



LIETUVOS BANKAS
EUROSISTEMA

Public consultation document

Increasing the Protection of Customer Funds Held by Payment and Electronic Money Institutions

2019

INCREASING THE PROTECTION OF CUSTOMER FUNDS
HELD BY PAYMENT AND ELECTRONIC MONEY INSTITUTIONS

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Participation in the Public Consultation

The aim of this consultation is to find out the opinion of market participants and other institutions on the need to increase the protection of funds received from customers by electronic money and payment institutions and on possible measures to achieve this aim. All interested parties are invited: electronic money and payment institutions, credit institutions, representatives of consumers and enterprises, market experts, academics, public sector representatives and the state company Deposit and Investment Insurance.

Questions of the public consultation are provided in each section of the document. Comments are accepted in Lithuanian and English.

Your opinion will be of most benefit, if it is clearly formulated and well-reasoned.

Please send your responses by email to payments-strategy@lb.lt or by post to Totorių g. 4, LT-01121 Vilnius. The public consultation will close on 1 August 2019.

Data Protection Policy

All personal data received during the public consultation will be processed at the Bank of Lithuania in accordance with the Description of Procedure for Processing Personal Data at the Bank of Lithuania Received during Public Consultations approved by Order No V 2016/(1.7-260603)-02-108 of the Chairman of the Board of the Bank of Lithuania of 27 June 2016 on the approval of the description of procedure for processing personal data at the Bank of Lithuania received during public consultations.

The data controller is the Bank of Lithuania (code of the legal entity: 188607684, address: Gedimino pr. 6, LT-01103 Vilnius).

The following personal data shall be collected and processed: name and surname of the respondent, contact details (phone number, address or email address), responses to questions posed during the public consultation, other data provided at the discretion of the respondent.

The Bank of Lithuania will publish the responses received from individual respondents along with their names, where the respondent is a legal person, or depersonalised responses, where the respondent is a natural person. Respondents have the right to request that their responses, comments and opinions or provided confidential information not be published, if this conflicts with legitimate interests of the respondent. Respondents not willing to have their data or certain information published must indicate this when submitting their responses. In such case, the response or information indicated as sensitive will not be published, however, it will be considered in the same manner as responses of other respondents.

Should you have any questions with regard to participation in the public consultation, please contact us by email payments-strategy@lb.lt.

Abbreviations

EMI	electronic money institution
PI	payment institution
DII	state company Deposit and Investment Insurance
Law on Insurance of Deposits	the Republic of Lithuania Law on Insurance of Deposits and Liabilities to Investors
CC	the Civil Code of the Republic of Lithuania

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INTRODUCTION

The sector of electronic money and payment institutions (EMIs/PIs) has been growing, and its role in the payment market has been continuously increasing as well. EMIs/PIs have been actively competing in providing services which traditionally are attributed to the banking industry – money transfers in foreign currency, issue of payment cards and acquiring of payment card transactions. In addition, the market has been introduced with some new services offered by EMIs/PIs. This increases competition which is beneficial both to residents and enterprises. Although these institutions compete with the market incumbents (banks), service provision opportunities in some important respects vary.

When making payments, customer funds are inevitably kept in accounts opened with payment service providers. Deposits held with banks are covered by deposit insurance, thus residents and enterprises feel safe as they know that should a bank become insolvent, they will recover their deposits to the insured amount. Although customer funds held with EMIs/PIs are not insured as deposits, there are some other protection methods. However, residents and enterprises are less likely to trust EMIs/PIs and it is one of the reasons why their services are used less actively. EMIs/PIs are also dependant on the performance of credit institutions. In case of insolvency of credit institutions, EMIs/PIs may also incur losses which would eventually affect their customers.

Development of a competitive and advanced payment market in Lithuania is one of the strategic directions of the Bank of Lithuania. In our view, market and public confidence in payment service providers is one of the key factors for increasing competition in the payment market. In this respect, deposit insurance gives an advantage to credit institutions vis-à-vis EMIs/PIs. Representatives of EMIs/PIs have also raised a question regarding boosting the protection of EMI/PI customer funds held with credit institutions in the event of insolvency of the credit institution. On the initiative of representatives of EMIs/PIs, the following point was included in the Action Plan for the FinTech Development in Lithuania prepared by the working group for the FinTech development in Lithuania: “To evaluate the possibility of revising the legal basis with the purpose of ensuring security of the funds of electronic money holders transferred to electronic money institutions, where a credit institution becomes insolvent”.

This document provides an overview of the current situation and the potential risks, an analysis of the measures which could increase the protection of funds received from customers of EMIs/PIs, as well as the protection of the EMIs/PIs themselves in case of insolvency of the credit institution where customer funds are kept. The purpose of the public consultation is to collect the opinions of market participants and other institutions on the need to increase the protection of EMI/PI customer funds and on the measures which could help to achieve this goal.

METHODS FOR SAFEGUARDING EMI/PI CUSTOMER FUNDS AND POTENTIAL RISKS

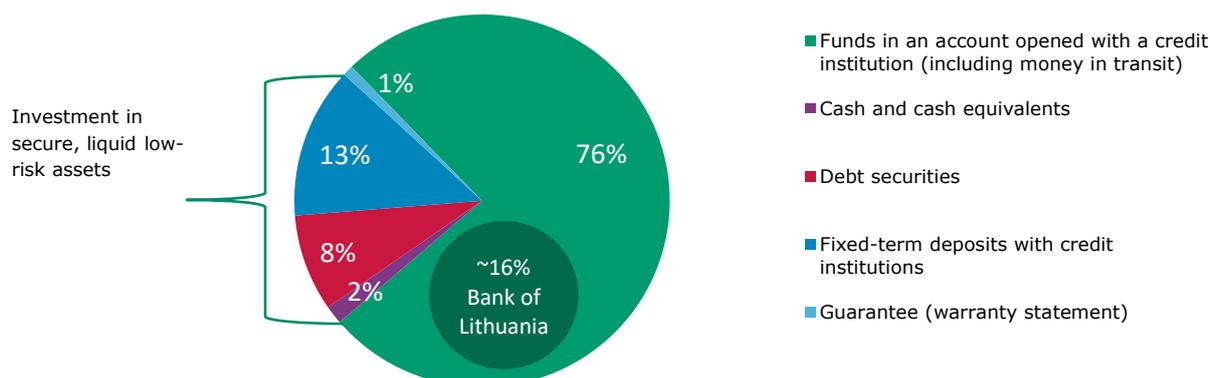
The Republic of Lithuania Law on Electronic Money and Electronic Money Institutions, and the Republic of Lithuania Law on Payment Institutions stipulate that EMIs/PIs must safeguard the funds which have been received from payment service users in accordance with one of the two following methods:

