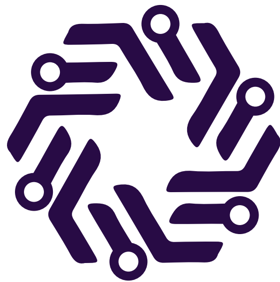

<u>Safeguarding arrangements</u>

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

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

<u>Guide 1: Overview of safeguarding arrangements</u>

<u>Background</u>

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 safeguard funds that are received from customers in relation to the provision of payment services or the issuance of e-money. The obligation to safeguard customer funds starts <u>immediately on receipt of those funds</u> and is an obligation of the firm, not an obligation for any Agents or Distributors used by the firm.

The safeguarding requirements are designed to protect customers, where their funds are held by a firm, by ensuring that those funds are either placed in a separate bank account (from the firm's own funds), or are covered by an appropriate insurance policy or comparable guarantee. On the insolvency of a firm, the claims of e-money holders, or payment service users, are paid from the asset pool formed from these funds <u>in priority to all other creditors</u>.

Firms must be careful to avoid giving customers misleading impressions about how much protection they will get from safeguarding requirements and must avoid suggesting that their funds are protected by the Financial Services Compensation Scheme ("FSCS").

Firms are also required to ensure that appropriate organisational arrangements are in place to protect the safeguarded funds which are sufficient to minimise *"the risk of the loss or diminution of relevant funds or assets through fraud, misuse, negligence or poor administration"*.

The requirement to safeguard applies to "Relevant Funds", as defined in both PSR and the EMR. Relevant Funds are:

- the funds that have been received in exchange for e-money that has been issued.
- the funds received from, or for the benefit of, a payment service user for the execution of a payment transaction (including sums received from a payment service provider

("PSP") for the execution of a payment transaction on behalf of a payment service user).

When does the safeguarding obligation start?

The safeguarding obligation starts as soon as the firm receives the Relevant Funds, including where funds are received by any Agents or Distributors that are used by the firm.

For example, a firm accepting cash in the provision of money remittance services would receive Relevant Funds as soon as the cash is handed over. As a general rule a firm will have received funds as soon as it has an *"entitlement"* to them.

For an EMI, Relevant Funds that are received in the form of payment by a payment instrument (e.g. by the customer using a credit or debit card) can be safeguarded when they are credited to the EMI's bank account, subject to the requirement that they are safeguarded by the end of five business days after the date on which the e-money was issued.

This allowance enables EMIs to issue e-money, and allow customers to use that e-money to make transactions, before the funds have been received by the EMI. A common example is where an EMI issues e-money upon confirmation of successful card authorization, rather than waiting for the payment scheme to settle funds before issuing the e-money (which would take several business days and lead to a rather delayed e-money service).

When does the safeguarding obligation end?

The general principle is that the safeguarding obligation remains in place until the Relevant Funds are no longer held by the firm, i.e. until the point in time that those funds are paid out to the payer or payer's PSP (i.e. e-money redeemed or the payment transaction processed).

Safeguarding Methods

There are two methods which a firm can use to safeguard Relevant Funds:

- **Segregation method** – Relevant Funds should be kept separate (i.e. be segregated) from all other funds held by the firm and, if the funds are still held at the end of the business day following the day on which they were received, be deposited into a separate account with an authorised credit institution[1] or invested in secure and liquid assets (the types of which have been approved by the FCA) and placed in a separate account with an authorised custodian.

  It is possible to use the same bank account to initially segregate funds upon receipt and up to the end of the business day following receipt, and then to continue to safeguard those funds from that point onwards (as long as the account meets the requirements of a safeguarding account, as described further see below). In practice most firms use the same bank account to both initially segregate and safeguard funds.

- **Insurance or bank guarantee method** - Relevant Funds are covered by an insurance policy with an authorised insurer, or a comparable guarantee given by an authorised insurer or an authorised credit institution. The guarantor must assume a primary liability to pay a sum equal to the amount of Relevant Funds on the insolvency of the firm. There must be no other condition or restriction on the prompt paying out of the

[1] An authorised credit institution means a UK bank or building society authorised by the FCA, including UK branches of third country credit institutions, or an approved foreign credit institution. A 'credit institution' is typically a bank, i.e. authorized to take deposits.

funds (see 'Insurance or bank guarantee method – considerations' section below for further details).

