

TIME TO GUARANTEE E-MONEY USERS' FUNDS!

Coordinating deposit guarantee coverage with trust in e-money and payment services activities

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Abstract

This paper aims to stimulate discussions on the possibility of including the funds of Electronic Money Institutions (EMI) and Payment Institutions (PI), placed with banks for safeguarding purposes, as part of the deposit guarantee schemes, as a means to increasing public confidence in digital payment services and financial inclusion as a result. This would also prevent the need of all these institutions, created to increase competition in the payment services market, to transform into banks to safeguard their clients' money and increase public trust in their business.

This paper addresses the topic in an Albanian perspective, in a country where increasing the public trust in alternative payment or e-money services is crucial to increasing financial inclusion of the population.

Introduction

Every time we hear the word deposit, our mind goes to banks. This is because deposits are one of the two most important activities of banks and distinguish them from other financial institutions. Acceptance of deposits is the mechanism that enables bank intermediation and at the same time helps in the process of money creation in the economy. It also makes payment systems easier through interbank transfers.

But in addition to benefiting banks and the economy as a whole, deposits represent the savings of households and businesses, and as a consequence the state takes care to provide sufficient security to ensure that this money is safe. This security is offered to the public in two main ways. Firstly by conducting a strong supervision process by the supervisory authority and secondly through the guarantee of deposits through deposit guarantee schemes.

But the advances in technology and the increasing share of digital financial services around the world, have created the opportunity for other forms of deposit-like or value preservation products offered by non-bank financial institutions to develop, such as electronic money or payment accounts. Experience around the world demonstrates several ways of protecting or safeguarding these funds, but, although they are also owned by the general public funds, their protection does not have the same treatment as banks deposits, on the basis that both EMIs and PIs do not lend out their clients' money. Currently, only bank deposits are commonly covered by deposit guarantee schemes.

Some countries have explicitly stated that electronic money is not covered by deposit guarantee e.g. Peru, Paraguay, Uruguay, and the Philippines. However, some countries have decided to extend deposit guarantee to individual electronic money accounts, either directly (individual electronic money accounts are directly insured up to the coverage limit e.g. India or Colombia) or indirectly (pass through approach e.g. in USA or Kenya).¹

¹ https://www.bbvaresearch.com/wp-content/uploads/2016/10/Safeguardingelectronicmoneyfunds_en.pdf

In the European Union, based on the Electronic Money Directive 2 (EMD2) and Payment Services Directive 2 (PSD2), EMIs and PIs are required to safeguard their client's funds by depositing them in banks or investing them in low risk and liquid assets. Although the funds deposited in banks constitute bank deposits and they should be clearly separated from the EMI's or PI's own funds, these 'client fund' deposits are not considered as eligible to be covered by any deposit guarantee scheme.

I. The impact of technology on, and the international approach to deposit and value preservation products

Rapid technological advances has made financial services today go beyond the traditional suppliers. More and more, digital financial services are being provided not only by banks, but also by other financial and non-financial institutions. This has increased competition and consequently reduced the costs associated with accessing and using these services and has increased their quality. Other digital products, such as e-money, are increasingly becoming similar, in some aspects, to the traditional concept of deposit, and the term deposit, becoming more blurred as a consequence. From a practical perspective, a client cannot find much difference between a traditional demand deposit, payment account with a PI or an e-money product. The presence in the market of innovative electronic money instruments with value storage function such as virtual wallets, virtual cards or other prepaid instruments, have made it difficult for the authorities, service providers or even consumers themselves to clearly identify which products should be considered or not as deposits and which are those products sufficiently similar to deposits to be considered as insurable.

This increase in the range of storage-value products has implications for financial inclusion. Driven by a Consultative Group to Assist the Poor (CGAP) study², the International Deposit Insurance Association (IADI) published a research paper³ in March this year on the different country practices related to the link between financial inclusion and deposit insurance focusing on digital value preservation products. According to the latter, as the number of digital products with value storage function is increasing, aiming an increase in the financial inclusion of the population, deposit insurance institutions, are paying more and more attention to these specific products. However, most deposit insurance institutions in the world still do not include digital value-storing products as insurable, even when they are offered by the institutions themselves participating in the deposit guarantee scheme, such as banks.

One of the most popular electronic money institutions in the world, and the largest in the United Kingdom, Revolut, in 2018 was licensed as a bank in Lithuania and through the passporting option within the European Union, it could operate in other member countries. After Brexit, in March 2020 Revolut applied for a bank license in the United Kingdom. In addition to providing lending services to customers, an important reason for the change the institution's license was the availability of protection of its customers' funds from deposit guarantee schemes that applied to banks and not to electronic money institutions⁴.

