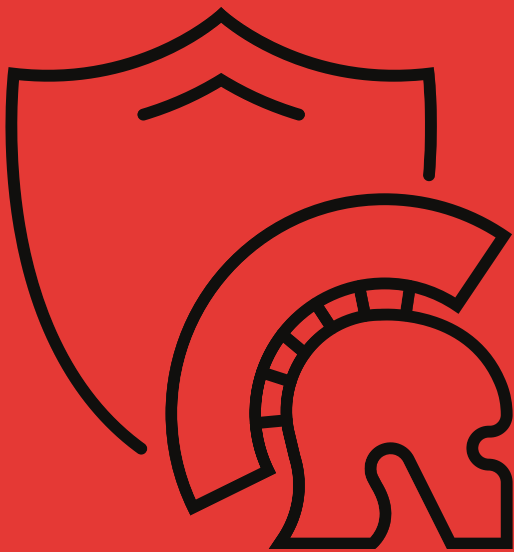
A SHORT GUIDE ON

SAFEGUARDING



FOR PAYMENT AND E-MONEY INSTITUTIONS

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Who must follow safeguarding requirements?

The **Financial Conduct Authority of the United Kingdom** emphasised that safeguarding requirement applies to **APIs, AEMIs, small EMIs** and credit unions that issue e-money and it is their responsibility to ensure appropriate organisational arrangements are in place to protect the safeguarded funds. In case of payment institutions, the requirement to safeguard the relevant funds emanates from regulation 23 of Payment Service Regulations 2017 (PSRs 2017). Whereas, for e-money institutions and credit unions requirements to safeguard arise from regulation 20 of Electronic Money Regulations 2011 (EMRs 2011). Furthermore, where EMIs provide unrelated payment services, they are subject to the safeguarding provisions of the PSRs 2017 as if they were APIs.

Interestingly, small payment institutions are not per se required to safeguard relevant funds but may choose to do so. In the latter case, they will need to inform the FCA whether they are safeguarding the funds or not. In cases that a small PI was safeguarding customers' funds in accordance with provisions of PSRs 2017 and thereafter decided to cease this practice, it should notify FCA in a timely manner. Furthermore, if a small e-money institution is providing unrelated payment services, it will be in the same position as small PIs with respect to safeguarding.

Credit unions that issue e-money and provide unrelated payment services are subject to regulation 23 of the PSRs 2017 on the same basis as small EMIs.

WHAT IS MEANT BY "RELEVANT FUNDS" IN TERMS OF SAFEGUARDING?

Plainly speaking "relevant funds" are funds that belong to the customers of the financial institution in question and against which such customers have a claim. They are covering the sums of money that were received by the institutions for the benefit or transactions that would be executed on behalf of a customer of a payment institution. Whereas, when speaking about e-money institutions, they concern the funds for which electronic money was issued to the customer.

Legal analysis

According to regulation 23 of PSRs 2017, for APIs the “relevant funds” are defined as:

> (a) “sums received from, or for the benefit of, a payment service user for the execution of a payment transaction; and
>
> (b) sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user.”

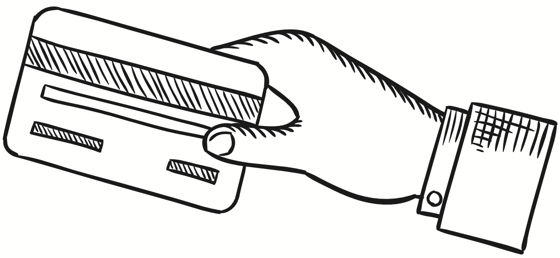
From the above excerpt, the main points are “sums received”, “from, or for the benefit of payment service user” and ”for the execution of a payment transaction on behalf of a payment service user”. The “sums” themselves are not concisely defined and can be interpreted as referring primarily to the value/amount of something of value when looking at the literal interpretation (which is the primary rule of interpretation in England and Wales) and the whole of the document in the context according to the purposive interpretation (i.e. purposive approach which is taken when considering the legislation stemming from the EU legislation, see Pickstone v Freemans plc [1989] AC 66).

Are we missing funds?

