



**LIETUVOS BANKAS**  
EUROSISTEMA

## Review of the Public Consultation Results

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

**2019**

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## Abbreviations

|     |  |
|-----|--|
| EMI | electronic money institution                   |
| EU  | European Union                                 |
| ALB | Association of Lithuanian Banks                |
| PI  | payment institution                            |
| DII | state company Deposit and Investment Insurance |

## **INTRODUCTION**

In June 2019, the Bank of Lithuania published a public consultation “Increasing the Protection of Customer Funds Held by Payment and Electronic Money Institutions”. The consultation document discusses the issues related to the protection of EMI/PI customer funds and the potential national and EU-level measures designated to increasing the protection of customer funds.

The purpose of the consultation was to find the opinion of the interested parties on the measures discussed in the document so that the Bank of Lithuania could assess the need for specific measures and the viability of the implementation of these measures.

Responses to the public consultation were provided by two associations uniting the EMI/MI sector (the Association of Payment and Electronic Money Institutions and the FINTECH HUB LT association), three EPIs, the Association of Lithuanian Banks, state company Deposit and Investment Insurance, and the Republic of Lithuania Ministry of Finance. The Bank of Lithuania has also held meetings with the interested parties.

The present document provides a summary of the opinions received, the assessment of the Bank of Lithuania, and further actions planned.

## **OVERALL ASSESSMENT OF THE NEED TO INCREASE THE PROTECTION OF EMI/PI CUSTOMER FUNDS**

The representatives of the EMI/PI sector hold a varied opinion towards the need to increase the protection of EMI/PI customer funds. The Association of Payment and Electronic Money Institutions, which unites the EMIs/PIs that have been active in Lithuania the longest, believes that the current measures are sufficient and EMIs/PIs are able to duly choose the measures for the protection of customer funds. In competing with banks, the EMI/PI sector often offers a greater availability of services (extensive network) and better prices. Should additional measures result in higher costs, EMIs/PIs would have reduced possibilities to compete with other payment service providers. This association has not commented on any specific measures discussed. The FINTECH HUB LT association (which unites over 30 EMIs/PIs) and separate EMIs that have provided their responses believe it is important to improve the possibilities of the EMI/PI sector to ensure the protection of the funds received from customers.

The ALB does not consider EMIs/PIs to have poorer conditions to protect funds received from customers, as compared to other payment service providers; therefore, this should not exert any negative impact on their possibilities to compete in the payment market. As regards the national measures discussed in the consultation document, the ALB notes that this raises questions as to the conformity of such measures with EU law; therefore, the best solution would be to harmonise and align the measures designated to the protection of EMI/PI customer funds on the EU level. The ALB also highlights that the additional measures implemented should not result in a heavier administrative burden imposed on other market participants.

## **ASSESSMENT OF THE SPECIFIC MEASURES DISCUSSED IN THE PUBLIC CONSULTATION DOCUMENT**

### **POSSIBILITY TO KEEP FUNDS WITH THE BANK OF LITHUANIA**

EMIs/PIs express support for the extension of the possibility of keeping funds with the Bank of Lithuania. The current possibility of keeping customer funds with the Bank of Lithuania, which is accessible to institutions using payment system services, provides an alternative to keeping funds with banks, yet it is not available to all EMIs/PIs. The extension of this possibility would also allow institutions that do not use payment system services (e.g. as they do not need to execute payments by using payment system services) to keep funds

with the central bank. It is expected that starting to use the service of keeping funds with the Bank of Lithuania without the possibility of payment execution would be easier and quicker as compared to starting to use payment system services. This would also bring considerable reputational benefits – since bankruptcy of the central bank is not possible, keeping customer funds with the Bank of Lithuania would allow EMIs/PIs to ensure practically full protection of customer funds and thus strengthen their image in the eyes of their customers.

In their responses, EMIs/PIs also indicate they would find it relevant if there was a possibility of keeping funds with the Bank of Lithuania denominated not only in euros but also in other frequently used currencies. This would allow EMIs/PIs to provide the payment service in a foreign currency with greater efficiency. As indicated, one of the drawbacks of keeping funds with the Bank of Lithuania is mainly that the Bank of Lithuania only allows keeping funds denominated in euros.

Another drawback is that the Bank of Lithuania applies negative interest on the balance of funds, which raises the price of the keeping of customer funds. Nonetheless, keeping funds with the Bank of Lithuania is still one of the cheapest alternatives.

In the opinion of the ALB, the extension of the possibility of keeping funds with the Bank of Lithuania would be the most efficient national measure discussed. This would also be a logical choice since the Bank of Lithuania supervises EMI/PI activities and is aware of their business specificities and risks.