² "Deposit Insurance and Digital Financial Inclusion", CGAP, October 2016

³ <https://www.iadi.org/en/news/iadi-research-paper-deposit-insurance-and-financial-inclusion-current-trends-in-insuring-digital-stored-value-products/>

⁴ [https://www.finextra.com/newsarticle/35753/revolut-launches-licenced-bank-in-lithuania#:~:text=Revolut%20has%20formally%20launched%20as,in%20deposit%2Dprotected%20bank%20accounts](https://www.finextra.com/newsarticle/35753/revolut-launches-licenced-bank-in-lithuania#:~:text=Revolut%20has%20formally%20launched%20as,in%20deposit%2Dprotected%20bank%20accounts;); and <https://www.finextra.com/newsarticle/35432/revolut-to-apply-for-uk-banking-licence>

The recent Wirecard story⁵ is another illustration of the fact that there is the need for an additional link in the customer's funds protection chain.

The above examples illustrate that there is a need, especially for EMIs which hold clients funds longer in time, to protect these funds and increase the public's trust in the e-money business, to transform into banks, so jeopardizing the original purpose of their establishment which was to increase competition in the payments market.

Under to international practice, the safeguarding of electronic money users' funds can be achieved in several ways e.g. by depositing the funds in a commercial bank or investing them in low-risk assets, or by securing the funds with private insurance policies (which is unlikely to be feasible in most developing countries where insurance markets are not yet well developed⁶) or placing the money in a trust account⁷ with a financial institution, specialized for this purpose. However, as a rule, regulators require providers to set aside assets worth 100% of the value of the mobile money liabilities.

In Europe, the guarantee of funds does not apply to financial institutions which hold client funds such as EMIs and PIs. These funds are not considered as deposits in its classical and legal definition and as such, they are not protected by deposit guarantee schemes. Although the European Union Directives such as EMD2 and PSD2 include safeguarding of funds provisions and prudential requirements, the funds placed by EMI clients in exchange for electronic money or those placed by PI clients for payment purposes are still not fully protected.

In August 2019 the European Banking Authority issued an opinion⁸ on the subject of coverage of deposits of electronic money institutions and payment institutions in credit institutions, which was based on the EU directive on the deposit guarantee scheme (DGSD). According to this directive, payment and e-money institutions are considered to be the same as other financial institutions and therefore their deposits with credit institutions are excluded from the coverage under the deposit guarantee scheme. However, this directive does not clearly specify its approach on the deposits placed in banks by these institutions for the purpose of protecting the funds of their clients under the safeguarding article of PSD 2 and EMD 2. Although the position is not clear in the directive with regard to these deposits placed in credit institutions by EMIs or PSP on behalf of their clients for safeguarding purposes, deposit's coverage through the pass-through approach seems to be currently regulated and applied with notaries or law firm's accounts in credit institutions on behalf of their clients⁹.

The EBA's opinion lists the arguments in favour of applying this approach at a European level, including the mitigation of contagion effects in financial stability, or the respective issues to be considered. In conclusion, the EBA considers that the relevant article of the EU directive on deposit guarantee schemes, which excludes as insurable all bank deposits of financial institutions, including those of payments and

⁵ <https://newmoneyreview.com/index.php/2020/07/02/wirecard-case-raises-e-money-concerns/>

⁶ https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2016/01/2016_GSMA_Safeguarding-Mobile-Money_How-providers-and-regulators-can-ensure-that-customer-funds-are-protected.pdf

⁷ Trust accounts are products mostly used in countries practicing common law such as USA or UK. Nevertheless, with the banking and capital markets activities becoming more and more global, there are cases when countries practicing civil law e.g. Italy or France have introduced in their legislation such concept. Other civil law countries use a similar concept called fiduciary account which can be adopted as an alternative (See "Safeguarding funds stored in mobile money systems" by Jonathan Greenacre, Sept.2020).

⁸ Opinion of the European Banking Authority on the eligibility of deposits, coverage level and cooperation between deposit guarantee schemes, EBA, August 2019

⁹ Opinion of the European Banking Authority on deposit guarantee scheme payouts, October 2019

electronic money institutions, needs further clarification to clearly distinguish the deposits of the institution *'on their own behalf and for their own account'*, from those deposits placed for the purpose of safeguarding the funds of the clients of these institutions according to the requirements of PSD 2 and EMD2. Although such an approach brings benefits from a consumer protection perspective, the EBA considers that this issue needs further clarification based on more in-depth analysis to this end. Consequently, EBA's opinion did not explicitly express an unfavourable opinion, but instead recommended to the Commission to *"enhance clarity in the DGSD on how the see-through approach applies to deposits placed with credit institutions by account holders that are excluded from eligibility"*.

In any case, although applying such a look-through approach to the beneficiary accounts held by non-bank financial institutions would seem to address the concern, this approach might also have some important operational implications which need to be considered as part of the process. Examples are the calculation of the repayable amount, the means of the payout of the beneficiary accounts, along with the respective timing and also the calculation of contributions.

