

Whitepaper

Safeguarding for payments and e-money institutions



What is safeguarding?

In the U.K, payments institutions, e-money institutions and credit unions that issue e-money are required by regulation to 'safeguard' customer assets.

Upon immediate receipt of funds, the Financial Conduct Authority (FCA) expects these firms to 'ensure appropriate organisational arrangements are in place to protect the safeguarded funds'. This is intended to safeguard relevant funds in a similar manner to client money, ensuring protection should a firm become insolvent.

Regulators are stepping up safeguarding expectations

While safeguarding measures have been in place since the Electronic Money Regulation 20 of 2011 and then amended with the Payment Services Regulation 23 of 2017, the FCA has emphasised and elevated the importance of safeguarding in the last two years.

Primarily, this has been through:

01

Dear CEO Letters

In May 2021, the FCA issued a Dear CEO letter to payments and e-money institutions. The letter emphasised the importance for firms to communicate with their customers about how their money is protected.

Specifically, the FCA asked organisations to write to customers 'to remind them of how their money is protected through safeguarding and that FSCS (Financial Services Compensation Scheme) does not apply'.

02

Changes to safeguarding guidance

In July 2020, the FCA published temporary guidance on safeguarding and prudential risk. New guidance aimed to bolster firms' arrangements to offset the disruption caused by the pandemic.

However, in a policy update in November 2021, the FCA made those temporary guidelines permanent. The move was intended to better protect consumers, reduce risk of financial loss and improve overall financial stability.

Understanding the complexity

Of course, the requirements of safeguarding will not be news to payments and e-money organisations. The challenge for firms here is not necessarily in the regulation itself, but more from the fact that safeguarding rules are not prescriptive in the same way that CASS rules are. In other words, the FCA stipulates what the requirements are, but not how organisations should implement them.

In this paper, we outline the specific requirements of safeguarding for payments and e-money institutions, paying particular attention to key dimensions like audits and reconciliations. Finally, we detail how the AutoRek solution helps firms to comply with their safeguarding obligations.

A summary of FCA recommendations for safeguarding

As discussed overleaf, safeguarding requires payments and e-money institutions to take appropriate steps to protect customer funds upon immediate receipt of those funds.

The Financial Conduct Authority (FCA) require payments and e-money institutions to maintain records that are sufficient to demonstrate and explain their compliance with all dimensions of their safeguarding obligations. This should include a documented rationale for every decision they make regarding safeguarding processes, as well as the systems and controls they have in place. Such decisions should be reviewed regularly.

Firms should ensure that an appropriate individual has oversight of all procedures relating to safeguarding and responsibility to ensure that every aspect of those procedures are compliant.

The FCA further stipulate that payments and e-money institutions should exercise all due skill, care and diligence in selecting, appointing and periodically reviewing credit institutions, custodians and insurers involved in safeguarding arrangements.

This includes:

- The need to diversify risks
- The capital and credit risk 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
- 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). When a decision is made on appropriateness, an institution should record the grounds for that decision

To ensure it is clear what funds have been segregated and via what method, institutions must keep records of any relevant funds segregated, any relevant funds placed in an account with an authorised credit institution and any assets placed in a custody account.

An institution's records should enable it to distinguish at any time what relevant funds and assets are held from one e-money holder payment service user from another. Firms should be able to distinguish these funds from their own, as well as explain the institution's transactions concerning those relevant funds and assets.