1. by not commingling these funds at any time with other funds and keeping them in a separate account with a credit institution or by investing them in secure, liquid low-risk assets;
2. by covering such funds by an insurance policy or a guarantee, a warranty statement.

These legal provisions are intended to safeguard customer funds, should an EMI/PI go bankrupt.

Lithuanian EMIs/PIs have chosen the first method for safeguarding funds and most of the funds obtained from customers are kept in a separate account with a credit institution. These funds are not subject to recovery of funds following the obligations of EMIs/PIs. According to the data as of the end of 2018, 76% of the funds obtained from customers are kept by EMIs/PIs in a separate account with credit institutions (some of them are kept with the Bank of Lithuania), 13% of funds are kept as fixed-term deposits with credit institutions (one of the alternatives for investing in secure, liquid low-risk assets). Investment in securities account for 8% of customer funds, whereas the second method of safeguarding customer funds (insurance) is hardly applied in practice at all.

Chart 1. Methods of safeguarding customer funds, applied by Lithuanian EMIs/PIs (end of 2018)



Source: Bank of Lithuania.

Several situations related to the risk of losing customer funds might be singled out:

1. An EMI/PI properly separates the funds obtained from customers and keeps them in a separate account with a credit institution or safeguards them in any other manner stipulated by laws.

Should the EMI/PI become insolvent, no recovery procedures could be applied to the customer funds held in a separate account, following the obligations of the EMI/PI. Investments of the EMI/PI, including fixed-term deposits, in the same way as funds held in an account with a credit institution, are safeguarded from loss in the event of bankruptcy of the EMI/PI which must indicate in its agreements that customer funds are to be invested. Therefore, should the EMI/PI become insolvent, its customers would recover all their funds and incur no losses.

2. An EMI/PI properly separates the funds obtained from customers and keeps them in a separate account with a credit institution, yet the credit institution becomes insolvent.

The Republic of Lithuania Law on Insurance of Deposits and Liabilities to Investors (hereinafter – the Law on Insurance of Deposits) stipulates that deposits of financial institutions are not covered by deposit insurance. This provision shall be interpreted as implying that the funds held in accounts opened with credit institutions on behalf of EMIs/PIs are considered as deposits of financial institutions and that they are not subject to deposit insurance, regardless of whether an EMI/PI keeps its own funds or funds obtained from its customers

in such an account. In the case of an insured event (bankruptcy of a credit institution), the EMI/PI will not get any insurance compensation but will be included in the common list of creditors of the credit institution.

Therefore, in the case of bankruptcy of a credit institution where an EMI/PI keeps the funds obtained from customers, the EMI/PI would incur losses. If an EMI/PI has the capacity to cover the incurred losses by its own funds, its customers will not be affected. However, if an EMI/PI does not have sufficient own funds, this might lead to the bankruptcy of the EMI/PI itself. In such case, the assets of the EMI/PI will be insufficient for returning all the customer funds, thus its customers will also incur losses.

It should be noted that there might be different situation in other EU Member States regarding insurance of EMI/PI customer funds held with credit institutions.

3. An EMI/PI improperly safeguards its customer funds, loses them and, as a result, eventually goes bankrupt.

If an EMI/PI implements insufficient risk management measures and improperly safeguards customer funds, they may be lost, e.g. in cases where funds are wasted because of irresponsible actions of EMI/PI employees. If an EMI/PI does not have sufficient own funds to cover such damages, this might lead to its bankruptcy. Since customer funds in such cases are lost, customers may recover only part of their funds, or, in an extreme case, lose all their funds held with such an EMI/PI.

Given the situations described above, we hold the view that there might be two types of measures which could boost the safety of EMI/PI customer funds: measures aimed at **protecting customers of EMIs/PIs**, and measures aimed at strengthening the protection of **EMIs/PIs** themselves.

The protection of customers of EMIs/PIs could be increased by insurance of funds following the example of deposit insurance in credit institutions. Since there are other methods provided for safeguarding EMI/PI customer funds (keeping the funds in credit institutions, investing in secure, liquid low-risk assets or a private insurance), additional national measures which, in principle, correspond to deposit insurance would be incompatible with the EU law. For this end, discussions on this issue are necessary at the EU level.

On the national level, a focus could be put on increasing the **protection of EMIs/PIs**. More options for EMI/PI could be provided for safeguarding customer funds and for reducing the impact of insolvency of credit institutions.

Questions

1. Apart from those mentioned above, what other risks related to safeguarding EMI/PI customer funds do you see?

POSSIBLE NATIONAL MEASURES AIMED AT INCREASING THE PROTECTION OF EMI/PI CUSTOMER FUNDS

POSSIBILITY TO KEEP FUNDS WITH THE BANK OF LITHUANIA

EMIs/PIs may avail of the currently available opportunity of using the services of the payment system CENTROlink of the Bank of Lithuania, opening a payment account with the Bank of Lithuania for this purpose and keeping the funds obtained from customers in such account.

