E-money risk management

1. Introduction & Background

Robust risk management and consumer protection has been at the heart of the Central Bank of Ireland's ("CBI") approach to the supervision of regulated financial services firms for many years. In recent times, we have seen European regulators requiring E-Money Firms ("EMI") to implement and maintain robust risk management and governance processes and procedures for the maintenance of their risk profiles and control environment. If risk and governance frameworks or systems and controls are not fit for purpose, the potential for harm to customers and markets increases materially, something we have seen in numerous consumer protection scandals across the EU. This heightened supervisory focus on EMIs risk management, controls and governance mechanisms are due in part to:

i. the increase of multi-national technology companies, in particular, seeking authorisation as e-money firms. In the last two years in Ireland, there has been an increase of 150% of e-money firms seeking authorisation from the CBI[1]. Brexit has predominantly been the catalyst for such an upsurge, with many UK regulated e-money firms seeking Irish authorisation in order to continue to avail of the free movement of financial services rules around the EEA;

ii. consumers using innovative e-money solutions (multi-currency cards accounts and virtual wallets accessed online quickly adopted as standard), which have the benefit of processing payments swiftly, simply, ubiquitously and increasingly in real-time using SEPA Inst Credit rails compared to more traditional payment methods (cash, debit cards). As of May 2020, 1 in 4 Irish adults have an e-money account[2];

iii. the Covid-19 effect on global market volatility, creating unprecedented stressful scenarios and business/services continuity issues for regulated financial services firms;

iv. an increase in e-money regulation imposing obligations on EMIs to design and implement robust and prudent risk management, control mechanisms and governance arrangements. This is set out in regulation 11(3) of the European Commission ("EMR") (E-Money) Regulations 2011 (Ireland)[3]; and

v. global e-money issues such as WireCard , Curve, and ANNA.

Recognising this heightened supervisory focus on EMIs alongside Deloitte's extensive risk management experience, this article will discuss the key regulatory requirements under EMR and Payment Services Directive 2 ("PSD") that EMIs must adhere to in order for them to identify, assess, manage and monitor their risks on an ongoing basis, whilst also recognising some of the challenges and opportunities faced by EMIs in this risk management journey.

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1. https://fintechireland.com/uploads/3/5/4/5/35459745/20200409__20200412_-irish-fintech-companies-v3.0-fintech-ireland-peter-oakes.png

2. https://www.altfi.com/article/6571_1-in-5-irish-adults-have-a-revolut-card. Further, 278m in M&A generated in this space in Ireland in H1 2020.

3. "The Bank shall grant an authorisation only if, taking into account the need to ensure the sound and prudent management of an electronic money institution, the electronic money institution has robust governance arrangements, including—
(a) a clear organisational structure with well-defined, transparent and consistent lines of responsibility,
(b) effective procedures to identify, manage, monitor and report the risks to which it is or might be exposed, and
(c) adequate internal control mechanisms, including sound administrative and accounting procedures.
Those arrangements, procedures and mechanisms shall be comprehensive and proportionate to the nature, scale and complexity of the services provided by the electronic money institution."

2. Effective Risk Management in the Context of EMIs

CBI's Expectation for EMIs Risk Management Function
The CBI expect that a firm have an **independent risk management** function, that is appropriately staffed and aligned to the business' own business model. As such, each EMI's **risk management function will be unique to their business** and should be structured **to support the management and mitigation of risks** through **sound governance** and **ongoing monitoring** and **reporting**.

It is important that the **Chief Risk Officer** is in a position of **seniority, independence** and has **unrestricted access to key stakeholders,** including the Board to ensure they can maintain effective processes for the identification and monitoring of risks.

2.1 Risk management

Implementing and maintaining a robust risk management structure, which are proportionate to the size, complexity and nature of the firm's business, is generally a condition of CBI authorisation; for financial services firms – such as EMIs and traditional banks. From our experience and the regulatory requirements (i.e. under EMR/PSD2) the CBI expects EMIs to design and implement effective risk management processes and procedures to identify, manage, oversee and monitor any risks that the EMI is or may be exposed to in the following manner:

i. robust risk architecture, (including the risk components outlined in Figure 1), so that risks can be identified and articulated as they arise from their business model and e-money activities;

ii. a centralised register of all risks, including residual and inherent risk ratings,

iii. risk identification and methodologies for assessment, and challenge;

iv. effective controls inventory and environment (risk taxonomy);

v. three clear lines of defence, comprising of experienced pre-approved control functions ("PCF"), and risk owners, control owners and senior management in place that maintain risk;

vi. robust reporting and governance processes so EMIs risks are overseen and monitored on an ongoing basis, in particular at Board and Risk Committee levels, e.g. using management information metrics and risk health metrics.[4] (Governance risk will be discussed in a subsequent article to this series); and

vii. governance and risk management processes which proportionately fit the risk profiles and evolving business activities of the EMI.

Figure 1: Risk architecture

01 **Risk taxonomy**
A centralised database of all risks the firm is exposed to including their residual and inherent risk ratings and associated controls

02 **Risk appetite**
Detailing the risks of the firm as informed by the risk taxonomy. This includes proportionate risk triggers and tolerances.

03 **Risk management framework**
A risk management framework will clearly outline how the risks are managed within a firm and the roles and responsibilities between the three lines of defense.

04 **Risk monitoring**
The monitoring activities undertaken to ensure the firms compliance to their risk appetite and overall risk exposure.