Preparing for safeguarding audits

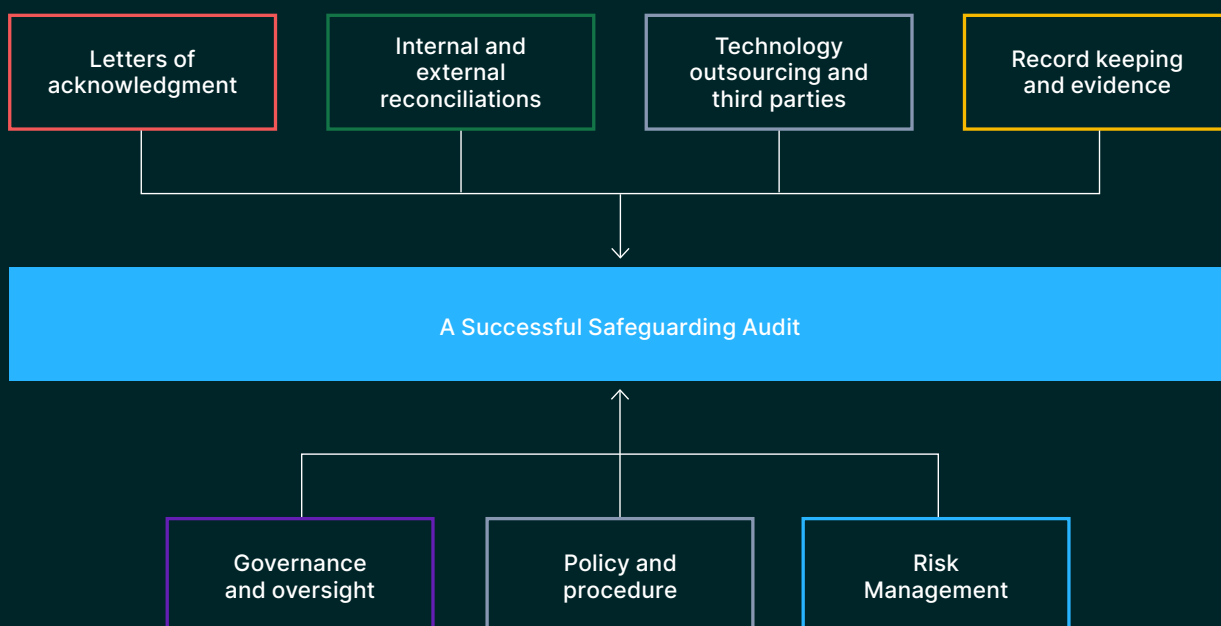
The FCA expect payments and e-money institutions to undergo an annual audit of their safeguarding compliance.

These audits will involve a full review of an organisation's relevant policies and procedures, which would give an understanding of both good existing practices and any areas of risk. Interviews will then assess how far this guidance transfers and is embedded into the practices, values and culture of the organisation.

The auditor will provide an opinion addressed to the firm on whether their arrangements are compliant with the FCA's expectations of safeguarding provisions.

Top tips for firms to meet their safeguarding obligations:

- 01 Perfect the safeguarding audit process
- 02 Stay on top of the regulation and its changes, make changes internally and externally as required and include this in safeguarding proposals
- 03 Streamline and modernise reconciliation procedures, which is the glue that ties safeguarding processes together
- 04 Ensure that all measures possible have been taken to identify relevant funds
- 05 Open clear lines of communication with partners and regulators. Internal staff should also be fully aware of their specific role in safeguarding compliance



The importance of reconciliations

Reconciliations are a critical dimension of safeguarding compliance.

Payments organisations are required to conduct internal reconciliations between: records and accounts of the entitlement of e-money holders/payment service users; and relevant funds and assets with the records and accounts of amounts safeguarded.

The above reconciliation should be completed as often as is necessary and as soon as is reasonable after the date to which the reconciliation relates. Records should be sufficient to show and explain the method of the internal reconciliation and its adequacy.

In addition, payments institutions should regularly carry out reconciliations between its internal accounts and records and those of any third parties safeguarding relevant funds or assets. Again, this should be performed as regularly as is necessary after the date to which the reconciliation relates, which ensures accuracy of internal accounts and records against those of third parties.

When determining whether the frequency of a reconciliation is adequate, payments firms should consider the risks to which the business is exposed. These risks might be the nature, volume and complexity of the business, as well as where and with whom the relevant funds and assets are held.



Reconciliation specifications

At times, the operational mechanics around approved forms of safeguarding create variations between safeguarded amounts and amounts to be safeguarded.

This could be due to how relevant funds are processed if there is an FX transaction involved. Moreover, there might be differences where funds are deposited directly into the safeguarded account from which payments are executed and processed by the institution as a form of netting of funds held in a safeguarded account.

In each of the above scenarios, the reconciliation process should be executed at least once each working day. The output of such reconciliation should ensure that sufficient funds are safeguarded without being excessive. FX reconciliations should be carried out at the appropriate rate, such as the previous spot rate.



Payments and e-money organisations will need to perform:



External reconciliations

In contrast to the internal reconciliation, which is only interested in the record of relevant funds held at the banking providers, the external reconciliation uses the total actual balance held in the safeguarding accounts, including non-relevant funds in the form of fees accrued.