In the opinion of the Ministry of Finance, the establishment of uniform possibilities for all EMIs/PIs to keep customer funds in an account with the Bank of Lithuania, without linking it to the use of payment system services, delivers the objective of increasing the protection of EMI/PI customer funds and reduces the problem of the loss of EMI/PI customer funds in the event of the bankruptcy of a credit institution.

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

In the opinion of EMIs/PIs, the key drawbacks of the possibility of the investment of customer funds relate to the necessity to use the services of intermediaries, cost of the investment service, lack of professional knowledge, and risk of losing the investment value. It has been noted that the investment alternative is more relevant to larger mature institutions. The unattractiveness of the investment possibility also stems from the current environment of low (negative) interest.

Although EMIs/PIs do not find the investment possibility an attractive alternative to increasing the protection of customer funds, they would still benefit from clearer requirements on diversification and investment. The example of the United Kingdom, which has guides and recommendations for such activities, serves as good practice. EMIs/PIs note that consultations with EMIs/PIs could be very beneficial when establishing the requirements, considerations for which should exclude a variety of dimensions, as establishing the requirements on the investment object and the investment maturity period would suffice. An opinion has been also expressed that the Bank of Lithuania could offer an assessment of specific securities. However, the requirements should not pose limitations on the investment possibility (i.e. should not be excessively strict and should not downsize the availability of options).

The Ministry of Finance has a positive view on the establishment of more detailed requirements on the diversification of funds obtained from customers in different credit institutions and on investment in secure, liquid low-risk assets. It is, however, agreed on that the risk of losing the investment value would persist.

## **POSSIBILITY OF A SPECIALISED BANK**

EMIs do not find the possibility of a specialised bank as a viable option to increase the protection of consumer funds. Several drawbacks of the possibility of a specialised bank have been distinguished: strict requirements on the business model of banks, increase in the administrative burden, as well as the necessity to provide crediting services. Changing the licence into a licence of a specialised bank would require substantial investments, as well as time. EMIs claim such a solution is suitable only for large and experienced EMIs.

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

In the opinion of EMIs/PIs, EMI/PI client funds held in accounts with credit institutions should be inclusively treated as insured deposits. Insurance where the maximum insured amount applies to one EMI/PI, regardless of the overall number of customers and the amount of funds held by them, would reduce the risk of losing customer funds in the event of the bankruptcy of a credit institution. Yet a substantial impact would be made if the insured amount were to be applied to every customer of an EMI/PI.

Inclusion into deposit insurance implies additional costs for credit institutions which, in the opinion of EMIs/PIs, would be transferred on to the EMI/PI. EMIs/PIs would also incur additional costs due to the requirement for the technical identification of end customers (where insurance applies to every customer). EMIs/PIs list these aspects as the main drawbacks of this alternative. It has been also noted that additional requirements on credit institutions might deter them from wanting to engage with EMIs/PIs.

The ALB considers this alternative the least acceptable of all the national measures described. The ALB states that the implementation of this alternative would lead to the distortion of competitive conditions between the credit institutions registered in Lithuania and foreign bank branches, as they would be subject to different terms. It would also result in the distortion of competition between EMIs/PIs and banks, since the security of EMI/PI customer funds and the attractiveness of their services would be improved at the expense of credit institutions.

In the view of the ALB, should this alternative be implemented, to prevent credit institutions from additional implementation-related costs, the same conditions should be applied as those laid down with respect to deposit accounts where funds of other entities are kept and contributions should be calculated assuming that all funds belong to one depositor. If deemed necessary, the duty to identify the end beneficiaries (customers) should directly lie upon EMIs/PIs as a means to not unduly increase the administrative burden on credit institutions.

DII points out that the purpose of deposit insurance is to safeguard the funds lent by depositors to credit institutions in the case of the latter's insolvency. Therefore, the provisions of deposit insurance should be interpreted on the basis of this purpose. Legislation lays down the measures that EMIs/PIs are required to apply in order to safeguard the funds received from customers in the event of the bankruptcy of an EMI/PI. However, this does not mean that EMI/PI customer funds kept with credit institutions are covered by deposit insurance. DII draws attention to the fact that EMIs/PIs are required to implement an efficient risk management system, which means that they have to carefully choose the credit institutions in which they keep (safeguard) the funds received from customers and, accordingly, to assume the resulting risk.