Another alternative could be the provision that any Lithuanian EMI/PI might open an account with the Bank of Lithuania without linking this possibility to the use of services of the payment system. In such case, a few limitations are foreseen:

- **only funds obtained from customers could be kept in such accounts (EMIs/PIs could not hold their own funds there);**
- **only balance of funds/liquidity management transactions would be available.**

In accordance with the amendments to the Republic of Lithuania Law on Electronic Money and Electronic Money Institutions and the Republic of Lithuania Law on Payment Institutions which came into force on 1 August 2018, in implementing the first method of safeguarding funds obtained from customers, the funds obtained from customers by EMIs/PIs may also be kept in a separate account opened with the Bank of Lithuania or in any other central bank of another Member State. Funds held in a central bank are safe and there is no risk of losing them. Currently, the possibility to keep EMI/PI customer funds with the Bank of Lithuania is provided only if services of the payment system operated by the Bank of Lithuania are used; otherwise, it is not possible for EMIs/PIs to keep funds obtained from customers with the Bank of Lithuania.

Possibility to keep funds with the Bank of Lithuania (in the context of the payment system)

EMIs/PIs using services of the CENTROLINK system operated by the Bank of Lithuania as ABIC holders (addressable BIC holders) open an account with the Bank of Lithuania for the purpose of making payments. EMIs/PIs can keep the funds obtained from their customers in this account and it shall be considered that this meets the legal requirements on the safeguarding of customer funds. The Bank of Lithuania allows EMIs/PIs to indicate whether the funds held in the account are customer funds or own funds of EMI /PI.

CENTROLINK services are most relevant to those EMIs/PIs which provide SEPA credit transfer or SEPA instant credit transfer (instant payments) services. EMIs/PIs that provide other services have no need to use CENTROLINK services. At the end of 2018, CENTROLINK services were used by 26 Lithuanian EMIs/PIs as ABIC holders. Different EMIs/PIs use this opportunity differently – some of them keep a significant part of customer funds with the Bank of Lithuania, others – only as much as is needed to make payments in the CENTROLINK system. In total, the amount of funds kept by EMIs/PIs with the Bank of Lithuania accounts for about 16% of all customer funds held with EMIs/PIs.

Currently, the interest rate is negative, which means that participants of the payment system of the Bank of Lithuania must pay interest on the balance of funds.

Possibility to keep funds with the Bank of Lithuania (in the context of the payment system)	
Advantages	Drawbacks
The use of the existing measure would increase the possibility to ensure the protection of customer funds.	Accounts with the Bank of Lithuania may be opened only by EMIs/PIs which intend to use services of the CENTROLINK system as ABIC holders. Other EMIs/PI do not have such right.
EMIs/PIs which make credit transfers in euro have an opportunity to become ABIC holders of the CENTROLINK system.	Interest receivable in the market is lost. In a period of negative interest rate, EMIs/PIs must pay interest to the Bank of Lithuania on the balance of funds in their accounts.
No amendments to laws are required.	

Extended possibility to keep funds in an account with the Bank of Lithuania

Another alternative is to provide the right to any Lithuanian EMI/PI to open an account with the Bank of Lithuania without binding it to the use of payment system services. In this way, an opportunity to keep customer funds with the Bank of Lithuania would be provided to all EMIs/PIs established in the country. Presently, the Republic of Lithuania Law on the Bank of Lithuania provides for the right to accept funds of EMIs/PIs in an account opened with the Bank of Lithuania only to the extent to which it relates to the opportunity to use payment system services.

In order to establish this possibility, the Republic of Lithuania Law on the Bank of Lithuania should be supplemented with the provision that the Bank of Lithuania is entitled to open accounts for EMIs/PIs which do not use any payment system services. Having in mind the purpose of such amendment, namely, to safeguard EMI/PI customer funds, it is supposed that the use of such accounts should be limited and designated solely for this specific purpose, i.e. to allow EMIs/PIs to keep funds obtained from customers with the Bank of Lithuania without allowing them to keep their own funds therein.

EMIs/PIs which use CENTROlink services are also provided with the payment services necessary for their activities. When an account is opened with the purpose to safeguard customer funds, transactions in such accounts should be limited – it shall be allowed to manage the balance of funds in the account, to transfer liquidity to the accounts of EMIs/PIs held with credit institutions.

The possibility to open an account with the Bank of Lithuania and its management would incur costs for the Bank of Lithuania. Therefore, a fee would be charged for this service. As in the case of the use of an account in the payment system, the aspect of negative interest is relevant as well.

Extended possibility to keep funds in an account with the Bank of Lithuania

Advantages	Drawbacks
All EMIs/PIs in Lithuania have equal opportunities to open an account with the Bank of Lithuania.	Interest receivable in the market is lost. In a period of negative interest rate, EMIs/PIs must pay interest to the Bank of Lithuania on the balance of funds in their accounts.
Funds kept with the Bank of Lithuania are secure; there is no risk of bankruptcy.	

Questions

2. Would the possibility to keep customer funds with the Bank of Lithuania for all Lithuanian EMIs/PIs, including those to which the services provided by the payment system are irrelevant, improve the capacity of EMIs/PIs to safeguard their customer funds (considering the fact that they would be allowed to initiate liquidity transfers only)?
3. What other advantages and drawbacks of keeping funds with the Bank of Lithuania, apart from those mentioned above, do you see?

REQUIREMENTS ON DIVERSIFICATION OF FUNDS AND THE USE OF THE INVESTMENT POSSIBILITY

More detailed requirements may be set for EMIs/PIs (by decision of the Bank of Lithuania) with regard to diversification of funds obtained from customers in different credit institutions and with regard to investments in secure, liquid low-risk assets. Compliance with the requirements would help to improve management of the risk of losing funds.

EMIs/PIs could also make use of the investment possibility more actively (as permitted by legislation: investments in secure, liquid low-risk assets) which mitigates the risk of losing funds in the event of bankruptcy of a credit institution.

