payments and crypto network

<u>Preparing an Application for Authorisation</u>

A series of guides addressing common issues in relation to preparing an application for authorisation.

<u>Guide 9: Capital requirements</u>

<u>Background</u>

Electronic Money Institutions ("EMI") and Payment Institutions ("PI") are required to submit a financial forecast, covering a period of three financial years, with their application for authorisation. The forecast will need to demonstrate that the firm is able to employ *"appropriate and proportionate systems, resources and procedures that allow the applicant firm to operate soundly"*. Part of this requirement will involve forecasting and maintaining a certain level of capital within the business; regulatory capital requirements are both <u>initial</u> (in order to become authorised) and <u>ongoing</u> (in order to remain authorised).

The financial forecast will need to provide a reasonable level of detail, being presented as a Profit & Loss Statement, Balance Sheet and Cash Flow, with accompanying descriptions of the assumptions upon which the forecasts have been prepared. A similar level of detail will need to be provided in relation to the forecast capital that will be <u>held</u> and the forecast capital <u>requirements</u>.

The forecast should be prepared for the <u>applicant entity</u> and be consistent with the written narratives provided in the Regulatory Business Plan (the main application document that you will need to prepare). The subject of preparing a Regulatory Business Plan is addressed in the ***Applications for Authorisation Guide 11 – Preparing a Regulatory Business Plan***.

The application will need to include a financial forecast, and detailed assumptions, for both a 'base case' and ideally two stress scenarios. The subject of preparing a financial forecast for inclusion in an application for authorisation is covered in ***Applications for Authorisation Guide 8 – Financial forecast.*** The forecast initial and ongoing capital requirements will need to be calculated under base and stressed scenarios.

In their review of the financial forecast, the FCA will have two main concerns:

1. Whether the business meets its regulatory capital requirements; and

2. Whether there will be sufficient cash to remain a 'going concern' (an accounting term referring to the ability to meet liabilities as they fall due).

Capital requirements and going concern are two separate issues and should not be conflated; capital requirements do not relate to the 'cash' held in the business whereas going concern is absolutely a cash flow issue.

The stress testing of the financial forecasts will be used to see whether the applicant firm will continue to hold sufficient capital in order to meet requirements (especially under the stressed scenarios).

This guide should help you understand the capital requirements that are applicable PI and EMI businesses so they can be reflected in the application and the development of the financial forecast.

<u>Initial capital requirement</u>

The initial capital requirement is the amount of capital that must be held in order to become authorised (applicants will not be authorised unless they can demonstrate that they hold the required amount of initial capital). This is an initial hurdle to become authorised.

Initial capital is measured in Euro.

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

The amount of initial capital represents an ongoing minimum, which must never be breached.

Note: if an EMI provides unrelated payment services in addition to e-money services there are no additional initial capital requirements.

<u>Ongoing capital requirement</u>

The ongoing capital requirement for a PI is calculated using one of three 'Methods' A, B or C. An EMI will need to use Method D in relation to its e-money services and, if it provides unrelated payment services, also one of the three Methods A, B or C.

An applicant can choose in its application for authorisation which Method from A, B or C it considers appropriate for the business. Calculations under all three Methods should be undertaken for the three forecast financial years and the reasoning for the choice outlined in the Regulatory Business Plan. The FCA will assess the applicants' reasoning and determine their own opinion of which Method is the most appropriate for the firm to use once authorised.

The FCA can also require an additional 20% capital requirement, based on their risk assessment of the applicants' business. They may also allow a 20% reduction. Either way, these adjustments are not common but should be considered when calculating whether the forecast capital held will exceed the forecast capital requirement.

The FCA will seek to ensure that an applicant firm can meet its capital requirement throughout the three-year forecast period.

<u>How is capital held calculated?</u>

The capital that your business holds, also referred to as “Own Funds”, is typically calculated as the sum of the Issued Share Capital, Share Premium and Profit & Loss Reserve, i.e. the bottom half of the Balance Sheet. A profitable business will have an increasing Profit & Loss Reserve due to the generation of profits that are retained in the business.

Conversely, retained losses will reduce the Profit & Loss Reserve over time, in which case a firm may need to seek additional capital investment (i.e. issue more Share Capital). The financial forecast will need to demonstrate whether the applicant firm will hold sufficient capital (Share Capital + Share Premium) to cover any initial forecast losses and whether (and where from) any investment is required in order to take the business through to profitability.

For a newly incorporated business applying for authorisation the focus will be on the Share Capital and Share Premium, since there will not have been any previous trading history and therefore no Profit & Loss Reserve.

FCA guidance should be consulted with regard to other items that can be counted towards the Own Funds held by the business since these can become quite complex. Some deductions may also be required. The majority of firms, however, would only need to consider Issued Share Capital, Share Premium and Profit & Loss Reserve.

<u>Capital requirement for Payments Institutions</u>

Payment Institutions will need to hold Own Funds in excess of the requirement calculated in accordance with one of Methods A, B or C. The application for authorisation will need to include calculations performed under each of the three methods and provide the reasoning for the applicants’ choice of preferred method. The FCA’s assessment of the application will consider the reasons put forward by the applicant for using a particular Method and will communicate their required Method to the firm upon authorisation.

The three Methods 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. The financial forecast model will need to include these calculations.

Capital requirement for Electronic Money Institutions

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 (for an applicant a projected six months will need to be used, based on the figures included in the financial forecast) 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 applicant EMI is seeking to provide '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. Calculations under Methods A, B and C should be included in the financial forecast (for the unrelated payment services) and 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 aligned with the increase in the size of the business, is the an 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, rather than having to seek additional fund raising, i.e. issuing further share capital and diluting existing shareholders. The business would be self-financing in terms of capital requirements in a similar manner to being self-financing in terms of cash flows.

The stress testing of the financial forecast is a requirement for the submission of an application for authorisation and should consider the implications on both the Own Funds requirement and Own Funds held when the base case assumptions are revised for certain stress scenarios. The FCA would like to see that the business can meet its Own Funds requirement in these stressed circumstances.

What do we need to describe in an application for authorisation?

An application for authorisation will need to include:

- **Initial capital** – descriptions of the initial capital that will be in place at authorisation will need to be included in the Regulatory Business Plan. If the initial capital is in place at the time of submission of the application this should be evidenced (e.g. include copies of audited financial statements, statutory filings detailing the issuance of shares, bank statements showing the receipt of investment funds). If the initial capital is not in place when the application is submitted the Regulatory Business Plan will need to clearly describe how the firm will meet the initial capital requirement and evidence will need to be provided to the FCA prior to authorisation being granted.

- **Ongoing capital** – in addition to the three-year financial forecast included in the Regulatory Business Plan, calculations of the Own Funds requirements (under all of the applicable Methods A, B, C and D) and the Own Funds held must also be included. These should be calculated as part of the financial forecasting exercise for base case and stress scenarios. In relation to the provision of payment services, i.e. applicants for authorisation as a PI, or EMIs that intend to provide unrelated payment services, calculations under all three Methods A, B and C will need to be provided together with the reasoning for the preferred choice of method. Remember that an EMI providing e-money and unrelated payment services will need to use both Method D and one of Methods A, B or C.