



# payments and crypto network

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## **Safeguarding arrangements**

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.

### **Guide 4: Annual Safeguarding Audit**

#### **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 require an EMI to *“safeguard funds that have been received in exchange for electronic money that has been issued”*.

The PSR require a PI to safeguard *“sums received from, or for the benefit of, a payment service user for the execution of a payment transaction”* and *“sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user”*.

Firms are required to ensure that appropriate organisational arrangements are in place to protect these safeguarded funds. The organisational arrangements must be sufficient to minimise *“the risk of the loss or diminution of relevant funds or assets through fraud, misuse, negligence or poor administration”*.

The FCA expect firms to arrange specific annual audits of its compliance with the safeguarding requirements under the PSR / EMR, if they are required to arrange an audit of their annual accounts under the Companies Act 2006.

FCA guidance states *“that adequate safeguarding measures are a pre-requisite for being granted and retaining an authorisation for the provision of payment and e- money services”*.

#### **When should a safeguarding audit be performed?**

The requirement is to commission an audit of the safeguarding arrangements on an annual basis. The FCA acknowledge that firms may wish to align their safeguarding audit with the audit of their financial statements, i.e. covering the same period as the firms’ financial year. Firms can schedule their audits to a different timeline, and cover a different period, if they



wish. The decision will likely need to consider who will perform the audit - if the financial auditor is to perform the safeguarding audit it would likely make sense to combine the safeguarding and year end audit work.

### Who can perform an audit?

Safeguarding audits could be carried out by a financial auditor (e.g. where the safeguarding audit is combined with the audit of the year-end financial statements) or by another “*independent external firm or consultant*”. An independent external firm or consultant may be a compliance consultancy, legal practice, small accounting firm, etc.

Importantly, the FCA expect firms to exercise “*due skill, care and diligence*” when selecting and appointing a safeguarding auditor. The due diligence process should enable firms to satisfy themselves that their proposed auditor has appropriate specialist skills in auditing compliance with the PSR / EMR safeguarding requirements.

Firms should keep records of the due diligence applied during the selection of a safeguarding auditor.

### What should the audit cover?

The safeguarding audit does not need to be performed in line with any specific audit framework but should obviously be conducted in a structured way and be capable of providing assurance that a firms’ safeguarding arrangements meet regulatory requirements and are appropriate given the nature and scale of the business.

The scope of the audit should enable the auditor to “*provide a reasonable assurance opinion*” confirming “*whether the institution has maintained organisational arrangements adequate to enable it to meet the FCA’s expectations of its compliance with the safeguarding provisions*”. The auditor should therefore have a good opinion on what areas they will need to audit and the level of review and testing work that would be required given the nature and scale of the firm.

The scope of the audit work could be set following discussion between the firm and the auditor to enable both parties to understand the risks associated with areas that are within scope and the availability of staff to participate in the audit enquiries, etc. Whilst the audit is focussed on safeguarding, there will be some overlap and interaction with other operational areas, including governance arrangements, internal controls, and risk management.

The audit opinion must be addressed to the firm and provide an opinion on the arrangements that have been maintained throughout a defined ‘audit period’ and whether the firm is meeting expectations at the audit period end date.

### Implications of significant changes

The FCA expect firms to consider whether it would be appropriate to arrange an additional audit if there are any changes to the business model of the firm which materially affect the safeguarding arrangements. Examples of material changes include:

- where an EMI begins providing payment services that are unrelated to issuing e-money, in which case Relevant Funds must be separately safeguarded; or
- a change in the firm’s safeguarding method, e.g. the introduction of the use of insurance as a method of safeguarding instead of, or in addition to, segregation.

Where a firm has made a material change affecting its safeguarding arrangements, the FCA expect a specific safeguarding report, to be prepared by an independent auditor, providing an opinion on the systems and controls and whether they are “*suitably designed to comply with the relevant safeguarding regulations*”.

The report should be shared with the FCA a reasonable period in advance of the new safeguarding arrangements being implemented. This would essentially be a notification in line with the requirement to notify the FCA of a ‘substantial change’ within ‘a reasonable period’ (which the FCA consider to be a period of at least 28 days before the change occurs), see, ***Compliance Arrangements: Guide 8 - Notifications and Reporting***.

#### Who should the auditor report to?

The audit report, and associated opinion, must be addressed to the firm. In accordance with the three lines of defence model that should be operated by firms, it would be reasonable to expect that the report would be sent for the attention of the firm’s Board or, if one is maintained, its Audit Committee. The three lines of defence model is discussed here, ***Risk Management Arrangements: Guide 4 - Three lines of defence model***.

#### Internal audit activities

Many EMI / PI businesses outsource their internal audit function, or parts of the function, in order to ensure that it can operate in an independent manner and that it has appropriate expertise available to address the scope of the audit work. Specialist third-party auditors are often used, and it would also be possible to outsource the audit of different areas to different parties in order to build the required expertise across the full scope of audit work, for example, the work of a specialist IT auditor could be combined with the work of a specialist compliance auditor and that of a safeguarding auditor.

Outsourcing can also be a cost-effective solution to access experts with specialised skills. Internal audit activities are covered here, ***Governance Arrangements: Guide 3 - Internal audit arrangements***.