payments and crypto network

Preparing an Application for Authorisation

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

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

Guide 10: Safeguarding arrangements

Background

Electronic Money Institutions ("EMI") and Payment Institutions ("PI") are required to 'safeguard' funds received from their customers in relation to the provision of e-money or payment services.

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 in priority to all other creditors.

Safeguarding arrangements are therefore a key concern for the FCA and adequate safeguarding arrangements are a pre-requisite for being granted (and retaining) an EMI / PI authorisation.

In an application for authorisation a firm will need to describe its safeguarding arrangements – see the last section of this guide for some advice on the scope and level of content to be included in your Regulatory Business Plan, see ***Applications for Authorisation Guide 11: Preparing a 'Regulatory Business Plan'***.

What funds need to be safeguarded?

The requirement to safeguard applies to "Relevant Funds", as defined in both the Payment Service Regulations 2017 ("PSR") and the Electronic Money Regulations 2011 ("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 for the execution of a payment transaction on behalf of a payment service user).

EMIs that provide unrelated payment services in addition to e-money services must safeguard these funds separately from those safeguarded in relation to e-money issuance.

When does the safeguarding obligation start?

The safeguarding obligation starts as soon as the firm receives the Relevant Funds. 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. The FCA state that, as a general rule, a firm will have received funds as soon as it has an *"entitlement"* to them.

Relevant funds received in the form of payment by a payment instrument (i.e. by a credit or debit card) only have to be safeguarded when they are credited to the EMI's bank account (or are otherwise made available to the EMI) 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 affords the EMI, for example, the ability to issue e-money upon confirmation of successful card authorization rather than waiting for the payment scheme to settle funds (which would likely take several days).

The general principle is that the safeguarding obligation remains in place until the funds are no longer held by the firm, i.e. until the funds are paid out (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 to invest the Relevant Funds in such secure, liquid assets (as approved by the FCA) and place those assets in a separate account with an authorised custodian.

  It is possible to use the same bank account to initially segregate funds on receipt and up to the end of the business day following receipt, and then to continue to safeguard the funds from that point onwards (as long as the account meets the requirements of a safeguarding account – as described below).

- **Insurance or bank guarantee method** - Relevant Funds to be 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 in an insolvency event of the firm. There must be no other condition or restriction on the prompt paying out of the funds.

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.

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[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.*

If desired, firms can use a combination of methods to safeguard Relevant Funds.

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).

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 due diligence arrangements, including the periodic review of findings, will need to be described in the application for authorization.

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. This is referred to as "co-mingling" and may cause delays in returning funds to e-money holders or payment service users if there is an insolvency event.

There are some requirements that relate to the operation of a safeguarding bank account, 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 invested), 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 (see the FCA website / guidance).
- **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 other activities (e.g. foreign exchange). 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"*. 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 to guide potential investments, which are limited in nature.

Insurance or bank guarantee method - considerations

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. 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 risk, firms should therefore seek to extend their insurance policy or comparable guarantee in good time before it expires. If unable to extend and the term has less than 3 months remaining, firms should prepare to use the segregation method.

If a firm is unable to demonstrate that it will be able to safeguard all of 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 (something to be considered in the firms' Wind Down Plan that will need to be submitted with the application for authorization).

Responsibility

Firms must ensure that an appropriate individual has been allocated with oversight of the safeguarding policies and procedures and responsibility for ensuring that the safeguarding arrangements are compliant. This responsibility should be defined in the relevant job description and would typically be allocated to the firms' Compliance Manager.

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 FCA also require firms to arrange specific annual audits of their compliance with the safeguarding requirements. The systems and controls to be operated by the applicant firm will need to be described in reasonable detail in the application for authorization.

Reconciliation controls

Reconciliations need to be performed between the records of the users' entitlement to Relevant Funds and the records of the amounts safeguarded. Reconciliations should be done as *"often as necessary"* – 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"*.

Reconciliations will need to be undertaken between internal and external accounts and records. Internal records would be (i) the user liabilities recorded in the firms' payment / e-money system, and (ii) the internal record of Relevant Funds held, i.e. the cashbook record from the firms' 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 held in the safeguarding bank accounts. The reconciliation process would therefore tend to be a three stage process.

Records must be maintained that provide a clear explanation of the internal reconciliation process and its adequacy (given the risks of discrepancies). The process must be signed off by the Board and a record kept.

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.

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

Safeguarding arrangements are a key area to be covered in an application for authorisation and are a particular focus for the FCA. Applicant firms should therefore aim to provide a good level of 'concrete' detail describing how they will meet the safeguarding requirements. The suggestions below should help.

- Describe the safeguarding method that the firm will use and the associated arrangements that will be operated, including due diligence applied during the selection of third-parties used (i.e. credit institutions and/or providers of insurance or guarantees) and the ongoing monitoring of those parties.
- Describe the flow of funds as part of the service description, the partners involved in the flow of funds, what funds the firm considers to be Relevant Funds, and outline when Relevant Funds are received (and how they are initially segregated) and when and how Relevant Funds will be safeguarded.
- Specify the role that is responsible for ensuring appropriate safeguarding arrangements are operated and how they discharge this responsibility. The responsibility and reporting lines will need to align with the staff organisation structure.
- Describe the controls applied in relation to the safeguarding arrangements, linking the content to the descriptions of the internal control environment (financial and administrative controls, the three lines of defence model), risk management arrangements (risk register), governance arrangements (reporting information provided to the Board) and the compliance controls (Compliance Manual and Compliance Monitoring Programme) that are included elsewhere in the Regulatory Business Plan.
- Reference the use of any outsourced support that is used, e.g. the operation of an outsourced accounting / finance function that performs reconciliations.
- Describe in reasonable detail the reconciliation process (not a step-by-step operational process but sufficient detail to enable the FCA to understand that there is a well-defined process). Ensure that the reconciliation process has been approved by the Board.
- Consider producing a stand-alone 'Safeguarding Policy' document referenced in the Compliance Manual to provide a higher level of operational detail, e.g. a step-by-step reconciliation process. The Safeguarding Policy could then be referenced in the application. The Compliance Manual should still have a safeguarding section, any Safeguarding Policy document would be used to provide the next level of detail.
- Incorporate safeguarding into the scope of any internal audit arrangements maintained by the firm and describe in the application.
- Include copies of agreements with the bank for the provision of safeguarding bank accounts or the insurance / bank guarantee provider. If these have not been finalised at the point of submission, clearly describe in the Regulatory Business Plan where the

discussions / negotiations currently stand. It would be prudent to have advanced discussions / negotiations to a point where the banking service provider or insurer / guarantor can be named in the application. In fact, you may want to name several potential partners (but avoid being too general and giving the impression that plans have not progressed sufficiently – it is important that the application content is assertive and as final as possible).

The opening of safeguarding bank accounts can take a significant amount of time. Discussions with potential banking service providers should be started as soon as possible during the application process. Charges levied by banks in relation to the operation of safeguarding bank accounts are not insignificant and will need to be considered in the commercial proposition and the financial forecast.