Internal reconciliations

The internal reconciliation provides assurance as to the accuracy of internal records with regards to how much should be safeguarded. This is done by comparing:

- The aggregate funds owing to clients as displayed on the firm's internal system; and
- The aggregate funds that the firm believes it holds in its safeguarding accounts (counting only the relevant funds, i.e., excluding fees that will be moved off the account)

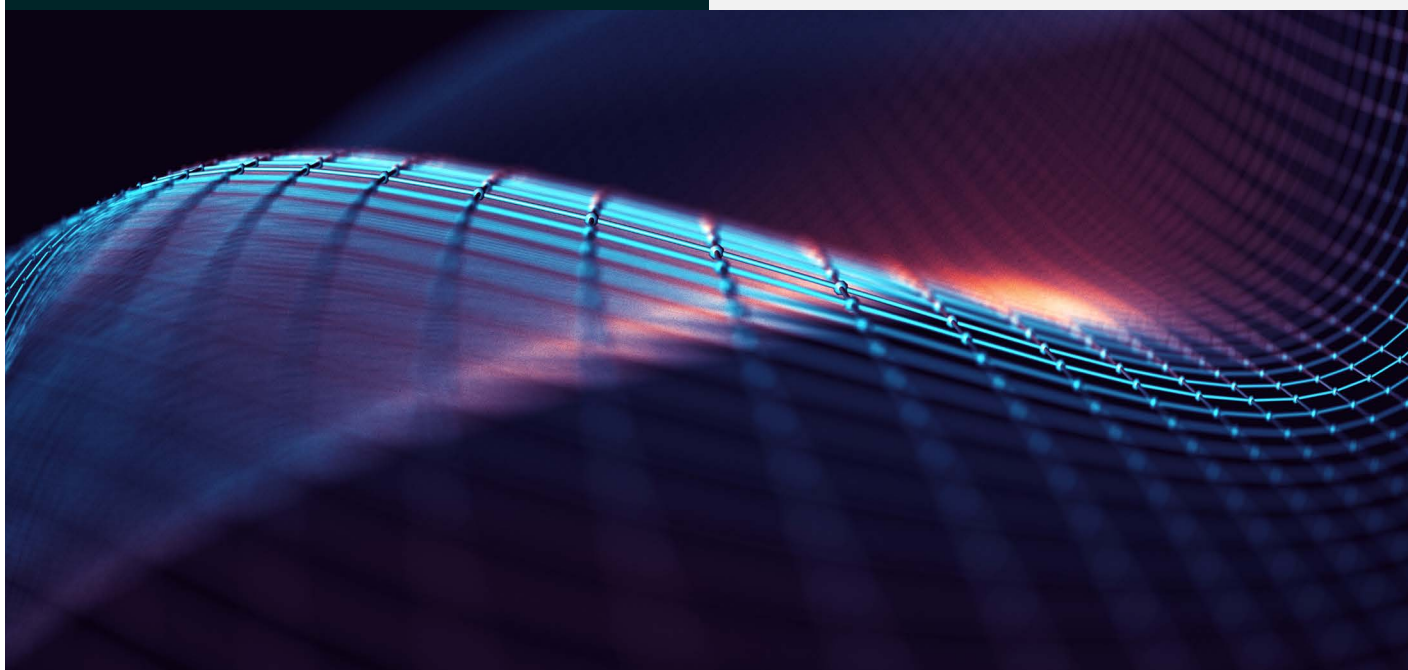
This enables the firm to check the accuracy of its records by comparing its internal customer balances with its own record of customer funds held in the safeguarding account. Taking account of timing issues, comparisons should result in an exact match.

Any discrepancies (and reasons for those discrepancies) must be promptly identified and corrected as soon as possible. This will involve paying the shortfall or withdrawing excess unless the discrepancies can be attributed to timing differences. Where differences cannot be easily resolved, the greater amounts for any such scenario should be assumed to cover a payment or withdrawal.

The bottom line

E-money is not state-backed in the same way as deposits held in commercial banks and as such, relevant organisations need to take the necessary steps to safeguard client funds. Firms within the payments industry will also be more than aware that stress-testing will become the norm, which will further elevate the importance of effective safeguarding measures. Doing this will ensure that payment service users are not exposed to unnecessary risk and will also minimise the systemic risk of the payments industry as a whole.

AutoRek envisage that the Bank of England and FCA will continue their focus on the rapidly growing payments industry in the short, medium and long-term. We continue to innovate and collaborate with our payments and e-money clients to build robust reconciliation solutions that ensure safeguarding compliance.