Interestingly, this definition does not have any reference to the "funds", which is used extensively throughout PSRs 2017 and FCA even stated that "safeguarding requirement applies to protect customers where funds are held by an institution". The confusion may arise when considering that funds are precisely defined as "banknotes and coins, scriptural money and electronic money" and hence whatever what is of value and "received" by the financial institution will constitute the value that must correspondingly be safeguarded. It is quite dubious in the context of PSRs 2017, especially when we consider the definition of "relevant funds" present in the EMRs 2011.

Funds for the benefit of a customer

Going back to the points "from, or for the benefit of payment service user" and "for the execution of a payment transaction on behalf of a payment service user"- it is important to note that safeguarding extends to funds that are not received directly from a payment service user, but includes, for example, funds received by an institution from another financial institution for the PI's customer.



When safeguarding requirements start to apply?

The general rule is that the obligation to safeguard starts immediately on receipt of the relevant funds by PIs or EMIs. The abovementioned rule applies with a minor variation depending on the channel transferring the value.

Funds arriving via a payment system

In case of an institution receiving funds through a payment system, the funds will need to be safeguarded at no later than the point when in accordance with the regulation 89 of PSRs 2017 or rules of a payment system in question they must be made available to the customer. Additionally, the FCA made clear that they expect from financial institutions that it will be the same point in time at which the funds are credited to the institution’s account with the payment system.

Cash denominated funds

For an institution accepting cash, for example in the provision of money remittance services, the funds will be received as soon as the cash is handed over. The PI or EMI will be deemed to have received funds as soon as it has an entitlement to them on behalf of their customer. This could include an entitlement to funds in a bank account in the institution’s name, funds in an account in the institution's name at another institution and funds held on trust for the institution.

Funds received via payment instruments

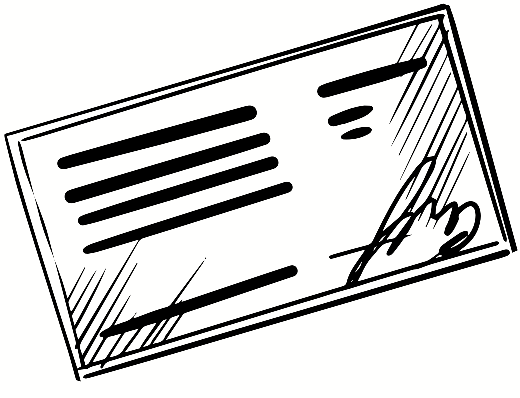
Notably, funds received in the form of payment by payment instrument (e.g. payment card) by an EMI may not be safeguarded until they are:

(a) "are credited to e-money institution's payment account; or

(b) are otherwise made available to EMI,

provided that such funds must be safeguarded by the end of five business days after the date on which the electronic money has been issued."

Meaning that they have to be safeguarded when they are credited to the EMI's or credit union's payment account or are otherwise made available to the EMI or credit union, 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 addition was established for the delay in the factual settlement which may arise from acceptance of payment instruments.



WHEN SAFEGUARDING REQUIREMENTS CEASE TO APPLY?

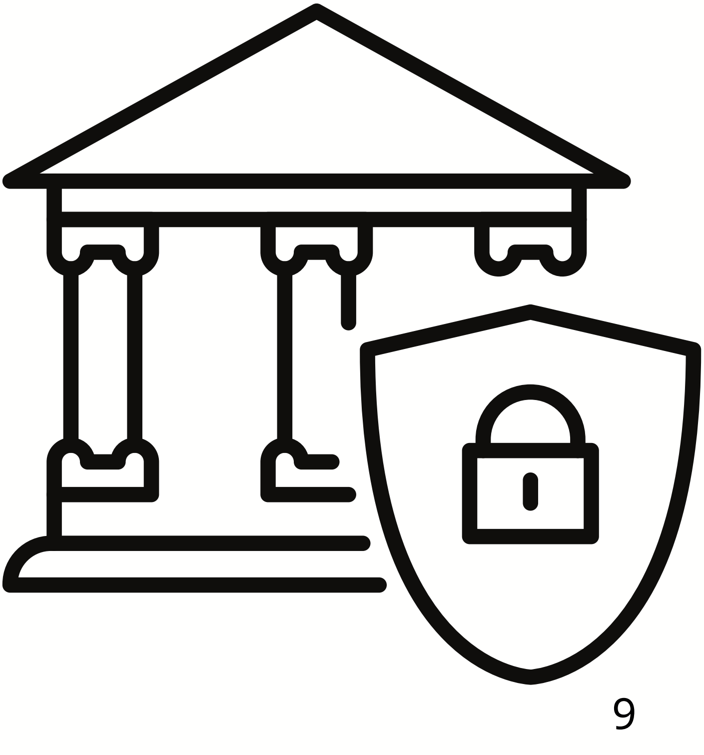
THE GENERAL PRINCIPLE IS THAT THE SAFEGUARDING OBLIGATION REMAINS IN PLACE UNTIL THE FUNDS ARE NO LONGER HELD BY THE INSTITUTION.

