

**ASSOCIATION „FINTECH HUB LT“ OPINION AND PROPOSALS TO PUBLIC CONSULTATION DOCUMENT
„INCREASING THE PROTECTION OF CUSTOMER FUNDS HELD BY PAYMENT AND ELECTRONIC MONEY
INSTITUTIONS“ BY THE BANK OF LITHUANIA**

The association „Fintech Hub LT“ (hereinafter – the association) and its members welcome the timing and contents of the public consultation by the Bank of Lithuania, seeking the opinion from Payment Service Providers (PSPs), users, market experts and public sector representatives on safeguarding customer funds held by Electronic Money and Payment Institutions (hereinafter – EMIs/PIs), i.e. what measures would help to increase the protection of such funds and strengthen the confidence of the market and public in these institutions: <https://www.lb.lt/lt/konsultacijos/viesoji-konsultacija-del-elektroniniu-pinigu-ir-mokejimo-istaigu-klientu-lesu-apsaugos> (hereby - the consultation).

Below you can find the opinion and proposals of the association and its members according to the questions formulated in the consultation.

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

The association strongly agrees with the mentioned potential risks arising from the lack of the protection of funds received from customers of EMIs/PIs in Lithuania, as well as the protection of EMIs/PIs themselves in case of insolvency of the credit institution where customer funds are kept. There are several reasons that lead to increased risks related to safeguarding EMIs/PIs customer funds:

- 1) Lack and costs of safeguarding options for protection/safeguarding of funds received from customers of EMIs/PIs stated in the local and EU laws and the market:
 - a. Currently available opportunity of opening a payment account with the Bank of Lithuania for the purpose of keeping the funds obtained from customers in such account is only available to the participants of the payment system CENTROLINK of the Bank of Lithuania, which is not available to all EMIs/PIs, increasingly difficult/slow to access and provides only accounts in EUR currency only reachable within SEPA.
 - b. There is extreme lack of existing credit institutions working or providing segregated (or even operational) accounts, safeguarding and payment services to EMIs/PIs or other services providers not only in Lithuania, but also in the European Union due to the risk aversion, lack of understanding and trust and fear of competition from the existing credit institutions towards EMIs/PIs. Currently, EMIs/PIs in many cases are forced to use other licensed PSPs than credit institutions to receive such services or credit institutions outside the EU.

- c. Law requirement to keep fund only within EU/EEA credit institutions is limiting EMIs/PIs to open accounts and safeguard customer funds in other currencies (for example USD in USA banks, JPY in Japan banks) in trusted credit institution outside EU/EEA.
 - d. Covering customer funds held by EMIs/PIs by an insurance policy, a guarantee or a warranty statement is not available in Lithuanian or even EU market and may be significantly too expensive making EMIs/PIs not competitive in the market.
 - e. Investing customer funds held by EMIs/PIs in secure, liquid low-risk assets requires a credit institution (which are extremely averse in supply of any services for EMIs/PIs, especially more sophisticated ones like investment management, refer to 1) b.), is significantly more costly given the management fees and negative interest rate environment, especially for liquid low-risk assets, risky and volatile and requires additional high-level resources and experience to evaluate, monitor and control the risk of the investments.
- 2) Most EMIs/PIs in Lithuania provide or aim to provide financial services in other currencies than EUR and outside SEPA area to its clients due to increasing demand for the electronic cross border payment in the world.

The aforementioned reasons lead to the lack of proper separation and security of the customer funds of EMIs/PIs, especially for other currencies than EUR, and the increased risks mentioned in the consultation:

- 1) Risks related to the insolvency of EMIs/PIs and recovery of funds by customers.
- 2) Risks related to the insolvency of credit institution where EMIs/PIs safeguard customer funds and recovery of those funds. Financial Institutions' deposits in commercial banks are not insured with deposit insurance in Lithuania, in other countries it may or may not be insured depending on the country, therefore, the EMIs/PIs and their clients' funds would be lost.
- 3) Risk of mismanagement and insufficient risk management measures of customer funds by EMIs/PIs.

What is more, the EMIs/PIs very clearly feel the perception from the customers that funds held within credit institutions are more secured than funds held within EMIs/PIs due to the deposit insurance scheme making them less competitive in the market (which is not true, since deposit insurance only covers funds up to 100 000 EUR in most EU countries, while EMIs and PIs must keep 100 percent of the client funds separated and be able to return them in case of insolvency).