II. The concept of electronic money

Electronic money in the broadest sense can be defined as electronically (including magnetically) stored monetary value as represented by a claim on the issuer which is issued against a cash balance in the official currency of a country and which can be used to make payments to entities other than the electronic money issuer. Electronic money can be held in digital wallets (online money), digital mobile wallets (mobile money wallet) or with prepaid payment instruments such as prepaid cards.

Giving fiat money in exchange for electronic money storage accounts or instruments can be done through placing physical money at the premises of the electronic money institution itself or its agents, by transfers from another client of the electronic money institution both inside and outside the country, or through transfers from the bank account of an individual (for example rent or utility payment), business (for example employee salaries or tax liabilities) or the state (for example pensions or social benefits).

Electronic money can be offered by banks, as well as by non-bank entities, whether financial or not (e.g. telecommunication companies), if they have received the respective license from the licensing authority. This type of product can be used by people who have a bank account, as well as those who do not have one but instead prefer to use their payment accounts with financial and non-financial institutions that offer digital wallets or prepaid cards with e-money.

III. The situation in Albania

The legislation regulating the activity of electronic money in Albania has been adapted from the second Electronic Money Directive of the European Union in the law on Banks in the Republic of Albania at the end of 2011. In 2013 the Bank of Albania issued the respective bylaws, thus creating the possibility for e-money institutions to be licenced, regulated, and have activity in the country.

According to Bank of Albania data, at present there are three licensed electronic money institutions, EasyPay shpk, Unioni Financiar Tiranë and Posta Shqiptare sha. Hence, for several years now the Albanian public has another alternative to bank accounts, namely the opening and use of an account with storage function at an electronic money institution. Between 2017-2019, the increase in e-money transactions was 170%.

The positive thing is that from year to year the number and value of transactions performed with electronic money instruments is increasing. Although the share of the total value of electronic money transactions by the above institutions to the total payments of customers in Albania is almost negligible (0.3% of the total at the end of 2019), their number is significant (15% of total at the end of 2019),¹⁰ thus competing with other media, especially in the category of non-paper payments such as internet banking and mobile banking.

Consequently, the concept of financial inclusion in Albania should be considered to be closely related not only to the increase in the number of open accounts in banks, but also to the increase in the number of storage accounts with electronic money institutions (8.484 e-money accounts by the end of 2019) and of payment accounts with payment institutions in the future. The increase in e-money or payment accounts could have a very positive impact on the next assessment of the level of financial inclusion in Albania according to the Global Findex of the World Bank¹¹.

IV. Safeguarding of funds

The new law "On Payment Services" in Albania, which is a transposition of the PSD2 Directive of the EU, requires the safeguarding of payment services users' funds, in case the payment institution fails, by depositing the client's money into commercial banks, or investing them in low risk assets or securing the funds with insurance policies. These funds should be insulated in the interest of payment service users against the claims of other creditors of the payment institution, in particular in the event of its insolvency.

On the other hand, the e-money issuance activity is regulated by the Law on banks in the Republic of Albania, but it does not include any provision covering the safeguarding of funds, unlike the new payment services law. Therefore, the legal safeguarding of clients' funds deposited by electronic money institutions remains uncovered. The only existing provision is that covering the regulation on risk management for non-bank financial institutions, which requires that the e-money institutions funds should be invested in low risk assets. But in any case, there is no legal provision stating that *"these funds can in no case be blocked, be the subject of claims of other creditors of the electronic money institution or be subject to compulsory execution"* or that *"in case of bankruptcy of the electronic money institution, these funds are not part of the bankruptcy measure and are distributed to the electronic money users in a proportional manner"*, as is the case for the payment institutions approach.

More importantly, the Albanian legislation does not cover the safeguarding of funds of users of payment services or those of electronic money, should the commercial bank, where these customer's funds are deposited by the electronic money institution or the payment institution, become insolvent. Such a situation undermines the public's confidence in the safeguarding of their savings.

Although e-money users' funds are similar to deposits, they are not technically deposits. This is why the law on banks in Albania, like European practice, explicitly excludes them from the definition of deposits. Consequently, the cash funds received by the institution in exchange for the issuance of electronic money, although kept until the user make use of the money, e.g. for a limited number of days, they are not defined as deposit. On the other hand, although the customer's funds that the electronic money institution

¹⁰ Source: https://www.bankofalbania.org/rc/doc/emoney_shqip_QERSHOR_2020_17419.xlsx

¹¹ According to the latest Global Findex (2017) only 40% of the population has a bank/financial institution account.

deposits in a commercial bank for safeguarding purposes are considered deposits, they are not included in the Albanian deposit guarantee scheme.