In practice, this means that the institution should generally continue to safeguard until funds are paid out to the payee or the payee’s financial institution. If a chain of financial institutions is involved, an institution’s safeguarding obligation continues while it holds the funds and ends when it has transferred them to another financial institution, which holds the funds on behalf of the payment service user. The funds must be safeguarded by the institution for the benefit of the payer or payee; it is not sufficient for the funds to be safeguarded for the benefit of another institution in the payment chain.

An institution may receive and hold funds through an agent or (in the case of EMIs and small EMIs) a distributor. The institution must safeguard the funds as soon as funds are received by the agent or distributor and continue to safeguard until those funds are paid out to the payee, the payee’s payment service provider (PSP) or another PSP in the payment chain that is not acting on behalf of the institution.

Methods for Safeguarding customers' funds

I. SEGREGATION
II. INSURANCE OR COMPARABLE GUARANTEE



What are methods of safeguarding customers' funds?

Authorised Payment Institutions (Payment Institutions, APIs, or PIs) and Authorised Electronic Money Institutions (E-money Institutions, AEMIs, or EMIs) are obliged to safeguard customers' funds in accordance with Payment Service Directive (EU) 2015/2366 (PSD2), Electronic Money Directive 2009/110/EC (EMD2) and national legislation implementing these directives (Payment Service Regulations 2017 (PSRs 2017) and Electronic Money Regulations 2011 (EMRs 2011) respectively.

There are two methods that PIs and EMIs may employ to adhere to this obligation and protect their customers’ funds. The first is the segregation method per which institution must keep relevant funds separate from all other funds it holds. The second is the insurance or comparable guarantee method. Furthermore, an institution may combine the two and safeguard certain relevant funds using the segregation method and the remaining relevant funds using the insurance or comparable guarantee method.

Whenever choosing one safeguarding method Payment Institution or E-money Institution must adhere to it, unless such institution decides to change the method of safeguarding the customer funds. In such a case, it must, without delay, inform the FCA regarding the shift in the practice of protecting its customers' funds.

Selecting, appointing and reviewing third parties

The FCA has reiterated countless times that institutions should carry out careful due diligence when appointing and periodically reviewing credit institutions, custodians and insurers. Whenever appointing or reviewing third parties to adhere to the regulatory requirements the institutions should exercise due skill, care and diligence.

Institutions should take account of the expertise and market reputation of the third party and any legal requirements or market practices related to the holding of relevant funds or assets that could adversely affect customers' rights or the protections afforded by PSR 2017 and EMR. Specifically, institutions should consider the following factors whenever appointing and reviewing credit institutions, custodians and insurers:

- the need for diversification of risks;
- the capital and credit rating of the third party;
- the amount of relevant funds or assets placed, guaranteed or insured as a proportion of a third party's capital and (in the case of a credit institution) deposits; and
- the level of risk in the investment and loan activities undertaken by the third party and its affiliates (to the extent that information is available).

Furthermore, the FCA clarified that both E-money and Payment Institutions should carry oue the periodic reviews as often as appropriate. This means they should be carried out whenever an institution believes that anything affecting the appointment decision has materially changed, such as a credit downgrade. In any event, such reviews should be conducted periodically at least once in each financial year.

What is the segregation method for safeguarding customers' funds?

