the business, and therefore an increasing amount of capital held.

From a regulatory perspective, capital items are classified into various 'Tiers'. The above items are included within Tier 1 which is the most important form of regulatory capital and is considered to be the highest quality capital. Tier 2 capital is considered to be of lower quality and typically includes subordinated debt and other forms of hybrid capital. Tier 3 capital is considered to be the lowest quality capital.

Additional items, other than those mentioned above, are included within these Tiers and there may also be some required deductions due to the firm's capital structure; this can become quite complex and FCA Guidance should be referred to and, if necessary, professional advice sought.

It is important to note that the capital held by a firm does not require an amount of cash to be held in a bank account. This is a common misconception. The only requirement to hold a certain amount of funds in a dedicated bank account comes from the 'safeguarding' requirements – see guidance ***Safeguarding Arrangements Guide 1 - Overview of safeguarding arrangements***.

Initial capital requirements

The required amount of initial capital differs depending on whether the firm is an EMI or a PI. Holding the requisite amount of initial capital is a requirement for authorization. Note that capital requirements defined in the EMR and PSR are measured in Euro.

- For an EMI, the initial capital is **€350,000**.
- For a PI, the initial capital will depend on the type of payment service permissions: **€125,000** for acquiring (and most other payment service permissions), **€50,000** for payment initiation services **€20,000** for money remittance.

Once authorized the initial capital requirement represents an ongoing minimum level of capital that must be held regardless of the level of business activities.

Ongoing ("Own Funds") requirement

The ongoing capital, or "Own Funds", requirement must be calculated in accordance with a prescribed 'Method' that is applied depending on whether the firm provides payment services

or e-money services. Firms will need to hold Own Funds that are in excess of the requirement, as calculated in accordance with one of the following Methods:

- PI – use **Method A, B or C** (as agreed with the FCA, either at authorization or subsequently through a change notification) for the payment services provided.
- EMI – use **Method D** for the e-money services provided.

As mentioned above, the initial capital requirement represents the minimum Own Funds requirement that must be maintained by the firm (regardless of the level of activity).

These separate Methods are described in more detail below.

Payment services - Method A, B or C

The three Methods applied to payment services are based on very different measures and frequently result in significantly different Own Funds requirements:

- **Method A** is based on the 'fixed overhead' of the firm. Where costs are low in relation to the size of the business / services provided (e.g. as a result of outsourcing within a group or due to an efficient low-cost business model) the Own Funds requirement under Method A will be low.
- **Method B** uses the value of the payments processed. This calculation is typically the highest of the three Methods and can be quite significant where the firm is processing a large amount of transactions. Method B is probably the least likely to be artificially reduced by arrangements such as outsourcing (as above) or inter-company revenues (see below).
- **Method C** is based on the income of the firm. This Method is typically lower than the Method B calculation and often higher than the Method A calculation. This Method can be affected by the reduction of income through, for example, the use of inter-company revenue recognition such as 'Cost-Plus' arrangements that may be lower than charges / fees that might otherwise be levied.

The calculations, particularly under Methods B and C, can be relatively complex and published FCA guidance should be consulted. Further guidance can also be found in these guides:

- **Capital Requirements Guide 2: Capital requirements PI**
- **Capital Requirements Guide 3: Capital requirements EMI**
- **Capital Requirements Guide 4: Methods A, B and C calculation spreadsheet**

Electronic Money services – Method D

An EMI will need to hold Own Funds in excess of the requirement calculated in accordance with Method D. The Method D calculation is 2% of the 'average e-money outstanding'.

Average e-money outstanding is calculated over the prior six months taking the e-money outstanding on the first calendar day of each calendar month and applying it throughout that month (i.e. calculations and adjustments are made monthly).

If an EMI provides 'unrelated payment services' (i.e. payment services that are not related to the e-money service) then one of Methods A, B or C will need to be used in addition to Method D. In such cases, calculations under Methods A, B or C would be combined with the Method

D calculation (for the e-money and related payment services) to provide the total Own Funds requirement.

How can a firms' Own Funds increase?

The Own Funds held within the business should meet, or preferably exceed, the Own Funds requirement. A growing business is likely to have an increasing Own Funds requirement due to an increase in the value / volume of payment transactions being processed and / or the amount of e-money being issued. In fact, an increasing Own Funds requirement in response to an increase in the size of the business, is the objective of regulation.

An ideal scenario for a growing business would be for the increasing Own Funds requirement to be met through profits that are being generated and retained by the business, i.e. an increasing Profit & Loss Reserve, as described above, rather than having to seek additional fund raising, i.e. issuing new share capital. Increasing the amount of capital held through retained profits would enable the firm to be, in effect, self-financing in terms of its capital requirements in a similar manner to being self-financing in terms of cash flows – additional external investment would not be required.

What if a firm cannot meet its capital requirements?

To become and remain authorised as an EMI or PI a firm will need to hold the required amount of Own Funds (i.e. the amount calculated under the prescribed method with the required Initial Capital as a minimum).

If a firm is unable to meet its Own Funds requirement it would be in breach of its authorization conditions. This would be a notifiable event to the FCA and should be notified as soon as the breach, or potential breach, is identified.

If notification takes place after the breach has occurred, this would indicate weak internal controls, i.e. that management was unaware of the financial position of the firm, funding issues or cashflow issues and, as such, their oversight and control of the business is somewhat lacking. This could trigger further issues being reviewed by the FCA as part of their supervisory activities.

Potential capital shortfalls should be identified in advance, through financial forecasting and budgeting processes that are linked to strategic planning activities.

The provision of management information to the Board that is appropriate for the business is essential to support their oversight of the business. Further information on the reporting of management information can be found in ***Governance Arrangements Guide 4: Management information reporting***.

Additionally, a potential breach of the capital requirements should be considered as a trigger for the Wind-Down Plan, i.e. if a breach of the capital requirements cannot be rectified quickly there is a strong likelihood that wind-down activities will need to be initiated.

What should a firm do to ensure it meets capital requirements?

Management information detailing the Own Funds requirement compared to the Own Funds held should be provided to the Board to facilitate business oversight, strategic and financial planning activities and the early identification of potential breaches so that proactive action can be taken. Proactive action could be cost-cutting (to increase retained profits) or seeking / arranging the investment of additional share capital (which obviously takes time).

Since the capital requirements set out in the PSR and EMR are expressed in Euro, firms should also hold sufficient capital to cover potential GBP / Euro exchange rate fluctuations.

If a firm is profitable, the retained profits which are represented by the Profit & Loss Reserve on the Balance Sheet will increase the amount of capital held. Additional Share Capital could also be issued from time to time, if required, to increase the capital held. This might happen where the firm is making a loss or insufficient profit to increase the amount of capital held in line with the increased activity (i.e. amount of e-money issues / payment transactions processed). Capital injections would obviously require planning and involve a potentially long-lead time, i.e. they should be identified well in advance of being required (through financial and strategic planning activities).