Safeguarding client funds with AutoRek

AutoRek has developed the first to market safeguarding solution for EMI, PIs and credit unions.

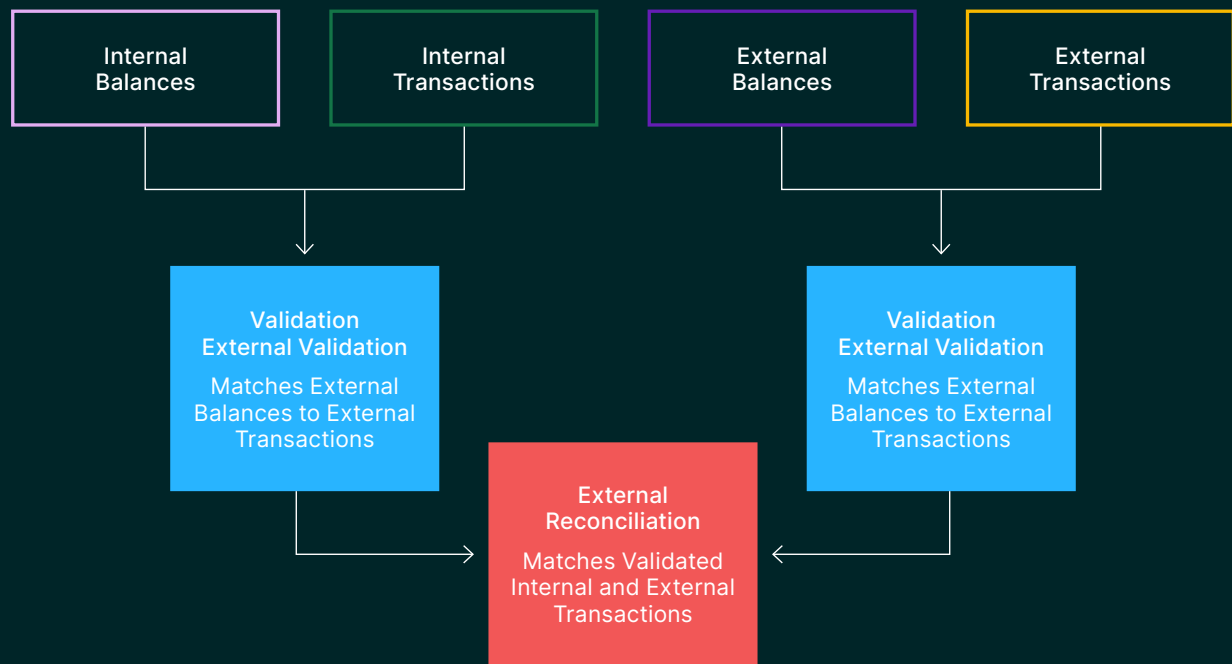
Our solution is specifically designed to streamline the manual processes involved and to ensure complete accuracy and timeliness for segregation of funds and reports.

Using the system's powerful rules-driven engine and high-volume capacity, AutoRek performs all the necessary external and internal reconciliations, identifies relevant and non-relevant funds and ensures all FX transactions are handled in line with the regulatory requirements, giving firms full control over their data in the reporting process.