The segregation method requires the institution to segregate the relevant funds (i.e. to keep them separate from all other funds it holds) and, if the funds are still held at the end of the business day following the day on which they were received, to deposit the funds in a separate account with an authorised credit institution (located within EEA) or the Bank of England, or to invest the relevant funds in such secure, liquid assets as FCA may approve and place those assets in a separate account with an authorised custodian. An authorised credit institution includes UK banks and building societies authorised by the FCA to accept deposits (including UK branches of third-country credit institutions) and EEA firms authorised as credit institutions by their home state competent authorities. Notably, according to draft Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provisions) (EU Exit) Regulations 2018 after Brexit this list will be expanded and shall include:

(i) central bank of a country which is a member of OECD,

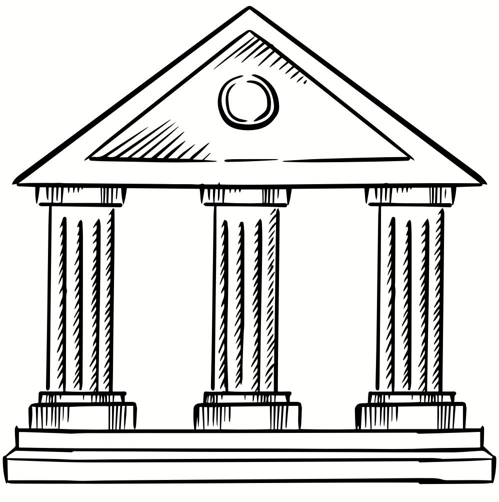
(ii) credit institution supervised by a regulator of an OECD member country,

(iii) any other credit institution from a non-OECD member state, which (a) provides audited accounts as required by national law, (b) has a minimum net assets of £5 million, (c) has a surplus of revenue over expenditure for the last two financial years, and (d) has an annual report which is not materially qualified.

Authorised custodians include firms authorised by the FCA to safeguard and administer investments and EEA firms authorised as investment firms under MiFID II and which hold investments under the standards set out in article 16 of MiFID II.

Furthermore, such segregated accounts must be named in a proper manner to reflect their purpose. As per the FCA guidance published on 22nd of May 2020, the name of the account shall include words "safeguarding" or "client". If it is impossible for a credit institution retaining such funds to make such designation in the name of the account, the payment institution or e-money institution must have evidence, such as a letter, confirming the appropriate designation according to the FCA provided template.

Neither PSRs 2017 nor EMRs prevent institutions from holding more than one safeguarding account. Both payment institutions and e-money institutions may have a number of accounts and perform reconciliations between the two. However, in such a case, institutions should have a clear record allowing for tracking which customer’s funds are held in which account. Furthermore, both PSRs 2017 and EMRs allow the same account being used to segregate funds up to the end of the business day following receipt, and to continue to safeguard the funds from that point onwards.



REMOVAL OF NON-RELEVANT FUNDS

THE SAFEGUARDING ACCOUNTS MUST NOT BE USED TO HOLD ANY OTHER FUNDS APART FROM THOSE THAT BELONG TO CUSTOMERS.

The FCA expects non-relevant funds (the funds which for whichever reason are on accounts of customers, e.g. fees which are due to the institution) to be removed as frequently as possible throughout each day and in no way should be left overnight (ideally, upon receipt but in whichever case at least once a day). Therefore, the reconciliation of accounts is of due importance and proper procedures and controls must be established within the institution. The FCA, as any other regulator, views this as core aspects that institutions must adhere to. The reason for it lies in the fact that if the reconciliation of the funds is not carried properly, it is difficult to track the funds. Furthermore, as a consequence of commingling funds of customers with funds of institution and subsequent insolvency of the institution the funds may form part of the institution’s insolvency estate. Hence, abolishing the benefits that safeguarding is aimed to achieve.

Charges by credit institutions and authorised custodians

It is important to note that safeguarding accounts must not be used to settle APIs or AEMIs obligations with the institution where the account is held. All charges should be made from the account with the funds of the payment/e-money institution itself. The institution should have an acknowledgement or otherwise be able to demonstrate that the authorised credit institution or authorised custodian has no rights (e.g. a right of set off) or interest (e.g. a charge) over funds or assets in the safeguarding account.

Funds held by agents/distributors

PIs and EMIs are ultimately responsible for supervising their agents/distributors. Therefore, where relevant funds are held on an institution’s behalf by agents or distributors, the institution remains responsible for ensuring that the agent or distributor segregates the funds.

Each payment institution and e-money institution must establish proper controls to ensure that their agents/distributors are following with their responsibilities. In cases that institution does not establish such controls, it still bears full responsibility and may subject to regulatory action.