While the association agrees with the complete level-playing field in the areas money laundering, fraud, risk management and other among all market participants, EMIs/PIs feel that the current laws give EMIs/PIs very limited options to protect customer funds held by EMIs/PIs, strengthen EMIs/PIs dependency on credit institutions licensed in the EU and decreases their competitiveness in the market. Therefore, the association believes that the consultation is extremely relevant and timely and changes in the local and EU laws are deemed as necessary and in urgent need.

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)?

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 or not available (considering the fact that they would be allowed to initiate liquidity transfers only), would significantly improve the capacity of EMIs/PIs to safeguard their customer funds for the EMIs/PIs that are newly licensed and are not yet participants of the CENTROLINK or do not plan to do so. There are many different technical and other reasons why the licensed EMIs/PIs may not be able to connect in a timely manner to CENTROLINK, especially keeping in mind the increased workload by the operators of the system (due to the significantly growing number of participants) and timelines (that currently exceed to more than half a year). The Bank of Lithuania also has a right to disconnect financial institutions from the payment system according to their internal rules, however, safeguarding of clients funds is still required by the laws and should be possible to implement for the benefit of the customers of EMIs/PIs.

3. What other advantages and drawbacks of keeping funds with the Bank of Lithuania, apart from those mentioned above, do you see?

The main advantage of keeping customer funds with the Bank of Lithuania for EMIs/PIs is mainly reputational – insolvency of the central bank is theoretically impossible making the customer funds completely secure (provided the proper segregation and management) and easier to attract/convince customers to use the services of the EMIs/PIs. Also, even considering current negative interest rates paid for the funds kept within the central bank, this option for safeguarding clients funds still seems to be one of the cheapest and most accessible in the market.

The main disadvantage of keeping customer funds with the Bank of Lithuania comes from its limitation in the currency used (only EUR) and funds management (the funds/liquidity) can be only managed within SEPA area, which in turns limits the available services for EMIs/PIs and their clients and increases the risks mentioned above. Therefore, the association urges the Bank of Lithuania to consider expanding the services (currencies and accessibility) of its payment system CENTROLINK (see the association Proposals below).

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?

There is a clear need for more detailed requirements on how EMIs/PIs customer funds held with credit institutions should be diversified, as well as for requirements on secure, liquid low-risk assets and control measures due to the drawbacks mentioned in the consultation: EMIs/PIs lack professional knowledge to properly make use of the investment possibility; the risk of losing the investment value is not completely

eliminated; there are incentives for EMIs/PIs to assume a higher risk. However, this option of safeguarding EMIs/PIs customer funds may still be the last resort and only available to very mature EMIs/PIs as it requires a credit institution or a broker (which are extremely averse in supply of any services for EMIs/PIs, especially more sophisticated ones like investment management), is significantly more costly given the management fees and negative interest rate environment, especially for liquid low-risk assets, risky and volatile and requires additional high-level resources and experience to evaluate, monitor and control the risk of the investments.

5. What other advantages and drawbacks in relation to diversification and investment requirements, apart from those mentioned above, do you see?

Refer to Answer 4.

6. What other aspects should be taken into consideration when setting requirements for diversification and investment of customer funds held with credit institutions?

The other aspects that could be taken into consideration when setting requirements for diversification and investment of customer funds held with credit institutions:

- 1) The available and accessible investment management services by credit institutions for EMIs/PIs in the market;
- 2) The fees and costs of using these investment management services by credit institutions, including management fees and negative interest rates for most secure, liquid low-risk assets.

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

Currently, all EMIs formally are able to apply for specialized bank license, while some of them are aiming to do so in the long term, there are a few reasons that are stopping EMIs to do so:

- 1) the requirements to apply for such a license are extremely high in terms of business model, maturity, experience and investment required making it feasible to only the most mature EMIs;
- 2) the main requirement to apply for the license is involvement in credit/lending and deposit business, which is not the main service of some EMIs or their customers;
- 3) the licensing process may take from 1 to 2 years from the application submitted.

Therefore, this option could only be eligible to the very few most matured EMIs in the market, however, may still not be desired by some the EMIs and their shareholders due to the additional related costs, business model restrictions or timelines.

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?