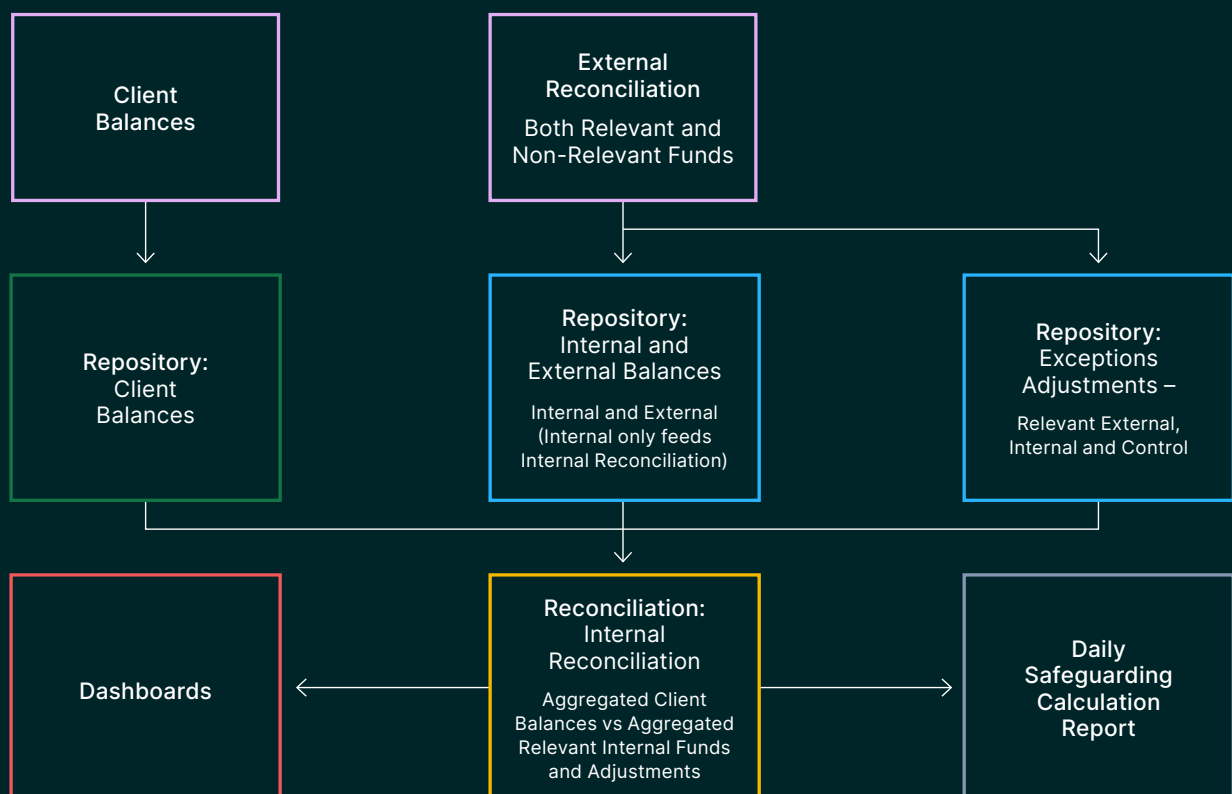
A typical AutoRek deployment for safeguarding works by:

- 01** Ingesting all internal and external transaction and balance data from any data source in any format
- 02** Validating data to eradicate duplicates and avoid incorrect data
- 03** Standardising and enriching data to ensure transparency and accuracy
- 04** Performing the external reconciliation, which is made up of all the internal and external transaction data, as well as identifying all relevant and non-relevant funds at this stage
- 05** Feeding all the client balances, matched internal transactions as well as any exceptions from the external reconciliation into the internal reconciliation non-relevant funds at this stage
- 06** The internal reconciliation then reconciles all the aggregated client balances, relevant internal funds, and any adjustments to provide an accurate calculation of the current
- 07** Details of these calculations are then presented to the client via real-time, configurable dashboards or deficit between these two figures
- 08** AutoRek then uses its reporting capability and workflow functionality to allow the client to perform daily signoff of the safeguarding report these two figures