As well as DII, the Ministry of Finance notes that the purpose of deposit insurance is to ensure financial stability. The measure specified in the consultation document would mean higher contributions to credit institutions, yet the distribution of costs with EMIs/PIs, whose customers are aimed at being protected, has not been sufficiently disclosed. The Ministry of Finance also indicates that the proposed measure would exclude credit institutions that have established their branches in Lithuania or that provide their services without being established, which would imply market distortions not only in the EU but in Lithuania as well. In

the opinion of the Ministry of Finance, decision on the protection method to be applied on EMI/PI customer funds kept with credit institutions, where the repayable amount applies to every customer of an EMI/PI, as discussed in the consultation document, should be made at the time of considerations of the amendments to the Deposit Insurance Directive.<sup>1</sup> In the judgment of the Ministry of Finance, insurance of EMI/PI customer funds, where an institution would receive an insurance compensation up to the maximum repayable amount (regardless of the number of customers), is contrary to both the Law on Insurance of Deposits and Liabilities to Investors and the Deposit Insurance Directive.

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

The views on the concept of trust deposit<sup>2</sup> vary. One EMI/PI association points to the need for more detailed analysis as to whether such a method would prove to be efficient in increasing the protection of EMI/PI customer funds. One institution claims it would agree with the consolidation of the concept of trust deposit. The greatest drawbacks distinguished relate to the potential increase in EMI/PI costs (due to the heavier administrative burden on credit institutions, which would result in a corresponding service fee).

As the present regulation lacks clarity, the use of deposit accounts where funds of other entities are kept does not guarantee that EMI/PI customer funds kept in such deposit accounts would not be used in the operations of a credit institution and that they would be recovered in the event of the bankruptcy of a credit institution. The concept of trust deposit, should such be introduced, would also avail other institutions obliged to protect separated customer funds, for example, financial brokerage firms, currency exchange offices, crowdfunding and peer-to-peer lending platforms.

An opinion has been expressed that the concept of trust deposit should be ensured (i.e. customer funds kept with credit institutions should be protected from the impact of the bankruptcy of a credit institution) if EMI/PI customer funds kept with credit institutions are not covered by deposit insurance.

The ALB judges that the consolidation of the concept of trust deposit would not resolve the issue of the protection of EMI/PI customer funds. This would entail changes to the Civil Code, which gives rise to doubts whether this would not be in conflict with the legislation, should the protection of a trust deposit be established as a mandatory requirement, as such changes might distort the competition. Furthermore, the implementation of such changes would be costly.

In the opinion of the Ministry of Finance, the possibility of keeping EMI/PI customer funds in a trust deposit would presuppose exceptional treatment of customers who keep their funds in such an account in the event of the bankruptcy of a credit institution and would affect the interests of other creditors, i.e. the possibilities of satisfying the requirements of the latter. The Deposit Insurance Directive stipulates that depositors are covered by insurance of up to €100,000, while the possibility of a trust deposit does not place such a limitation. The consequences of the unequal level of the protection of depositors and unequal business conditions of credit institutions and EMIs/PIs ought to be addressed.

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<sup>1</sup> Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.

<sup>2</sup> The trust deposit in a credit institution would bear a special status, providing protection from loss in the case of the bankruptcy of a credit institution. In order to achieve this, funds held in a trust deposit should not be used in the operations of a credit institution and should be segregated and kept separately from own funds of the credit institution.

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

Although EMI/PI representatives support EU-level measures, they are more inclined towards national measures. The main drawback of EU-level measures is claimed to be the duration of implementation – amendments to EU legislation would take years, while decisions are needed now, whereas national measures could be implemented more quickly. Given the fact that representatives of Lithuanian public authorities have considerable experience in the Fintech sector, they could lead the formation of the EU agenda on these matters.

In the opinion of EMIs, the equating of EMI/PI customer funds kept with credit institutions with insured deposits under the deposit insurance requirements would improve the conditions of the protection of EMI/PI customer funds. Still, one EMI/PI association notes that as there is currently limited choice of the services rendered by credit institutions, differences in treatment between countries does not significantly impact the choice of a credit institution to keep customer funds with.

EMIs/PIs support the concept of a payments bank. The licence of a payments bank would allow concentrating towards payments business (providing crediting services as in the case of credit institutions would not be required) and would ensure the protection of customer funds, as deposit insurance protection would be in place. This would also bring reputational benefits, as institutions would gain more trust from their customers and other market participants. However, the association believes this alternative would avail only some EMIs, which have more experience in the payment market (mature institutions). This alternative would not be too attractive due to strict requirements imposed on banks as well as major time and financial resources needed in the process of changing the licence.