05 **Risk reporting**
Clear reporting templates concerning the firm's risks as defined in the risk taxonomy and the frequency and escalation processes.

06 **Risk analytics**
The risk data that is available to the firm which is leveraged in identifying risk trends and any emerging risks.

4. In addition to the above list, EMIs must also manage with outsourcing risk, including intra-group and chain outsourcing, in accordance with the EBA Outsourcing Guidelines, February 2019.

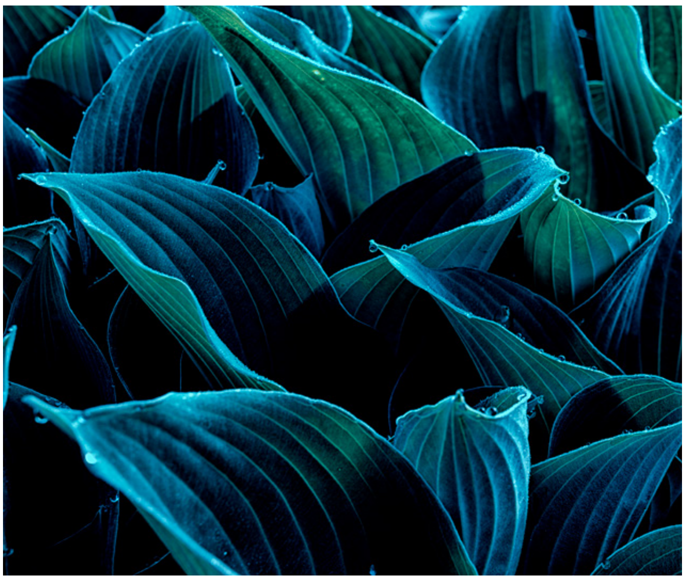
2.2 Risk Management is an Evergreen Journey

There is a regulatory requirement and expectation that EMIs shall have compliant risk management structures and processes in-place from D1 post-authorisation. These risk management structures and processes should organically develop and be refined as the EMI risk management architecture and team matures, in particular via the hiring of experienced risk and compliance staff, PCFs and senior management, and also to fit within the EMIs overall group risk structure. Effective and compliant risk management must develop in parallel with the EMIs business.

From our experience, it is important that all the teams involved in the EMIs business (e.g. commonly the Irish EMI will receive outsourced services from one of its Group members) that are located in another jurisdiction or group entity are brought along and involved in the risk management journey.

Effective and regulatory compliant risk management is an evergreen process – one which must be constantly reviewed, monitored and challenged. Upon the identification of new risks, or changes to existing risks, firms are expected to asses and adequately rate the risks and map controls accordingly. This commonly arises with the launch of a new product or a material change is made to an existing one. Effective risk management must adapt with the constantly evolving regulatory environment, the market, Supervisory expectations, and as the EMI's business, product and jurisdictional remit grows.

However, from our experiences firms that implement and maintain robust risk management structures are generally more accurately aware of the risks it is or could be exposed to because they have implemented proportionate structures and process to monitor and oversee their risks. Therefore, the firm is in a stronger position to successfully to maintain continuity of services and prevent adverse exposures to the market or consumers from stressful scenarios, as they occur, such the international market volatility caused by Covid-19.



3. Conclusion

The risk landscape for EMIs is under heightened supervisory scrutiny and likely to be subject to thematic reviews by Regulators over the coming months. This is partially due to economic and market risks stemming from the Covid-19 crisis and global headlines about EMI solvency issues, alongside substantial increases of Irish regulated EMIs primarily caused by Brexit, the large increase in consumers using EMI products, and increase in targeted Irish and European e-money applicable regulation[5].

Although the risk management rules and risk supervision for regulated financial services firms are well-established in Ireland, the mass influx of EMIs and nuances of these firms, whose origins are generally founded in a technology multi-national parent, pose challenges for both the supervisory team of the CBI and the EMI itself, as both learn to charter the risk management sea. EMI risk management has become a supervisory priority of European Regulators (e.g. the UK Financial Conduct Authority[6]).

A strong EMI risk management architecture encapsulates:

i. robust risk management architecture (including risk management framework, comprehensive risk register, appropriate risk appetite, risk policies and procedures);
ii. risk identification and methodologies for assessment, and challenge;
iii. risk management information, and reporting templates, including indicator reporting, embedded throughout the three lines of defence;
iv. three clear lines of defence and adequately resourced risk and compliance teams;
v. governance processes and procedures so the EMI can make prudent decisions about the EMIs identified risks and monitor risks are managed and controlled;
vi. governance and risk management processes which are fit their risk profiles and evolving business activities; and
vii. control inventory and environment.

As with all supervisory and regulatory challenges, this presents an impetus and opportunity for EMIs to design, implement and proactively engage with strong risk management processes and systems. This should be integrated throughout all elements of the EMI's business and culture, including at Group international level, and will translate into the EMI and the CBI having a positive supervisory relationship, create greater resilience for the EMI to manage and cope with risks and unprecedented stressful scenarios, and ultimately result in positive consumer and market outcomes.

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5. EBA Outsourcing Guidelines 2019, imposed outsourcing rules on E-Money Firms and Payment Institutions, which previously did not apply under the CEBS Guidelines.

6. See – FCA Coronavirus and Safeguarding of Consumers' Funds Guidance and FCA Dear CEO Letter.

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