Legislation allows not only keeping separated funds with credit institutions but also investing them in secure, liquid low-risk assets. This possibility is detailed in the Requirements for Electronic Money and Payment Institutions Concerning Internal Control, Risk Management and Protection of Received Funds approved by the Bank of Lithuania. Currently, the use level of the investment possibility is very low. According to the data as of the end of 2018, almost 25% of the funds are considered as invested in secure, liquid low-risk assets, however, most “investments” are fixed-term deposits in credit institutions and only 8% of all funds obtained from customers are invested in debt securities.

Securities held with a financial brokerage firm or a credit institution are not lost in case of the bankruptcy of a financial brokerage firm or a credit institution; their ownership remains with the purchaser of the securities. In the event of bankruptcy, securities are transferred to another institution which can keep securities owned by other persons. Taking into consideration the fact that in the event of bankruptcy of a credit institution assets in the form of securities are protected more than cash held in an account, EMIs/PIs could invest more funds in securities. EMIs/PIs should assess accordingly what amounts they can invest taking into account the need for funds in their daily operations.

Pursuant to legal acts, EMIs/PIs are obliged to take measures to ensure the protection of the ownership rights of payment service users. Requirements for Electronic Money and Payment Institutions Concerning Internal Control, Risk Management and Protection of Received Funds include the requirement for EMIs/PIs to have an effective risk management system encompassing a strategy for the management of all types of risk, the limit system and other aspects. In addition, there are requirements for mitigation of the investment risk: the market risk of invested funds must be evaluated and monitored, in particular with regard to foreign currency exchange rates and interest rate risk. Furthermore, the risk of concentration of invested funds must be evaluated in terms of specific concentration type; in addition, securities in which investments may be made are indicated.

Since the investment possibility ensures higher protection of customer funds in case of insolvency of a credit institution, while proper distribution of funds reduces the risk of loss, the possibility of providing for more detailed safeguarding requirements could be considered. When investing in securities, other risks arise, e.g., the probability of loss of the investment value. However, if an investment portfolio is chosen appropriately, the risk regarding the loss of investment value is reduced and the liquidity risk, should customers reclaim their funds, is managed. The requirements should cover both customer funds held with credit institutions and investment. The new provisions could include the following requirements:

- regarding concentration by issuers (including credit institutions where EMIs/PIs keep their customer funds);
- regarding concentration in terms of investment ratings established to issuers;
- regarding the investment maturity period;
- regarding the investment object;
- regarding currency conformity between customer funds/deposits held with credit institutions and securities.

The share of funds allowed to be invested for a longer period depends on the operational model of a particular EMI/PI. For this reason, there should be no requirement to invest a certain amount of customer funds in securities. However, following the requirements of the Bank of Lithuania, "free" funds may be invested in secure, liquid low-risk assets.

Requirements on diversification of funds and the use of the investment possibility

Advantages	Drawbacks
No need for amendments to laws; the decision of the Bank of Lithuania should be modified.	Since business models of EMIs/PIs are different, they have different amounts of funds to be invested for a longer period. For this reason, not all EMIs/PIs find the investment possibility relevant.
Holding securities ensures the protection of assets in case of bankruptcy of other institutions which provide securities safekeeping services.	EMIs/PIs lack professional knowledge to properly make use of the investment possibility.
Diversification reduces the risk and the scale of losing the funds.	The risk of losing the investment value is not completely eliminated.
	There are incentives for EMIs/PIs to assume a higher risk.

Questions

4. In your opinion, is there a need for more detailed requirements on how EMI/PI customer funds held with credit institutions should be diversified, as well as for requirements on secure, liquid low-risk assets and control measures?
5. What other advantages and drawbacks in relation to diversification and investment requirements, apart from those mentioned above, do you see?
6. What other aspects should be taken into consideration when setting requirements for diversification and investment of customer funds held with credit institutions?

POSSIBILITY OF A SPECIALISED BANK

Large EMIs which accumulate significant amounts of funds obtained from customers have the possibility to re-qualify as a specialised bank.

In 2016, amendments to the Republic of Lithuania Law on Banks were adopted which provided for the possibility of setting up a specialised bank. A specialised bank is considered to be a bank, however, it is subject to certain restrictions: a specialised bank cannot provide some riskier financial services, e.g., provide investment services, manage investment and pension funds, conduct crowdfunding and peer-to-peer lending platform operator's activities, provide clearing services. Specialised banks are also subject to a lower minimum capital requirement of €1 million.

Operations of EMIs, which carry out a high number of payments and where a significant amount of customer funds is held, are similar to the activities of banks related to payments. Therefore, such EMIs may avail of the possibility to change their EMI licence to a specialised bank licence. A specialised bank is not subject to the provisions of laws requiring that the funds obtained from customers be separated. The obtained funds are treated as deposits which are the object of deposit insurance.

The €1 million own capital requirement would not be a great challenge for large EMIs. The own capital of some of the largest EMIs already exceeds the required minimum of €1 million. Establishment of a specialised bank would not be suitable for small EMIs, since the change of the licence would require considerable additional investments in increasing own capital which would not be proportionate to the extent of their operations. Such solution is not appropriate for PIs either. The operations of PIs are focused on fund transfers and customer funds cannot be held in their accounts for longer than necessary for conducting payment orders. None of the PIs have their own capital similar in size to the minimum capital of a specialised bank.

Once an EMI re-qualifies as a specialised bank, its operational model shall be altered as well. Specialised banks have to provide crediting services which are not allowed for EMIs (except for 12-month credits closely related to the provision of payment services granted from own or borrowed funds). The activities of EMIs/PIs focus on payment services. Crediting activities might not be attractive, since EMIs/PIs would have to prepare new processes and assess credit-related risks. It should be noted that a bank licence (including a specialised bank licence) implies the obligation to provide crediting services. If an institution applying for a licence does not intend to provide crediting services, it will not be issued a specialised bank licence. For this reason, this option might not be appropriate even for large EMIs which have sufficient capital but do not plan to engage in crediting activities.