In the opinion of the ALB, ensuring EU-level measures and uniform conditions on the EU level would be the most efficient and appropriate way to safeguard EMI/PI customer funds. The concept of a payment bank has been given support. This would provide greater clarity as regards the protection of EMI/PI customer funds and would also align the conditions of competition between EMIs/PIs and other market participants both on the level of a single country (there would be no difference between the institutions operating in the country and foreign branches), and between different countries (there would be no difference in the regulation-related conditions).

In its opinion regarding the national provision, by which EMI/PI customer funds kept with credit institutions are to be included in the deposit insurance system, the Ministry of Finance claims that this issue should be addressed on the EU level when considering amendments to the Deposit Insurance Directive.

## **OTHER POTENTIAL MEASURES IMPROVING THE PROTECTION OF EMI/PI CUSTOMER FUNDS**

EMIs/PIs have additionally indicated several aspects related to the protection of customer funds:

- legislation provides the private insurance of funds as one of protection methods. There are practically no entities offering this service in the market. As a result, this calls for a more comprehensive analysis of this alternative;
- there is the need to allow keeping funds with the Bank of Lithuania not only denominated in euros, but also in other frequently used currencies. EMIs/PIs would find it sufficient if only the possibility of transferring these funds from (to) other EMI/PI accounts was ensured;
- the list of institutions deemed eligible for keeping customer funds could be extended, encompassing not only EU-based credit institutions but also non-EU banks, as well as not only credit institutions but

also other reliable EMIs. The Bank of Lithuania could establish criteria or specify the countries and institutions deemed reliable;

- EMIs/PIs could be allowed to voluntarily enrol in the Lithuanian deposit insurance system;
- the currently available alternative of acquiring a guarantee or surety is not attractive due to the price of the service and the necessity of having a certain part of the funds frozen in a bank account.

The Ministry of Finance has also noted that the risks related to other methods of the protection of customer funds, besides solely the keeping of funds in an account with a credit institution, could be also analysed. For instance, where customer funds are insured under an insurance contract, the insurance undertaking might go bankrupt; where customer funds are invested, the issuer might not redeem the issued financial instruments. In the opinion of the Ministry of Finance, attention should be paid to increasing the protection of EMI/PI customer funds by choosing any of the methods of the protection of customer funds as provided in the legislation.

## **OPINION OF THE BANK OF LITHUANIA AND FURTHER ACTIONS**

The possibility of keeping EMI/PI customer funds with the Bank of Lithuania will not be further developed, as such a possibility has been already implemented for users of the CENTROlink payment system. As CENTROlink users account for over 95% of the EMI/PI market by the amount of customer funds (liabilities to customers), an additional solution for other EMIs/PIs would offer little added value.

Demand from the market has been noted to adjust and detail the requirements of the Bank of Lithuania with respect to the investing and keeping of funds received from customers with credit institutions. For this reason, the Bank of Lithuania plans to update the Requirements Concerning Internal Control, Risk Management and Protection of Received Funds and to more explicitly clarify which funds should not be kept in a separate client funds account with a credit institution, which investments are deemed secure, liquid low-risk assets, and how these funds should be segregated from other investments of own funds of the institution. Revision of the requirements would bring more clarity to market participants as to how to implement the provisions related to the protection of customer funds; however, it would not substantially change the possibilities of the protection of customer funds.

The inclusion of EMI/PI customer funds kept with credit institutions into the deposit insurance system and the consolidation of the status of a trust deposit at the national level would only have a limited effect. Therefore, it is proposed that the possibilities of the implementation of these national measures should not be pursued any further. The implementation of these measures would result in different conditions being applied to the credit institutions operating in the Republic of Lithuania and foreign bank branches. Since EMIs/PIs may choose whether to use the services of the credit institutions operating in Lithuania or those of foreign institutions, the newly offered possibilities might be not utilised. The implementation of these possibilities would also result in a heavier administrative burden for credit institutions and DII.

Having regard to the fact that the national measures related to the increasing of the protection of customer funds kept with credit institutions would only have a minor effect and could be applied with a limited capacity, the Bank of Lithuania will seek that the issue regarding increasing of the protection of EMI/PI customer funds was discussed at the EU level. The Deposit Insurance Directive is currently under review. Amendments to the directive could generate positive developments. In its [Opinion on the Deposit Insurance Directive](#),<sup>3</sup> the European Banking Authority (EBA) also looks into the situation where a credit institution holds a deposit of another institution in which the institution keeps the funds of its customers. The EBA concludes that an interpretation from the European Commission, as well as more detailed analysis of the issue, is necessary.

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<sup>3</sup> Paragraphs 236–248.