Yes, EMI/PI and other PSPs funds and their customer funds held with credit institutions should be covered by deposit insurance, so that in the event of bankruptcy of a credit institution EMIs/PIs would recover their customer funds, however, the additional costs levied by the credit institutions may be likely transferred to EMIs/PIs making them less competitive and/or credit institutions will be even more discourage to provide any services to EMIs/PIs. In our opinion, the fees for such services cannot be different from the one applied to other corporate clients for same or similar services.

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)?

It would be sufficient to some extent lowering some part of risk arising from safeguarding EMIs/PIs and their clients funds within the credit institution. EMIs/PIs should be able control the insolvency risk of credit institutions themselves by strictly evaluating each credit institution's risk worthiness and by distributing their funds within several different credit institutions (and the central bank). However, this solution does not lower the risk arising from the insolvency or mismanagement of funds by EMIs/PIs themselves.

Alternatively, if insurance was applied to each customer of EMIs/PIs, it would almost completely solve the risk of insolvency of credit institution, however, would potentially increase the costs by credit institutions and EMIs/PIs themselves due to the technical reasons (e.g. tracking of clients), however, with a reasonable cost/technical implementation this may be a desirable solution.

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?

The main advantage the inclusion of EMI/PI and their customer funds held with credit institutions in the deposit insurance system is the opportunity to EMIs/PIs to better manage the risks related to the banking partners (credit institutions) and recover some of funds in case of insolvency.

The main disadvantages may be the resulting decrease in supply for safeguarding funds services by credit institutions to EMIs/PIs and increase in fees related to these services making EMIs/PIs nearly impossible to compete in the market.

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?

Currently, due to the very limited options for credit institutions providing safeguarding of EMIs/PIs and their customer funds and other services, different deposit insurance regimes in different EU countries have no effect on EMIs/PIs' decision where to hold their own and their customer funds yet, however, with increased supply of such services this may start playing a big role in EMIs/PIs' decision making.

12. In your opinion, is it necessary to consolidate the concept of a trust deposit?

The more detailed investigation and definition may be needed for trust deposit itself to define if this type of measure is effective and efficient for safeguarding of clients' funds of EMIs/PIs. However, this measure may not be effective, because the additional costs levied by the credit institutions may be likely transferred to EMIs/PIs making them less competitive and/or credit institutions will be even more discouraged to provide any services to EMIs/PIs. In our opinion, the fees for such services cannot be different from the one applied to other corporate clients for same or similar services.

Furthermore, there are possible long-term macro-level effects if the funds of EMIs/PIs are not used in the activities of credit institutions (assuming that trust deposit does not allow the credit institution to lend/invest the funds) and it would not be invested in the economy, especially considering the growing number of EMIs/PIs and their users together with the funds safeguarded and transferred through these institutions.

13. What other advantages and drawbacks related to consolidation of the concept of a trust deposit do you see, apart from those mentioned above?

The main disadvantage of trust deposit may be costs associated with it. See Answer 12.

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)?

We believe that if trust deposit is defined in the local laws clearly and would have incentives/requirements to be used by credit institutions, it should be enough to prevent the use of the funds held by EMIs/PIs and their clients within credit institutions.

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

Any other licensed financial institutions that receive or hold their customer funds for limited or unlimited time, e.g. wealth management funds, brokers, currency exchanges, P2P lenders, crowdfunding companies, etc.

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?

We believe that both national and EU level measures are required and should be explored, however, national measures may be slightly preferred due to the faster implementation process and potential advantages to Lithuania as financial technology hub due to “friendlier” regulation (within the allowed framework). Moreover, we see Lithuania and its government institutions as potential leaders in shaping the EU agenda in financial regulation due to its pioneer initiatives and already acquired experience within financial technology sector.

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?

Currently, due to the very limited options for credit institutions providing safeguarding of EMIs/PIs and their customer funds and other services, different deposit insurance regimes in different EU countries have no affect for EMIs/PIs decision where to hold their own and their customer funds yet, however, with increased supply of such services this may start playing a big role in EMIs/PIs decision making. Therefore, countries with better protection measures may attract more EMIs/PIs or their client funds held in credit institutions.

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?