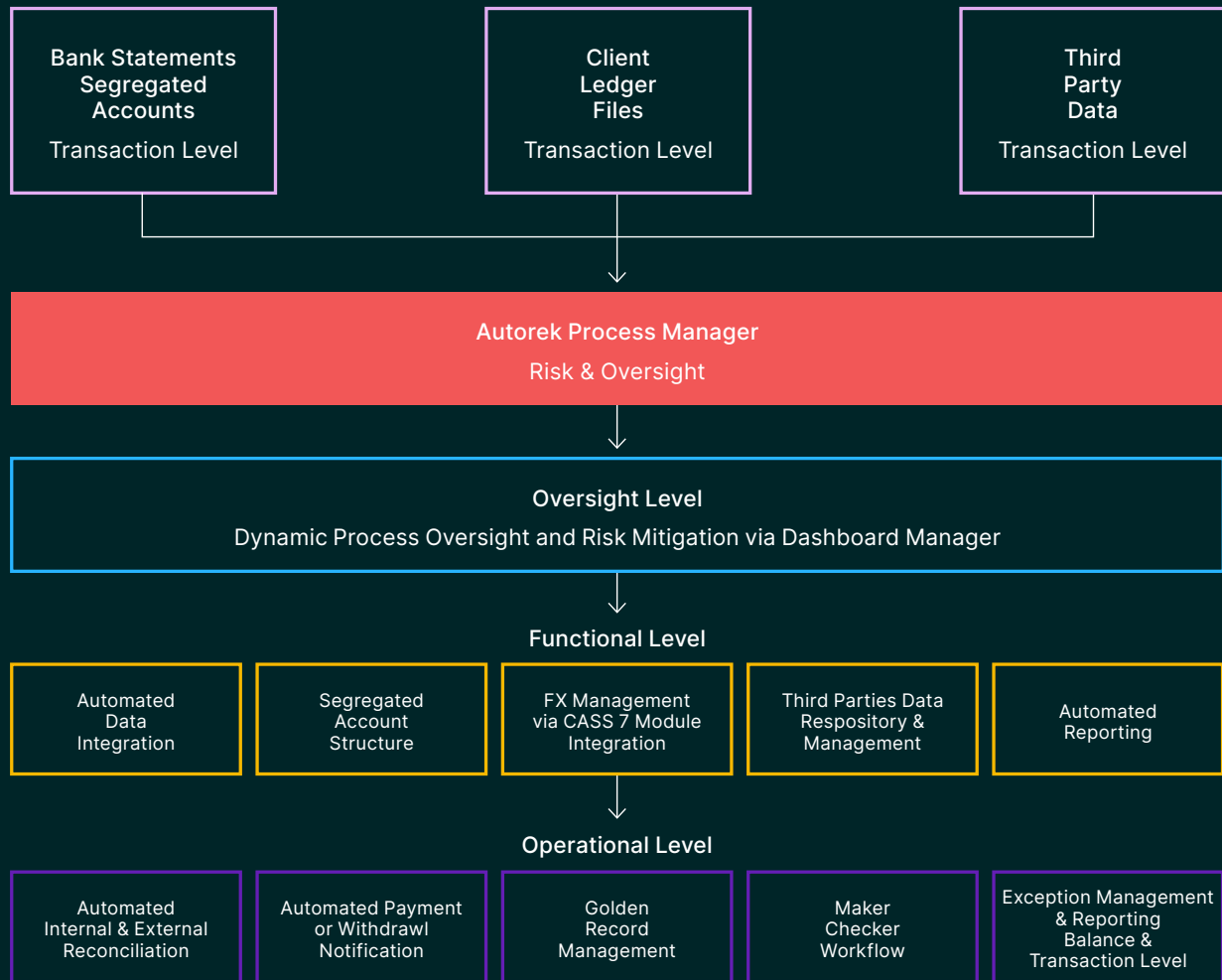
Safeguarding Process Flow



Safeguarding Process Flow



Advantages of using the AutoRek Solution



AutoRek is extremely well placed to meet these requirements and is currently helping clients to:

- Automate external reconciliations between internal records and third party data
- Automate internal reconciliations between client records and safeguarded asset data
- Integrate third party feeds to enrich & explode core data
- Build and maintain a golden data repository
- Segregate between relevant funds and applicable fee structures per user account
- Distinguish between safeguarded or insured funds per user account
- Store and enrich third party data linked to relevant funds
- Integrate CASS 7 regulatory compliance for relevant FX transactions
- Implement maker checker processes with integrated workflow & sign-off capability
- Generate exceptions and reports for each legal entity
- Generate payment notification for transfer or withdrawal of segregated funds
- Integrate rich & insightful dashboards to embed appropriate oversight and risk management



The AutoRek solution has been consistently developed over 27 years of collaboration with some of the largest and most sophisticated financial institutions in the world.

We combine cutting edge technology, first class implementation and subject matter expertise to deliver custom solutions that save our clients both time and money.

At its core, AutoRek is a self-contained financial and operational reconciliation system that uses intelligent automation to eliminate manual processes, perform intelligent matching and analyse breaks. The platform's rich MI insights and high configurability truly puts the end user in the driver's seat.

Key Benefits

- ✓ ROI in 9 months
- ✓ Save time and money
- ✓ Mitigate risk of regulatory breaches
- ✓ Real-time insight into status and exposure
- ✓ Reduced dependency on manual processes
- ✓ Single repository for control frameworks and data management
- ✓ Automated workflow for governance and audit
- ✓ Efficient electronics sign off and record retention
- ✓ Adaptability to meet new regulatory requirements

Get in touch

Book your demo at autorek.com/request-a-demo
Chat to our team on +44 (0) 845 603 3613

Email us at marketing@autorek.com
Discover more at autorek.com