Possibility of a specialised bank

Advantages

The largest EMIs which might re-qualify into specialised banks already have sufficient capital.

Funds of specialised banks' customers fall under the deposit insurance system, customers are provided with protection (insurance coverage).

Drawbacks

The possibility of a specialised bank also means the necessity to change the business model – it is obligatory to provide crediting services.

The possibility of a specialised bank is not appropriate for small EMIs due to significant capital requirement differences compared to the present need; it is not an appropriate solution for PIs either.

Questions

7. What is your view on the possibility for the largest EMIs to re-qualify into specialised banks?

INCLUSION OF EMI/PI CUSTOMER FUNDS HELD IN CREDIT INSTITUTIONS INTO THE DEPOSIT INSURANCE SYSTEM

It may be established that EMI/PI funds obtained from customers and held with credit institutions are included in the deposit insurance system with a provision that the maximum repayable amount (insurance compensation) stipulated in the Law on Insurance of Deposits applies to:

- **EMIs/PIs, regardless the fact that they hold funds of multiple customers; or**
- **each customer of EMIs/PIs.**

EMI/PI funds held in the accounts of credit institutions are presently not treated as insured deposits – credit institutions do not pay insurance contributions on such funds, and in case of an insured event (bankruptcy) EMIs/PIs, whose customer funds are held with credit institutions, are not subject to any insurance compensation. For this reason, to boost the protection of customer funds, inclusion of EMI/PI customer funds held with credit institutions in the deposit insurance system should be considered. The Directive on Deposit Insurance (implemented in the Law on Insurance of Deposits) stipulates that deposits of financial institutions are not covered by insurance. However, the Directive does not clearly indicate whether only financial institution funds are not subject to insurance or it also applies to funds obtained from customers and held in the account opened on behalf of such financial institution.

Insurance of deposits is intended to safeguard the customers of financial institutions – residents and enterprises – from the loss of funds in the event of bankruptcy of a credit institution. Since the accounts of EMIs/PIs held with credit institutions are used for holding customer funds, their inclusion in the deposit insurance system is compatible with the general deposit insurance idea. Besides, the Directive stipulates that in cases where a depositor does not have an absolute right to the amounts held in accounts, a guarantee shall apply to the person who has this absolute right.

Attention should be drawn to the fact that foreign bank branches operating in Lithuania cover deposits with insurance according to the requirements of the home country (i.e. the country in which the main head office is located) and pay contributions to the deposit insurance agency of this country. Accordingly, issues related to insurance of EMI/PI customer funds kept in such branches would be resolved in accordance with the laws of the EEA state where the credit institution (whose branch operates in Lithuania) is established, and no amendments to Lithuanian laws related to deposit insurance would apply to the branches of foreign credit institutions operating in Lithuania. The number of such branches has been increasing in Lithuania and, at the beginning of 2019, two banks were reorganised into branches.

Two options of inclusion in the deposit insurance system could be considered. It could be established that the maximum repayable amount (insurance compensation) specified in the Law on Insurance of Deposits would apply to:

- each customer of EMIs/PIs; or
- EMIs/PIs, regardless of the number of their customers and the amount of funds held.

Insurance where the maximum repayable amount applies to every customer of an EMI/PI

Unlike ordinary depositors of credit institutions (residents or enterprises), an EMI/PI account held with a credit institution is used for holding funds of multiple customers. The Law on Insurance of Deposits provides a definition of a deposit account where funds of other entities are kept, and states that deposits held in such accounts are subject to insurance. When funds are kept in such deposit account, funds of each individual entity are considered to be an individual insured deposit. Based on the definition of a deposit account where funds of other entities are kept, funds in such accounts can be held in cases specified by legislation. Segregated accounts of EMIs/PIs where customer funds are held are not deemed to be a proper deposit to be insured following the Law on Insurance of Deposits.

To include the EMI/PI customer funds in the deposit insurance system to the maximum, an analogous solution, as in the case of a deposit account where funds of other entities are kept, could be applied. The Law on Insurance of Deposits stipulates that having opened a deposit account where funds of other entities are kept, the entity must at any moment provide a credit institution or the state company Deposit and Investment Insurance (hereinafter – DII) with information on the funds owned by each individual depositor. When an EMI/PI keeps its customer funds in several credit institutions, it is not clear what specific amount of which EMI/PI customer is held in a specific credit institution at a specific moment. In such case, EMIs/PIs should ensure measures to be able to provide information on each customer's funds when requested. Following the principle set out in the Law on Insurance of Deposits, it should also be ensured that in the case of an insured event an insurance compensation should not compensate for the loss of funds uncovered by deposit insurance (e.g., balances of other financial institutions held with EMIs/PIs). Therefore, information on such funds must also be identified.

If detailed information is required, EMIs/PIs will have to allocate an appropriate share of their customers to a specific credit institution. It would be disproportionate to demand that an EMI/PI should clearly attribute customer's funds to a specific credit institution at any moment. Moreover, without having established such principles, in case of an insured event EMIs/PIs might be tempted to attribute customers to a specific credit institution so that as many funds as possible are included in the "insured deposit". To avoid such situations, principles on how the funds should be distributed could be established. For instance, funds of each EMI/PI customer would be allocated to every credit institution where the EMI/PI keeps customer funds, proportionally to the allocation of all EMI/PI customer funds among different credit institutions.