While the association certainly welcomes the initiative to introduce a payment bank license (please see answer 7) as a reliable solution for some EMIs/PIs focusing mainly on payment business. However, possibly very few EMIs/PIs in the market may be able to apply for such a licence:

- 1) the requirements to apply for such a license are possibly to be extremely high in terms of business model, maturity, experience and investment required making it feasible to only the most mature EMIs;
- 2) the licensing process may possibly take significant amount of time and resources.

Therefore, this option could only be eligible to the very few most matured EMIs/PIs in the market and will not act as an immediate or complete for the all EMIs/PIs.

19. What advantages and drawbacks in relation to the consolidation of the concept of a payments bank do you see?

The main advantages to EMIs/PIs in upgrading its license to payment bank are mainly reputational: the EMIs/PIs would become more trusted by its clients, partners and possibly other credit institutions. It will also be allowed to participate in national deposit insurance scheme, which brings certain reputational benefits and more freedom in funds management, however, in case of insolvency of the customers would recover only up to 100 000 EUR from payment bank compared to 100 % (assuming proper segregation and management of customer funds) from EMIs/PIs.

The main disadvantages would be the required time to implement such a license on the EU level and later acquiring such a license (possibly totalling to at least 4-5 years), making it rather a long term solution. Also, the license would only work for some, more mature of EMIs/PIs, i.e. would solve only part of the problem.

20. What impact could such amendments have on the EMI/PI sector?

Generally, it should further strengthen the EMI/PI sector and increase competition with existing credit institutions with introduction of the new upgraded license available to certain mature EMIs/PIs.

21. Which of the methods discussed above, in your view, would be the most effective?

The association considers the following proposals by the Bank of Lithuania as the most effective (in order of priority), although deems that none of them can solve the problems mentioned in Answer 1 fully and effectively, therefore, inviting the Bank of Lithuania to consider to explore a combination of several proposals as well as proposals from the association that were not mentioned in the consultation (see Answer 22):

- 1) Possibility to keep funds with the Bank of Lithuania without being a participant in CENTROLink payment system;

- 2) Inclusion of EMIs/PIs customer funds held in credit institutions into the deposit insurance system (for each EMIs/PIs or each customer of EMIs/PIs depending on additional costs levied on them, preferably on national level);
- 3) Payments bank license;
- 4) Trust deposits;
- 5) Setting requirements for diversification and investment of customer funds held with credit institutions.

22. In your opinion, are there any other ways to increase the protection of EMI/PI customer funds?

In addition to the answers provided to the questions formulated by the Bank of Lithuania within the frame of the consultation, the association has consolidated additional proposals from its members.

Additional proposals from the association (in order of priority):

Infrastructure measures on the national level

- 1) The Bank of Lithuania could allow EMIs/PIs to keep their clients' funds in other currencies than just in EUR within the central bank accounts, starting with the other European Union currencies. Transfers to and from these accounts at the central bank could only be allowed from and to EMIs/PIs own accounts at other financial institutions and therefore would not be equal to correspondent banking/SWIFT services.

Legal measures on the national level:

- 2) The Law on Electronic Money Institutions could be amended in order to allow the safeguarding of clients' funds "within other reliable payment service providers" in addition to currently allowed central banks and credit institutions (or in liquid investments or insured funds). The specific list of PSPs which could be deemed as reliable for this purpose could be specified by the Bank of Lithuania or by EMIs themselves in their internal procedures.
- 3) The Law on Electronic Money Institutions could be amended in order to allow the safeguarding of clients' funds "within credit institutions at other reliable countries outside the EEA" in addition to currently allowed central banks and credit institutions (or in liquid investments or insured funds). The specific list of countries which could be deemed as reliable for this purpose could be specified by the Bank of Lithuania or by EMIs themselves in their internal procedures.
- 4) The Bank of Lithuania could allow EMIs/PIs to voluntarily join national deposit insurance scheme in Lithuania, which could lift the requirement to keep clients' funds only within central banks and credit institutions since it would be insured up to 100 000 EUR. The costs national deposit insurance scheme seems to be lower than other alternatives and proposals and it would provide

a complete level playing field to all financial institutions in terms of safeguarding customer funds and liquidity management.

- 5) A new specialized payments bank License could be introduced (similar as the proposal no. 7) – the Bank of Lithuania could explore the options to introduce such a license within the national legal frame.

23. Please provide any other comments on this issue.

No additional comments

Kind regards,

Titas Budrys

Chairman of the Board

Association „Fintech Hub LT“