Good Practice Guidance for Member Firms

Topic: **Safeguarding**

Date published: **4th February 2020**

Next Review Date: **Q1 2021** – unless significant regulatory changes prior to that.

About AFEP

Founded in 2012, AFEP works on behalf of its members to be the representative body for Authorised Payment and Electronic Money Institutions. Our mission is to elevate the standards of the FX and e-money industry, and advocate on behalf of our members with regulators and government bodies.

Background

In August 2018 the FCA opened consultation on applying the FCA's Principles for Businesses to payment services and e-money sectors, as well as applying communication rules to advertising and communication (CP18/21). The outcome of this consultation was issued on 1st February 2019 by the FCA as the 'General standards and communication rules for the payment services and e-money sectors' (PS19/3).

In preparation for this in late 2018, the AFEP Executive Committee began writing industry guidance on several key topics to act as good practice for our industry. As this good practice guidance has significant impact on how FX, e-money and payment services firms are encouraged to operate and how AFEP works with the FCA, AFEP worked with members to write this good guidance through working groups and Round Table sessions.

Good Practice Guidance documents have been written and issued to members on the following topics:

1. Communications with customers (currency convertors & disclosure)
2. Safeguarding
3. Customer interests & Conflicts of interest
4. AML
5. Corporate Governance

AFEP recognises the importance of members not only adhering to the FCA rules outlined in PS19/3 but also these Good Practice Guidance documents. Member firms are required, as a condition of membership, to confirm they are using the Good Practice Guidance and applying it to their business to ensure quality and compliance with the regulations.

Overview

This Good Practice Guidance relates to the requirement for payment services firms to safeguard funds received from payment service users for the execution of payment transactions. This is high level guidance as it is for each firm to determine how to comply with the requirements as relevant

to their business model. This guidance is intended for Authorised Payment Institutions (API's) and Authorised Electronic Money Institutions (AEMI's) who are full members of AFEP.

Specific Legislative Background

The specific legislative background to the safeguarding requirements for payment services firms are set out in the Payment Services Regulations 2017 (the "PSRs") and the Electronic Money Regulations 2011 (the "EMRs") respectively.

In addition, there is further guidance to the legal requirements set out in Chapter 10 of "Payment Services and Electronic Money – Our Approach. The FCA's role under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011" more commonly known as the "FCA Approach document".

1. Oversight and Governance

Clearly defined oversight and governance in respect of safeguarding requirements are key in ensuring that customer funds are adequately protected, and risks are correctly identified. AFEP has issued separate guidance on Corporate Governance and we do not seek to duplicate this in this document but have set out below the key areas we believe may have an impact on safeguarding and some of the considerations that should be applied by member firms.

Key risks

Failure to ensure that robust oversight and governance structures are in place may result in customer funds not being adequately safeguarded.

Guidance

We expect all member firms to:

a) adhere to AFEP's Safeguarding good practice guidance
b) allocate overall responsibility for safeguarding to a Director or Senior Manager who should have clear, documented, individual responsibilities and accountabilities
c) explicitly consider the requirement to safeguard funds and consider how it applies to their business and the products and services offered to ensure total capture
d) put in place policies, processes and procedures in relation to the safeguarding requirements under the PSRs and EMRs as appropriate
e) provide sufficient MI to the Board to enable it to understand the firm's safeguarding measures
f) Carry out periodic independent reviews
g) Put in place robust processes for breach identification, recording and reporting

	Good practice	Poor practice
1	Clearly documented oversight framework and control matrix commensurate with the size and nature of the business.	Lack of documented governance framework and/or one that is documented but not implemented in practice.
2	Member of the Board or Senior Management given explicit responsibility for safeguarding customer funds.	Lack of defined responsibility for safeguarding requirements at senior level.

3	Clearly documented Safeguarding Policy commensurate with the size and nature of the business approved by Board, including identification of relevant funds. Safeguarding Policy and identification of funds is updated to reflect new business products and processes.	• Lack of documented Safeguarding Policy and/or one that is documented but not implemented in practice. • No evidence of Board approval.
4	Clearly documented roles and responsibilities for safeguarding processes and procedures, accepted by relevant staff confirming their understanding and acceptance of those responsibilities.	Lack of or ill-defined responsibilities and/or gaps/overlap in areas of responsibility.
5	Clear policy for breach recording and reporting, breaches escalation process and reporting threshold to the regulator.	Failure to identify, record or report breaches
6	Regular MI presented to the Board regarding: • amounts safeguarded and whether the amount has been considered inline with regulatory capital requirement • banks/insurers used and due diligence carried out • global bank population control • Breaches identified and remediation, including as to whether these are reported to the regulator • Staff training	Failure to provide adequate MI to permit the board to understand safeguarding processes and requirements
7	Independent periodic audit by external firm or internal audit function	Internal reviews by staff involved in administering safeguarding policy and processes.