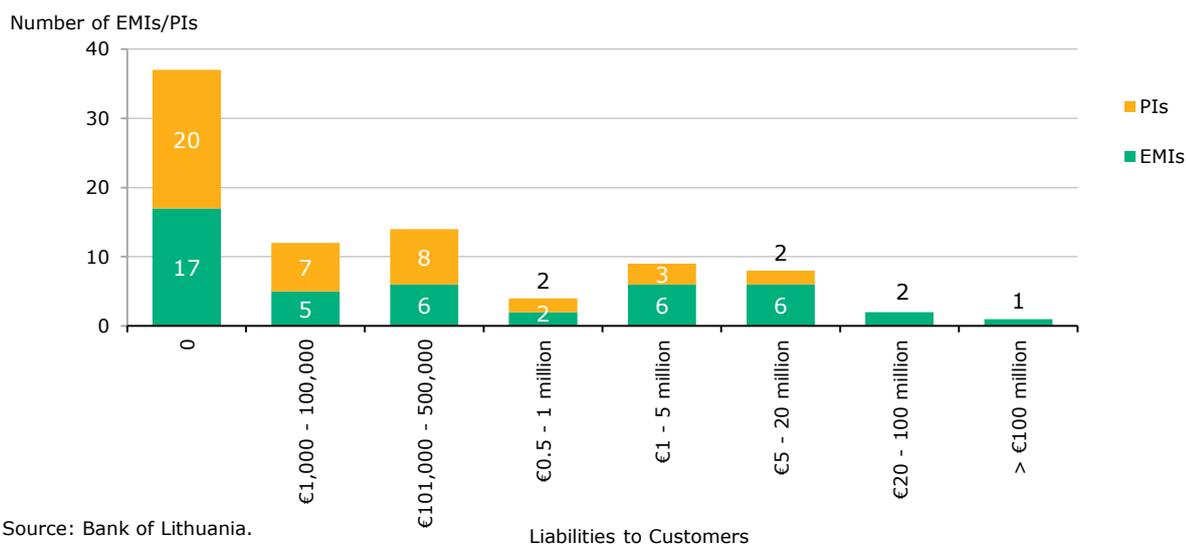
The Law on Insurance of Deposits also states that an insurance contribution shall be paid considering that all funds in a deposit account where funds of other entities are kept belong to one depositor. Given the amounts of an EMI/PI obligations to their customers, the amount held in a credit institution would be higher than €100,000, and an insurance compensation should be paid for the whole balance or its significant part. For this reason, in case of EMI/PI accounts where customer funds are kept, such principle would not be proportional compared to a standard situation. Hence, in this case an insurance contribution should be calculated in a different way, for example, it should be paid on the total amount of funds held by the EMI/PI, or another method of calculation designed for this specific situation should be developed and applied.

Insurance where the maximum repayable amount applies to a single EMI/PI regardless of the number of customers

Another alternative would be to provide that an EMI/PI deposit, when customer funds are kept in it, is included in the deposit insurance system but deemed to be one single deposit. This means that an EMI/PI account in a credit institution would be covered by deposit insurance of up to €100,000. In this case, to ensure consistency with the deposit insurance concept, an insurance compensation should also not be paid to cover funds which are not subject to insurance in the case of a credit institution. In this situation, the provision of information on every individual customer to a credit institution or DII is irrelevant, since one sum is insured regardless of the number of customers.

Assessing the activities of EMIs/PIs, the amount of €100,000 per institution is relatively low. According to the data as of the end of 2018, some EMIs/PIs had no liabilities to customers for outstanding electronic money and the provided payment services.¹ There were 11 EMIs and 15 PIs whose liabilities amounted to €0.5 million² or less. Therefore, such a change regarding insurance would be significantly beneficial to these institutions, if they distributed their funds among several credit institution (see Chart 2). Although such changes would be also beneficial to other EMIs/PIs, this would not help them to avoid losses (for instance, EMIs/PIs having a few million euro of customer funds generally hold higher than €100,000 amounts with each credit institution).

Chart 2. Distribution of EMI/PI liabilities to customers by amount (as of the end of 2018)



If EMI/PI customer funds held with credit institutions were included in the deposit insurance system, credit institutions would incur additional costs (insurance contributions); for this reason, it is likely that such costs would be transferred on the EMI/PI as a fee for account management.

¹ EMIs/PIs which had not commenced their activities or which had chosen a business model where EMIs/PIs immediately transfer funds obtained from customers instead of holding them had no liabilities to customers.

² The amount of €0.5 million is used only as a reference amount which could be distributed among several credit institutions so as to guarantee maximum protection.

Inclusion of EMI/PI customer funds held with credit institutions into the deposit insurance system

Advantages	Drawbacks
Protection of EMIs/PIs (along with their customers) in case of bankruptcy of a credit institution.	Amendments to laws would not apply to foreign bank branches operating in Lithuania.
The existing deposit insurance system may be partially used.	If a repayable amount was applied to a single EMI/PI, the amount of €100,000 per institution would be fairly low. Insurance contributions would cause additional costs to credit institutions; they would most probably be transferred on EMIs/PIs.

Questions

8. Should, in your opinion, EMI/PI customer funds held with credit institutions be covered by deposit insurance, so that in the event of bankruptcy of a credit institution EMIs/PIs would recover their customer funds?
9. Would, in your opinion, it be sufficient to establish that the amount of insurance applies to a single EMI/PI (and not to each customer)?
10. What other advantages and drawbacks do you see in the inclusion of EMI/PI customer funds held with credit institutions in the deposit insurance system, apart from those mentioned above?
11. How, in your view, would different deposit insurance regimes in different states affect EMIs'/PIs' decision to hold customer funds in Lithuanian credit institutions, foreign bank branches or banks of other states?

SPECIAL STATUS OF A CUSTOMER FUNDS ACCOUNT ENSURING IMMUNITY OF FUNDS (PROTECTION FROM LOSS) IN THE EVENT OF BANKRUPTCY OF A CREDIT INSTITUTION (TRUST DEPOSIT)

It could be established that EMI/PI customer funds held with credit institutions have a special status, i.e. considered a trust deposit:

- **EMI/PI funds held in an account of a credit institution cannot be used for operations of the credit institution;**
- **requirements for credit institutions with regard to accounting of such funds and segregation from own funds shall be set;**
- **EMI/PI funds held in an account of a credit institution shall not be included in the assets which are used to meet the claims of the credit institution's creditors; in case of bankruptcy of a credit institution, these funds shall be returned to the EMI/PI.**

The Civil Code of the Republic of Lithuania (hereinafter – the CC) stipulates that in certain cases the debtor has the right to fulfil the monetary obligation by repaying the debt into the deposit account of a notary, bank or other credit institution. In the event of bankruptcy, funds in a deposit account where funds of other entities are kept shall not be included in the assets of an insolvent bank or other credit institution which are used to cover creditors' claims. With regard to safeguarding EMI/PI customer funds, an analogous provision could be provided.