The segregation method is the most commonly used method for EMI and PI businesses. The insurance or bank guarantee method is less commonly used, in part due to the relatively few numbers of insurance providers / guarantors and the cost of such arrangements. Also, the insurance or bank guarantee method still requires the opening of a safeguarding bank account into which funds would be paid.

If desired, firms can use a combination of methods to safeguard Relevant Funds. If a firm chooses to use both methods of safeguarding, it should be clear from the records which funds are safeguarded using each separate method.

Changes in the choice of safeguarding methods must also be notified to the FCA.

It should also be noted that the EMR and PSR do not prevent firms from holding more than one safeguarding bank account. In any case, the holding of safeguarding bank accounts with several institutions would be prudent in case of account closure (which has been known to occur and cause significant issues for EMI and PI businesses).

Comingling of funds

It is important that the asset pool (i.e. the safeguarded funds held in a safeguarding bank account) from which the claims of e-money holders or payment service users are paid in priority to other creditors in the event of the insolvency of an institution is not improperly mixed with funds, assets or proceeds received or held for different purposes. This is referred to as *"co-mingling"* and may cause delays in returning funds to e-money holders or payment service users following an insolvency event of the firm.

Where a mixture of Relevant Funds and non-Relevant Funds are received, the FCA expect firms to segregate the Relevant Funds by moving them into a segregated account as frequently as practicable throughout the day.

Where funds are due to the firm, e.g. fees payable by the customer, they must be removed from the segregated bank account as frequently as practicable. **In no circumstances should such funds be kept comingled overnight.**

Unregulated business activities

Where firms provide unregulated services, they may not know the precise portion of Relevant Funds versus the funds received in relation to the unregulated services. It is also possible that the amount is variable in some way. Firms are able to make a reasonable estimate on the basis of *"relevant historical data of the portion that is attributable to e-money/the execution of the payment transaction and so must be safeguarded",* thus stripping out, on the basis of the estimate, the funds that arise from unregulated activities.

Evidence of the estimation method / calculation would need to be retained to show that the proportion actually safeguarded was a reasonable estimate. Where a mixture of funds are received the FCA expect firms to segregate the Relevant Funds by moving them into a segregated account as frequently as practicable throughout the day.

Similarly, where a customer incurs fees and the firm has a valid right to deduct such fees from the Relevant Funds, they should be removed from the segregated account as frequently as practicable (and not kept comingled overnight).

Segregation method: Safeguarding bank account requirements

It is important that the safeguarded funds from which the claims of e-money holders or payment service users will be paid (in priority to other creditors in an insolvency event) is not mixed with funds, assets or proceeds received, or held, for different purposes, i.e. that they are co-mingled, since this may cause delays in returning funds due to e-money holders or payment service upon insolvency.

There are some specific requirements that relate to the operation of a safeguarding bank account, in which Relevant Funds should be held, including:

- **Held in the name of the firm** - the safeguarding account must be held by the firm and not be used to hold any other funds or assets.
- **Account designation** - the safeguarding bank account used to hold Relevant Funds, or equivalent assets (if Relevant Funds are invested in permissible assets), must be named in a way that shows it is a safeguarding account rather than an account used to hold money belonging to the firm. The words "safeguarding", "customer" or "client" should be included in the account name.
- **Acknowledgement letter** – the FCA expect firms to hold an acknowledgement letter issued by the bank that confirms that they have no interest in, or rights over, the funds held in the safeguarding bank account. The FCA have published a useful template letter that can be used.
- **No "co-mingling" of funds** – Relevant Funds must not be mixed with other funds received by, or due to, the EMI / PI, such as fees due to the business or funds received for unregulated activities. Any such funds should be removed from the segregated bank account as frequently as practicable and in no circumstances should such funds be kept commingled overnight.

Segregation method: Investment of funds

Assets that may be used by an EMI or a PI when investing safeguarded funds, if they wish, must be approved by the FCA as being *"secure and liquid"*. The FCA use a common approach for identifying suitable assets under both the PSR and EMR.