2. Relevant funds

The requirement to safeguard applies to 'relevant funds' in both the PSRs and EMRs.

All authorised APIs are required to comply with the safeguarding requirements in regulation 23 of the PSRs, where relevant funds are defined as:

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

All AEMIs are required by regulation 20 of the EMRs to safeguard funds received in exchange for e-money that has been issued. Where an AEMI provides unrelated payment services, it is required to comply with the safeguarding requirements in regulation 23 of the PSRs above.

Key risks
Failure to correctly define and identify relevant funds may result in significant customer detriment in the event of the insolvency of an API or AEMI

Guidance

We expect all member firms to:

a) identify and define relevant funds in relation to their business model, including the treatment of first party fx settlement payments and "two leg out" transactions
b) identify and define when the safeguarding obligation begins and ends in terms of the firm's business model and the products and services it offers, and document rationale if aspects of the firm's business are considered out-of-scope to ensure total capture
c) put in place policies, processes and procedures to adequately safeguard relevant funds received from, or for the benefit of, payment services users
d) documented rationale for every decision the firm makes in relation to the safeguarding process and the systems and controls they have in place.
e) For AEMI's, have a clear understanding of when they are providing payment services unrelated to the issuance of e-money

	Good practice	**Poor practice**

1	Clearly articulated definition of what constitutes relevant funds in the Safeguarding Policy, in the specific context of the firm's business, including in-scope and out-of-scope business and products.	Lack of clarity as to what constitutes relevant funds and what does not and whether the firm is acting as agent or distributor for another service provider
2	Clear articulation in both the Safeguarding Policy and client documentation (Terms of Business – ToB) of when the safeguarding obligation is triggered in the context of the firm's business, and when it ceases.	Lack of clarity as to when the safeguarding requirement begins and ends
3	Clearly defined processes and procedures to adequately safeguard relevant funds received from, or for the benefit of, payment services users, including a control matrix designed to ensure compliance with each Safeguarding requirement.	Lack of clarity around safeguarding processes and procedures
4 **AEMI's only**	Ability to identify between the issuance of e-money and unrelated payment services.	Failure to identify when unrelated payment services are being carried out.

3. Safeguarding methods

Under the PSRs and EMRs, there are two ways in which a firm may safeguard relevant funds:

- the segregation method – where relevant funds are segregated from all other funds the firm 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 (or the Bank of England) or invest them in FCA approved secure liquid assets placed in a separate account with an authorised custodian.

- the insurance or comparable guarantee method – where 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.

Under the FCA Approach guidance, it is possible to use both methods at the same time.

Key risks

- Funds are not adequately segregated from the member firm's own funds leaving them open to claims from other creditors
- Insufficient cover is provided under the insurance or guarantee method

Guidance

3A Segregation method

We expect all member firms to:

a) Before placing relevant funds with an authorised credit institution or investing in assets to be held with a custodian, ensure that the third party is appropriately authorised by FCA or another EEA competent authority.
b) Ensure that relevant funds are not placed with another API or AEMI for safeguarding
c) Before placing relevant funds or assets with a third party, carry out an initial documented assessment of the third party, including the capital, credit rating, and risk profile of the third party, and periodic assessments thereafter.
d) Consider legal requirements, market practice and diversification of risk and document the rationale behind decisions.
e) Ensure that safeguarding accounts should be clearly identified as such within the name of the account,
f) Safeguarding accounts must not be used to hold any other funds or assets
g) Where relevant funds are invested in assets, these should be approved by FCA as secure and liquid as set out in Chapter 10 of the FCA Approach document.
h) Where relevant funds are held on a Member firm's behalf by agents or distributors, the firm remains responsible for ensuring that the agent or distributor segregates the funds.

	Good practice	**Poor practice**
1	The firm carries out documented due diligence on any third party used to ensure they are correctly authorised, with selection approved at Board or defined Senior Management level.	• Due diligence is not performed or is not adequately documented. • Relevant funds are safeguarded with other entities in a payment chain such as APIs or AEMIs

		rather than authorised credit institutions • No evidence of approval by Senior Management
2	The due diligence includes a written credit assessment of the third party's capital position and leverage ratio etc.	No consideration is given to the third party's credit rating.
3	The due diligence includes a documented consideration of the third party's risk profile and activities.	No consideration is given to the third party's risk profile or activities.
4	Firm's Safeguarding Policy gives consideration to risk diversification between third party's holding relevant funds and limits established per third party or as a percentage of money held.	Risk diversification is not considered or documented.
5	Periodic reviews are carried out at a defined frequency (at least annually) to ensure that the third party continues to be appropriate to hold relevant funds or assets.	Once appointed, no further due diligence is carried out on a third party
6	The title of the account(s) should 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 title of the account(s) only identifies the firm not the purpose of the account
7	The firm identifies and transfers non-relevant funds received from clients such as fees and profits out of the safeguarding account(s) as often as possible each day, in line with the Safeguarding Policy.	Excess funds are held overnight in the safeguarding account without good reason