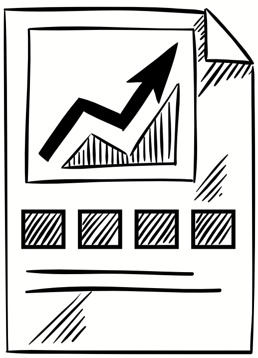
Investing in secure and liquid assets

The suitable assets are both secure and liquid, and payment and e-money institutions can invest in them and place them in a separate account with an authorised custodian in order to comply with the safeguarding requirement, if they are:

(a) items that fall into one of the categories set out in article 114 of the Capital Requirements Regulation (EU 575/2013) for which the specific risk capital charge is no higher than 0%; or

(b) units in an undertaking for collective investment in transferable securities (UCITS), which invests solely in the assets mentioned previously.

This means that exposures to European Central Bank, member states' central governments, and central banks denominated and funded in the domestic currency of that central government and central bank are falling under secure and liquid assets within the meaning of PSRs 2017 and EMRs. Furthermore, in exceptional cases the FCA may determine other assets to be secure and liquid for the sake of the safeguarding.



What is the insurance or comparable guarantee method for safeguarding customers' funds?

The second method which is available under PSRs 2017 and EMRs 2011 is to cover customers' funds by an insurance policy with an authorised insurer, or a comparable guarantee given by an authorised insurer or an authorised credit institution. Authorised insurer in this instance refers to one authorised in the UK or EU. Following Brexit this will most likely change, subject to the negotiations between the UK and EU.

As already stated above this method may be used together with the segregation method. Hence, insurance or comparable guarantee method may cover either all customers' funds (if solely this safeguarding method is chosen) or only part of customers' funds (if another part of is safeguarded by the means of the segregation method).

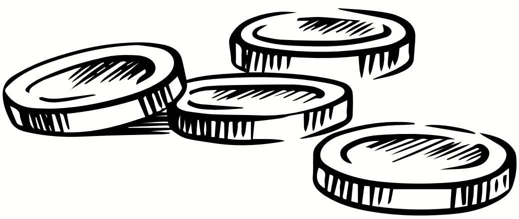
The guarantor must assume a primary liability to pay a sum equal to the amount of relevant funds upon the occurrence of an insolvency event (as defined in regulation 24 of the EMRs and regulation 23 of the PSRs 2017). There must be no other condition or restriction on the prompt paying out of the funds, accepting that some form of certification as to the occurrence of an insolvency event is a practical necessity.

How widely insurance or comparable guarantee method is adopted?

Notably, the insurance method is not widely followed in the industry (as it is often not practicable whilst requiring to safeguard an amount equal to the money transferred) and is mostly applied only in those instances that the account with an institution employed by the payment institution or e-money institution does not satisfy segregation requirements. Furthermore, insurance or comparable guarantee method can be of benefit in instances where segregation is not feasible because of the difficulty or uncertainty associated with payment flow for particular product/service offered by the PI or EMI.

In which account proceeds of the insurance or comparable guarantee must be paid?

The proceeds of the insurance policy or comparable guarantee must be payable into a separate safeguarding account held by the institution. If the institution is using the insurance or comparable guarantee method to safeguard all relevant funds, the account must be used only for holding such proceeds. If an institution has decided to use a combination of the two safeguarding methods at a later stage such a safeguarding account may also be used.



Are there any specific considerations for EMIs?

Note that for e-money institutions that engage in unrelated payment services, the insurance/guarantee proceeds must be paid into two separate safeguarding accounts (one with respect to e-money float and the other for relevant funds with respect to unrelated payment services).

How the safeguarding insurance must be structured?

Below is the summary of points that the safeguarding by the means of insurance or comparable guarantee must include:

(i) No condition or restriction in the terms of the insurance policy on the prompt paying out of the funds in full (once the insolvency event has been confirmed)

(ii) Policy pays in the event of insolvency regardless of how this was caused (e.g. fraud, negligence, unforeseen circumstance etc.)

(iii) No level below which the policy does not pay – it must not have an excess or deductible

(iv) Any claim is paid into a designated safeguarding account

(v) Automatic right to extend the policy period to allow renewal discussion or a change to the safeguarding method being adopted

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