These investments must be placed into a separate account with an authorised custodian in order to comply with the safeguarding requirement. FCA Guidance should be consulted when considering potential investments, which are limited in nature.

Insurance or bank guarantee method - considerations

Firms should consider the following when deciding whether the insurance / bank guarantee method is appropriate:

- The proceeds of the insurance policy or comparable guarantee must be payable into a separate safeguarding account held by the firm. If the firm is using the insurance or comparable guarantee method to safeguard all relevant funds, the account must be used only for holding such proceeds. If the firm has decided to use a combination of the two safeguarding methods, the account may also be used for holding funds segregated in accordance with the segregation method.
- There must be no other condition or restriction on the prompt paying out of the funds (allowing for a short period of time to prepare any necessary certification of the insolvency event).

- The amount of the insurance cover / comparable guarantee must at all times include reasonable headroom to allow for any foreseeable variation in the amount of the safeguarded funds being protected.
- There should be no level below which the insurance policy / comparable guarantee does not pay out.
- The firm must ensure that their insurer / guarantor understands that the circumstances that would lead to a claim and would provide no grounds to disputing their liability to pay.
- The FCA require firms using this method to assess and mitigate any increased operational risk arising from the reliance on insurance or comparable guarantees as a means of safeguarding. For example, increased risks could arise in the event that a firm is not be able to extend or renew their insurance cover or comparable guarantee, or find an alternative insurer or guarantor. To mitigate this specific risk, firms should seek to extend their insurance policy or comparable guarantee in good time before it expires. If they are unable to extend and the term has less than 3 months remaining, firms should prepare to use the segregation method (noting that they should already have a safeguarding bank account into which the proceeds from the insurance / guarantee would be payable).
- If a firm is unable to demonstrate that it will be able to safeguard all its Relevant Funds using the segregation method in good time (i.e. before the insurance policy / guarantee expires) the firm must consider whether it is appropriate to continue in business or whether the business should be wound up. This would be an issue to be considered when developing the firms' Wind Down Plan. Guidance on the subject of risk management can be found here ***Risk Management Arrangements: Guide 1 - What is risk management?***

Related and unrelated payment services provided by EMIs

An EMI can provide both related and unrelated payment services. 'Related' payment services are those that are related to the e-money service, for example, e-money is used to fund a remittance payment (because e-money is used to funds the remittance transaction it would be considered a related payment service).

Unrelated payment services are separate and distinct from the e-money service, e.g. a money remittance service offered by an EMI that does not involve e-money at any point.

The distinction may not always be obvious, however, firms will need to clearly understand whether their payment services (if there are any) are related or unrelated in order to meet the safeguarding requirements, as well as the separate capital requirements that apply to unrelated payment services, see guidance ***Capital Requirements: Guide 3 - Capital requirements EMI***.

Clearly understanding the services that the firm offers and the implications for the permissions that must be held is essential – both at authorization and to define the parameters for service development. The subject of regulatory permissions is addressed in the guide ***Applications for Authorisation: Guide 1 – Permissions.***

EMIs that provide unrelated payment services, in addition to e-money services, are also subject to the safeguarding provisions of the PSR and must safeguard funds that have been received for the unrelated payment services separately from those that are safeguarded in relation to e-money issuance (in accordance with the EMR).

Responsibility

Firms must ensure that an appropriate individual has oversight of, and responsibility for ensuring compliance with, all procedures relating to safeguarding and responsibility for ensuring that every aspect of the firms' safeguarding arrangements are compliant. This responsibility should be defined in the relevant job description and would typically be allocated to the firm's Compliance Manager (or similar role).

The individual performing the role that has been assigned with responsibility for safeguarding will need to be considered an EMD Individual or PSD Individual (depending on whether the firm is an EMI or PI), see guidance ***Compliance Arrangements: Guide 6 - EMD PSD Individuals***.

Operational aspects of the safeguarding arrangements, in particular the daily operation of the systems and controls that are relevant to safeguarding may be outsourced, for example, the performance of reconciliations being outsourced by the firm to a group finance function is a common arrangement. However, as with all outsourcing arrangements, responsibility must still reside with the firm (with the outsourcing arrangement subject to oversight by the Compliance Manager). Guidance on outsourcing can be found here ***Compliance Arrangements: Guide 4 - Outsourcing arrangements***.