8	The firm identifies and transfers relevant funds received from clients such as mixed remittances into the safeguarding account(s) as often as possible each day, in line with the Safeguarding Policy.	Relevant funds are co-mingled with the firm's own funds for long periods intraday or overnight.
9	Where possible, written confirmation obtained from third parties confirming the trust status of the safeguarding account(s) signed by an authorised signatory.	The firm does not notify and confirm the status of its safeguarding account(s) in writing with the third party.
10	Documented assessments are maintained to demonstrate that any safeguarded funds are invested in an FCA's approved list of investments.	Assets are purchased without checking or documenting that they meet FCA criteria to be approved as liquid and secure.
11	The firm has identified instances where agents or distributors hold relevant funds and the segregation approach is clearly documented in safeguarding policy and agreements.	The firm has not taken into consideration relevant funds held at agents or distributors and has not implemented any measures to ensure that they are segregated on receipt.

3B Insurance or guarantee method

We expect all member firms to:

a) Before insuring with or taking a guarantee from a third party, member firms should ensure that the third party is appropriately authorised by FCA or another EEA competent authority.
b) Notify FCA when changing the methods used for safeguarding
c) Before insuring with or taking a guarantee from a third party, member firms should also carry out an initial documented assessment of the third party, including the capital, credit rating, and risk profile of the third party, and periodic assessments thereafter.
d) Legal requirements, market practice and diversification of risk should be considered and the rationale behind decisions documented.
e) The insurance policy or guarantee should meet the requirements of the PSRs and EMRs, covering all relevant funds held at any point, or a defined amount with any remaining relevant funds covered using the segregation method in section 3A above.

f) A guarantee should also oblige the guarantor to assume primary liability to cover any relevant funds in an insolvency event.
g) Liquidity management.
h) In an insolvency, the proceeds from any insurance policy or guarantee should be paid into a Safeguarding account and be protected from other creditors.
i) Where an AEMI carries out unrelated payment services, the insurance policy or guarantee should cover both sets of services and be paid into separate Safeguarding accounts.

	Good practice	**Poor practice**
1	Firm's Safeguarding Policy gives consideration to risk diversification between third party's offering insurance or guarantees with limits established per third party or as a percentage of money held. The Safeguarding Policy should also clearly document the manner in which insurance policy should be used and how daily requirement is adequately captured.	Risk diversification is not considered or documented.
2	The firm carries out documented due diligence on any third party to ensure they are correctly authorised, with selection approved at Board or defined Senior Management level.	• Due diligence is not performed or is not adequately documented. • No evidence of approval by Senior Management
3	The due diligence includes a written credit assessment of the third party's capital position.	No consideration is given to the third party's credit rating.
4	The due diligence includes a documented consideration of the third party's risk profile and activities	No consideration is given to the third party's risk profile or activities.
5	Periodic reviews are carried out at a defined frequency (at least annually) to ensure that the third	Once appointed, no further due diligence is carried out on a third party

	party continues to be appropriate to offer insurance or guarantees.	
6	The firm should establish a Safeguarding account for the purpose of holding funds received pursuant to an insurance policy or guarantee in the event of an insolvency or for "top up" safeguarding of relevant funds in line with the Safeguarding Policy.	• No specific Safeguarding account is established • The account is used to hold other funds of the firm
7	The title of the account(s) should 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 title of the account(s) only identifies the firm not the purpose of the account.
8	Segregation letters are obtained from third parties confirming the trust status of the Safeguarding account(s) signed by an authorised signatory.	The firm does not notify and confirm the status of its Safeguarding account(s) in writing with the third party.
9	The insurance policy should be periodically reviewed.	Claim cannot be processed due to changes in circumstances that are not reflected in the insurance policy.
10	Any guarantee issued accepts primary liability for the issuer in the event of an insolvency of the firm. There should be clear documentation on who the issuer is and periodic due diligence should be performed on the issuer.	Guarantees only provide secondary liability in the case that the institution fails to pay a debt or obligation

4. Records and Reconciliations

Member firms must keep accurate records of safeguarding under the PSRs and EMRs. These records should include:

- relevant funds segregated;

- relevant funds placed in an account with an authorised credit institution; and
- assets placed in a custody account.

In addition, member firms must keep accurate records that enable it to distinguish relevant funds and assets held:

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

The records should be sufficient to show and explain the member firm's transactions concerning relevant funds and assets.

To ensure the accuracy of these records, member firms should regularly carry out reconciliations between its internal accounts and records and those of any third parties safeguarding relevant funds or assets.