In its judgments, the Supreme Court of Lithuania has ruled that protection of funds held in deposit accounts where funds of other entities are kept, as provided for in Article 6.56(8) of the CC, implies that a bank or a credit institution cannot have in their disposition the funds held in deposit accounts specified in Article 6.56(1)

of the CC. However, there are no provisions prohibiting banks from having such funds in their disposition. In addition, the Supreme Court of Lithuania has repeatedly noted that a deposit account, which is subject to the specific rules laid down in Article 6.56(8) of the CC, may be opened both on the legal basis and on a basis of a signed contract (which has a legislative effect). However, as in the case where a contract is signed on the basis of the CC, banks are not required not to have such funds in their disposition; therefore, in case of bankruptcy of a bank, application of such a contract in practice could become problematic. Therefore, the expectation that funds held in such accounts would remain in the customer's ownership and would be returned to them in case of bankruptcy without following the queue of creditors' claims may be unjustified.

For this reason, in order to establish a special status for EMI/PI customer funds held with a credit institution, legal acts (the Civil Code) should be amended, providing that in case of bankruptcy of a credit institution, the EMI/PI customer funds would not be included in the assets of the insolvent credit institution, used to meet the creditors' claims. Respectively, requirements should be set for credit institutions as well. In other words, the concept of a trust deposit should be established and related obligations of credit institutions and deposit owners should be defined.

First, the funds of a trust deposit should be accounted separately from other deposits held with a credit institution. To safeguard the funds from loss in case of bankruptcy of a credit institution, they should not be used in the operations of a credit institution (i.e. borrowed) – they should be kept separately and safely. Holding of funds in another credit institution would not guarantee security, as they would also have to have an analogous status and be held in yet another institution. Given the aforesaid, a logical decision would be that a credit institution should keep funds with the Bank of Lithuania.

To implement this measure, credit institutions should prepare for that and carry out continuous monitoring of EMI/PI accounts in order to always ensure (e.g. at the end of every business day) segregation of the required amount and its transfer into a separate account. With an obligation to establish a special status and hold funds with the Bank of Lithuania, while being unable to make any profit from them, yet providing the service of management of such accounts, credit institutions will most probably charge a certain fee for such services and, at the same time, transfer negative interest.

The established requirements would be applicable solely to credit institutions operating in Lithuania, thus EMIs/PIs would not be subject to analogous provisions, if they held their funds with a credit institution of another Member State. Yet another aspect is that we are unable to assess how such provisions of the CC would apply in case of bankruptcy of a foreign bank with a branch established in Lithuania, since the legislation on bankruptcy as well as other regulation in each particular country may differ.

Special status of customer funds ensuring immunity of funds (protection from loss) in the case of bankruptcy of a credit institution (trust deposit)

Advantages	Drawbacks
EMIs/PIs are ensured that in case of bankruptcy of a credit institution they will not lose customer funds held in such credit institution.	Additional administrative requirements to credit institutions and costs for technical implementation, aiming to ensure proper segregation of funds. Uncertainty regarding the application of provisions applied to branches of foreign banks operating in Lithuania.

Questions

12. In your opinion, is it necessary to consolidate the concept of a trust deposit?
13. What other advantages and drawbacks related to consolidation of the concept of a trust deposit do you see, apart from those mentioned above?

14. What are other potential methods for ensuring that the funds are not used in operations of a credit institution (not only by segregating the funds of trust deposits into a separate account opened with the Bank of Lithuania)?

15. What other entities, apart from EMIs/PIs, could find consolidation of the concept of a trust deposit relevant?

ALTERNATIVES FOR INCREASING THE PROTECTION OF EMI/PI CUSTOMERS ON THE EU LEVEL

The described measures are implemented on the national level; for this reason, only Lithuanian EMIs/PIs would be affected, whereas measures related to holding funds in credit institutions would affect only those EMIs/PIs which hold funds in credit institutions established in Lithuania. Moreover, although the discussed measures broaden the choice of options for ensuring the protection of EMI/PI customer funds, the decision on the use of a specific measure shall be made by the EMI/PI itself. This might mean that if EMIs/PIs do not see the alternatives very attractive, they can decide not to choose them and hold funds in foreign credit institutions. EMI/PI customer funds would (not) be safeguarded according to legislation of a respective country.

To ensure the security of EMI/PI customers by equalling it to the security of deposits held with credit institutions, national measures are not sufficient. Therefore, it is worth initiating a discussion on ensuring the protection of EMI/PI customers on the EU level.

Questions

16. Would, in your view, national measures aimed at the protection of EMIs/PIs be sufficient to strengthen market and public confidence in EMIs/PIs? Or would it be more effective to do that on the EU level, instead of applying national measures?

INCLUSION OF EMI/PI CUSTOMER FUNDS HELD WITH CREDIT INSTITUTIONS IN INSURED DEPOSITS ACCORDING TO REQUIREMENTS FOR DEPOSIT INSURANCE

The EU legislation stipulates that funds obtained from customers by EMIs/PIs and held with credit institutions are covered by deposit insurance, so that in the event of bankruptcy of a credit institution EMIs/PIs could recover the funds of their customers.