The deposit guarantee scheme today in Albania covers the deposits of individuals and businesses in banks up to ALL 2.5 million (around 25k US\$). The limit was increased from 700 thousand (around 7k US\$) to 2.5 million ALL as one of the measures taken during the global financial crisis of 2008-2009 to provide more guarantee to the public and increase their confidence in the banking system in the country. In 2014, savings and credit associations were also added to the deposit guarantee scheme, and all deposits of up to ALL 2 million (around 20k US\$) of the members of these associations are insured, thus offering one more guarantee for this segment of the financial market by make it more attractive for absorbing new memberships.

Thus, by the same logic, given that the financial inclusion level in Albania is quite low and the authorities aim to increase the number of non-cash transactions by 130% by 2022, it is necessary to build policies or take actions to make the activity of electronic money institutions more attractive and reliable for the public, more secure and at the same time competitive under the same conditions as the banking system. Moreover, increasing competition and the provision of an additional protection scheme by the authorities, would serve as an incentive for that segment of the population, which does not prefer the use of banking products, but instead prefers making payments through electronic money instruments. This is due to the convenience they offer in their remote areas locations through agents or through the provision of lower service costs.

The end users of these funds have entrusted their money to a financial institution licensed and supervised by the Bank of Albania. Thus, the Albanian state has taken care to provide basic consumer protection. But an electronic money institution is not a financial institution like all the others. It keeps the public's funds until the latter decides to spend or withdraw them. Although it is not considered a deposit in its legal sense¹², the electronic money institution offers to the public a digital financial product that stores value for which it has a legal obligation to return it as soon as it is asked or to hold it if the client decides not to use the funds. As mentioned above, if the electronic money institution goes bankrupt, Albanian legislation does yet provide safeguarding of funds as it provides for payment institutions under the new law on payment services. But even if this issue was addressed or legally interpreted as covered by any secondary legislation provisions, the Albanian legislation does not specify what deposit guarantee these clients have if the bank where the electronic money institution has deposited the money of its clients for safeguarding purposes, goes bankrupt.

V. Conclusions and recommendations:

From a European and international perspective, the legislative steps undertaken so far regarding the development of the payment services and other mobile or electronic money activities, have created many opportunities for PI or EMI institutions to conduct their activity, and, in addition, to increase innovation and competition in the payments market. Despite the safeguarding and prudential provisions, PI or EMI funds placed in banks on behalf of their customers still need a more complete protection covered by the DGSD. This would increase the public trust in digital payment services offered by non-banks but would

¹² We are referring here to the definition in Law on Banks in the Republic of Albania, although the Civil Code in Albania has a broader definition of the deposit, by clearly distinguishing it from the bank deposit.

also let the PI or EMI activity continue without having the competitive pressure of transforming into a bank in the future.

From an Albanian perspective, the steps undertaken by the Bank of Albania, the private sector and other authorities in the country, with international professional support, have addressed a series of legislative gaps which modernized the Albanian digital payments market. These ventures have made Albanian banks and other financial institutions able to provide payment and e-money services and increase the public interest. But the level of financial inclusion of the population is still very low, and so is the level of use of non-cash instruments. Additional protection for EMI or PI customer's funds would increase public trust in and use of innovative payment services.

The proposed alternatives for further evaluation are as follows:

(a) In an international and Albanian context:

Addressing the possibility of including within the deposit guarantee scheme, the funds of EMIs or PIs deposited in banks on behalf of their clients for safeguarding purposes. This fact would enable the reimbursement of the funds, in case the bank where the EMI or PI have deposited their customer's funds for safeguarding purposes, goes bankrupt. This would not just provide an additional guarantee for the clients and increase public trust in these types of institutions, but also would prevent possible financial instability due to the chain effects that a bank bankruptcy could create on the financial health of EMIs or PIs. In such case, operational implications need also to be considered such as the calculation of the repayable amount, the way the payout of the beneficiary accounts will be executed, the respective timing and also the calculation of contributions.

(b) In an Albanian context:

In addition to the abovementioned measures addressing the legal safeguarding of funds by the electronic money institution, similar to that provided for in the new law "On payment services in Albania" is also necessary. The first contractual relationship that e-money holders have, is the one with e-money institutions. Consequently, ensuring that their funds are protected in the event that the e-money institution goes bankrupt, is an immediate necessity to protect the consumer, in line with the requirements of the e-money directive.

Although in the short term the above mentioned proposals may be associated with costs for banks, electronic money or payment institutions or the state budget itself, the benefits they bring should be endorsed on a holistic and long-term perspective. This is important for: i) increasing competition in the payments market under fair conditions ii) the development of the digital payments market in countries with low financial inclusion levels such as Albania or other Western-Balkan states, aspiring to enter the EU iii) the increase of public confidence in alternative digital payment products and iv) benefits for the economy as a whole.

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