Key risks

- Inadequate records may make it difficult or impossible to identify for whose benefit relevant funds are being held
- Failure to reconcile regularly may conceal errors or shortfalls in safeguarding of relevant funds

Guidance

We expect all member firms to:

a) Maintain detailed and accurate records in respect of amounts held for e-money holders and payment service users
b) Maintain detailed and accurate records in respect of relevant funds and assets placed with third parties
c) Maintain detailed and accurate records in respect of its own funds
d) Ensure that relevant funds are not co-mingled with own funds inadvertently
e) Carry out regular reconciliations of relevant funds, both internally and externally
f) Correct any discrepancies by paying in any shortfall or withdrawing any excess from Safeguarding accounts as often as necessary

	Good practice	**Poor practice**
1	Firm's Safeguarding Policy should clearly set out the adequate procedures for reconciliation	Reconciliation is performed inconsistently

	including the methodology and basis of reconciliation frequency.	
2	Where a firm maintains payment accounts or e-wallets for clients, these are clearly identifiable in the firm's systems.	Lack of distinction between payment service users' entitlements
3	Firm's maintain up-to-date internal ledger accounts for all third parties holding funds.	Firms rely on the third parties to provide account information
4	Firms own accounts are easily identifiable from Safeguarding accounts.	Lack of distinction between firm accounts and those used to hold relevant funds
5	Regular reconciliations carried out between the firms records of relevant funds held for payment services users, and the firm's internal ledger accounts for third parties holding those funds (internal reconciliation).	Reconciliations only carried out between client accounts and third party records
6	Regular reconciliations carried out between the firm's internal ledger accounts for third parties holding those funds and statements provided by those third parties (external reconciliation).	Reconciliations only carried out between client accounts and third-party records
7	Reconciliation of other accounts such as suspense accounts should be carried out on a regular basis to identify if there are any relevant funds that should have been identified and safeguarded. This should include AML/sanctioned frozen account and unallocated funds if they are deemed to be relevant.	Suspense accounts and other assets/liabilities not reconciled regularly

8	Reconciliations carried out at least daily or more frequently as required as per Safeguarding Policy, with reconciling items promptly identified and investigated.	• Sporadic or infrequent reconciliations • Reconciling items carried forward without adequate identification and investigation
9	Where resources permit, reconciliations are signed off by a senior member of staff who did not perform the reconciliation.	• Reconciliations performed and reviewed by the same person • No evidence of approval
10	Any excess or shortfall identified is moved out of or into the Safeguarding account(s) promptly in accordance with the Safeguarding Policy.	• Excess funds are maintained in the Safeguarding accounts without documented rationale • Shortfalls are not covered promptly from firm's own funds

5. Hybrid firms and independent FX services

The FCA Approach document allows firms that undertake activities unrelated to payment services to treat these outside of the safeguarding and other requirements of the PSRs and EMRs. In particular, paragraphs 10.18 and 10.20 refer to foreign exchange transactions carried out independently from payment services and carve these out from the safeguarding requirements.

FCA's view is that, in making a payment of currency to its customer in settlement of a foreign exchange transaction, an FX provider will be acting as principal in purchasing the other currency from its customer, and this does not constitute a payment service.

The extent to which a Member firm carries out foreign exchange transactions independently from its payment services will depend on its business model and contractual documentation, however it is important that this is clear to both customers and regulators alike.

Key risks

- Failure to identify whether foreign exchange transactions are carried out independently from payment services may result in incorrect identification and safeguarding of relevant funds, thereby corrupting the asset pool
- Customers may believe their funds are being safeguarded when they are not.

Guidance

We expect all member firms to:

a) Identify when they may be carrying out activities unrelated to payment services, including independent foreign exchange transactions
b) Ensure that funds received for such unrelated services or independent foreign exchange transactions are not treated as relevant funds, or co-mingled with relevant funds inadvertently
c) Ensure that all contractual and other customer documentation is clear as to when a transaction is subject to the PSRs/EMRs and when it is not
d) Ensure that websites and marketing materials do not give the impression that funds received in settlement for unrelated services or independent foreign exchange transactions will be safeguarded when they are not

	Good practice	**Poor practice**
1	Firm's Safeguarding Policy should have a clear articulation of whether they are carrying out foreign exchange transactions independently from their payment services.	Little or no consideration has been given to whether unrelated activities or services are provided
2	Firms clearly identify in their processes how to treat funds received for unrelated activities or services.	Funds received for unrelated activities or services are co-mingled with relevant funds
3	Firms clearly identify in their client ToB when services are subject to the Safeguarding and other provisions of the PSRs and EMRs, and when they are not.	Lack of clarity in contractual documentation what provisions apply to activities or services carried out independently from payment services
4	Firms clearly identify as part of their onboarding process when services are not subject to the Safeguarding and other provisions of the PSRs and EMRs.	Firms imply that funds are safeguarded at all times when they are not