The Payment Services Directive and the E-money Directive set out that EMIs/PIs can hold their customer funds with credit institutions, and that this ensures the protection of these funds in case of their bankruptcy. However, these directives do not provide for the status of such funds in case of bankruptcy of a credit institution. The directives lay down that holding funds in credit institutions guarantees protection thereof, and thus EMIs/PIs should choose credit institutions carefully.

The Directive on Deposit Insurance lays down that deposits of financial institutions are not covered by deposit insurance, however, it does not explicitly state how the funds of other persons (customers) held by financial institutions should be treated. For this reason, different countries might interpret it differently. This depends on the aspects of application of the legislation regulating bankruptcy, as well as on the interpretation of provisions of the Directive on Insurance of Deposits.

The possible difference in its treatment determines that customer funds held with credit institutions of different countries may be subject to different protection. Differences appear with regard to EMIs/PIs established in different countries (when the decision is made to hold customer funds in the home country), as

well as with regard to different accounts of EMIs/PIs that hold funds in several different countries. Subject to the business model, EMIs/PIs inevitably hold part of their funds with credit institutions in different countries. For example, when distributing payment cards, EMI/PI partners request collateral in a specific bank. Moreover, if cross-border payments or payments in foreign currency are conducted, in order to ensure smooth operation, funds in foreign banks are also required. Foreign credit institutions may also offer better account management conditions.

For instance, in Luxembourg, as well as in Lithuania, no insurance compensation would be paid for the accounts of EMI/PI customer funds in an insolvent credit institution. Accounts of EMI/PI customer funds have no special status to safeguard them either. In France, EMI/PI customer funds held with credit institutions are covered by deposit insurance. In the event of bankruptcy of a credit institution, EMIs/PIs regain funds held in customer funds protection accounts considering that every customer of the EMI/PI has the right to the established maximum amount of insurance.

To ensure that EMI/PI customers do not lose their funds due to the bankruptcy of a credit institution, it would be beneficial to amend legislation on the EU level and establish the same rules in all countries. Once it is determined that EMI/PI customer funds held with credit institutions (as required by legislation regulating such institutions) are considered insured deposits, it would ensure clarity and certainty about the fact that EMI/PI customers will not lose their funds because of the insolvency of other (i.e. credit) institutions. Additionally, this would guarantee higher security of EMI/PI activities.

Inclusion of EMI/PI customer funds held with credit institutions in insured deposits in accordance with deposit insurance requirements on the EU level

Advantages	Drawbacks
EMIs/PIs would be subject to the same conditions with regard to safeguarding funds, regardless of the country of the credit institution where funds obtained from customers were held.	Initiation and implementation of amendments on the EU level may take quite some time.

Questions

17. In your opinion, would amendments to the EU legislation, establishing that EMI/PI customer funds held with credit institutions in all countries should be equated to insured deposits, help to increase the protection of EMIs/PIs and their customers? Would such amendments help to ensure stronger market and public confidence in the EMI/PI sector?

CONSOLIDATION OF THE CONCEPT OF A PAYMENTS BANK

The EU legal acts provide for the concept of a payments bank that refers to an institution which provides only payment services; however, funds obtained from customers, as in the case of credit institutions, are covered by deposit insurance.

The greatest protection for EMI/PI customers would be ensured if the funds held in EMI/PI accounts were equated to deposits in banks, i.e. if the security of customer funds was guaranteed through the deposit compensation system. Currently, there is no such legal form which would allow an institution to provide only payment services, and customer funds held in an institution to be covered by deposit insurance. Holding a bank licence imposes certain obligations on the service provider, as it must provide crediting services. Institutions willing to specialise in the area of provision of payment services do not find requalification into a bank an attractive option.

For this reason, it should be considered on the EU level whether the concept of the “narrow banking” or “payments bank” should be established. This would imply that an institution provides payment services and

can accept funds from customers into accounts opened with it. Customer funds in its accounts would be covered by deposit insurance (or another analogous insurance) for which deposit insurance contribution would be paid. In case of an insured event, i.e. bankruptcy of a payments bank, its customers, as in the case of credit institutions, would recover the funds up to the insurance amount. This would protect residents and enterprises from loss of funds, regardless of the reason for the payments bank's insolvency.

Such amendments would enable institutions having a significant amount of customer funds to ensure security thereof and to continue providing payment services only.

Consolidation of the concept of a payments bank on the EU level

Advantages	Drawbacks
Funds of residents and enterprises held in a payments bank would be covered by insurance. It would increase trust in these payment service providers.	Initiation and implementation of amendments on the EU level may take quite some time.
Institutions unwilling to provide crediting services would have a choice to provide payment services only and provide customer funds with the same warranties as banks.	

Questions

18. In your opinion, would amendments to the EU legislative acts providing for the concept of a payments bank help to resolve the issue of the protection of EMI/PI customer funds?
19. What advantages and drawbacks in relation to the consolidation of the concept of a payments bank do you see?
20. What impact could such amendments have on the EMI/PI sector?

The risk of losing funds in case of bankruptcy of a credit institution is reduced, if EMIs/PIs implement additional measures. As pointed out in this consultation document, additional investments are inevitable in the implementation of any measures – almost all the proposed measures require additional preparation and costs, and it concerns not only EMIs/PIs. Some measures are implemented by efforts of EMIs/PIs and/or the Bank of Lithuania. To implement some other measures, political support is required, since amendments to legal acts (CC, Law on Insurance of Deposits), as well as establishment of new functions and obligations for other institutions (DII, credit institutions), are required.

National measures might improve the options for EMIs/PIs to choose measures for safeguarding customer funds and protect them from the effect of bankruptcy of a credit institution where they are held. However, to ensure that all EMI/PI customers have the same guarantee of protection of funds and that it is the same as in case of bank deposits, amendments to legal acts on the EU level are required, since national measures are insufficient to reach this goal.

Questions

21. Which of the methods discussed above, in your view, would be the most effective?
22. In your opinion, are there any other ways to increase the protection of EMI/PI customer funds?
23. Please provide any other comments on this issue.