Systems and controls

Firms must *"maintain organisational arrangements that are sufficient to minimise the risk of the loss or diminution of relevant funds or assets through fraud, misuse, negligence or poor administration".* This is in addition to the requirement to have adequate internal control mechanisms, including sound administrative, risk management and accounting procedures. The three lines of defence model should also be considered when developing the safeguarding systems and controls. This guide may be helpful, ***Risk Management Arrangements: Guide 4 - Three lines of defence model***.

Firms will need to exercise *"all due skill, care and diligence in selecting, appointing and periodically reviewing credit institutions, custodians and insurers involved in the institution's safeguarding arrangements"*.

The FCA also require firms to arrange specific annual audits[2] of their compliance with the safeguarding requirements. Guidance is provided here, ***Safeguarding Arrangements: Guide 4 - Annual Safeguarding Audit***.

Reconciliation controls

Reconciliations need to be performed between the records of the users' entitlement to Relevant Funds and the records of the amounts that have been safeguarded.

The FCA require that reconciliations should be done as *"often as necessary and as soon as reasonably practicable after the date to which the reconciliation relates"*. The frequency of the reconciliations should consider the risks to which the business is exposed, for example, the nature, volume and complexity of the services provided. Where there is a potential for discrepancies, e.g. holding Relevant Funds in different underlying currencies or where investments are made, reconciliations should be carried out *"not less than once during each business day"*.

[2] Safeguarding audits to be carried out by either an audit firm or by another independent external firm or consultant. The FCA expect institutions to exercise due skill, care and diligence in selecting and appointing auditors for this purpose and to satisfy themselves that the proposed auditor has, or has access to, appropriate specialist skill in auditing compliance with the safeguarding requirements under the PSRs and EMRs, taking into account the nature and scale of the institution's business.

The FCA have, in certain circumstances where the business model and transaction flows are complex, required reconciliations to be performed throughout the day, potentially on an hourly basis. The automation of the reconciliation process, or parts of the process, would be essential where multiple reconciliations need to be performed during the day.

Reconciliations will need to be undertaken between internal and external accounts and records. Internal records would be:

(i) the firms' records of the user liabilities that have been recorded in the firms' payment or e-money system, i.e. the record of the payment transactions that are being processed (i.e. not completed) or the e-money that has been issued (and which is still in issue, i.e. outstanding and not redeemed), and

(ii) the internal record of Relevant Funds held, i.e. the firms' cashbook record from the accounting system.

These would be reconciled to each other and then to the external records of Relevant Funds held, i.e. the bank statements showing the balances that are held in the safeguarding bank accounts. The reconciliation process would therefore tend to be a process involving three stages.

The firm must document the reconciliation process and prepare a clear explanation of the process. The process must be signed off by the Board and a record kept for reference purposes.

Records of the reconciliations should also be retained, including any discrepancies identified and the actions taken to rectify them.

The subject of reconciliations is addressed in the guidance, ***Safeguarding Arrangements: Guide 2 - Reconciliation requirements***.

Record keeping

Firms will need to maintain clear and accurate records that are sufficient to show and explain their compliance with all aspects of their safeguarding obligations, including a documented rationale for every decision made regarding the safeguarding process and the systems and controls that are operated.

Records should also enable firms to distinguish Relevant Funds and assets held:

- for one e-money holder / payment service user from those held for any other e-money holder / payment service user; and
- for one e-money holder / payment service user from its own money.

Safeguarding Policy

Firms could prepare a stand-alone 'Safeguarding Policy' to provide operational detail relating to safeguarding, e.g. details of the step-by-step reconciliation process. The Safeguarding Policy could then be referenced in the Compliance Manual (to keep the Compliance Manual to a reasonable size and minimise the need for updates to the manual each time an aspect of the safeguarding arrangements changes). Further guidance can be found in:

- ***Safeguarding Arrangements: Guide 3 - Safeguarding Policy***
- ***Compliance Arrangements: Guide 2 - Developing a Compliance Manual.***