International Association of Deposit Insurers

IADI Fintech Briefs provide high-level overviews and key takeaways on Fintech topics of relevance to deposit insurers.

FINTECH BRIEF

BENEFICIARY ACCOUNTS: CHALLENGES FOR DEPOSIT INSURANCE SCHEMES

NO. 7

CARLOS COLAO and ROMAN KAHANEK

April 2022

IADI Fintech Briefs are written by Members of the IADI Fintech Technical Committee (Fintech TC), and from time to time by other authors, and are published by IADI. They provide high-level overviews and key takeaways on fintech topics of relevance to deposit insurers. The views expressed are those of the authors and do not necessarily represent the views of IADI or the institution to which the authors are affiliated. The authors are grateful to Jan Nolte (IMF), Juan Carlos Izaguirre (CGAP), and staff from CDIC (Chinese Taipei), CDIC (Canada) and DICJ (Japan) for helpful comments.

The editor of the IADI Fintech Brief series is Bert Van Roosebeke (IADI).

This publication is available on the IADI website (www.iadi.org).

International Association of Deposit Insurers (IADI), C/O Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, Switzerland. Tel: +41 61 280 9933 Fax: + 41 61 280 9554

Carlos Colao
Fondo de Garantía de Depósitos
de Entidades de Crédito
ccolao@fgd.es

Roman Kahanek
Financial Market Guarantee System
rkahanek@gsft.cz

BENEFICIARY ACCOUNTS: CHALLENGES FOR DIS

Executive Summary

Accounts opened by financial institutions in banks on behalf of their clients ("beneficiary accounts") have become a common tool used by such institutions to safeguard and segregate from its own funds the money they received from clients. The rapid evolution of Fintech has fostered the use of beneficiary accounts, particularly by e-money institutions and payment institutions (hereinafter, "EMI&PI"), which are regularly subject to these safeguarding requirements

In beneficiary accounts, EMI&PI can hold funds of a high number of clients. Thus, the protection of these funds and, where appropriate, coverage by the deposit insurance scheme (DIS) is acquiring greater relevance.

Beneficiary accounts are deposits, and therefore and in principle they count with protection of DIS. However, the eligibility of these accounts for DIS coverage depends on the eligibility of the holder and/or the beneficiary of the balances deposited in the bank account.

This Brief sets out possible approaches for DIS towards beneficiary accounts and identifies the main risks and challenges for DIS in the case of failure of the bank and EMI&PI[1] where the funds are placed.

1 Introduction

Most e-money institutions and payment institutions (EMI&PI) are not banks (although there are banks that can provide emoney/payment services) and, therefore, and with the exception of some particular cases, they are not adhered to a deposit insurance scheme (DIS) and funds given to EMI&PI by the clients are not considered deposits. For this reason, in case of an EMI&PI bankruptcy, clients would not have the same level of protection as if they had their money placed in regular bank deposits.

To minimise this risk, several jurisdictions have implemented safeguarding measures in addition to other prudential regulatory requirements measures such as the need for previous authorisation by the relevant competent authority, capital requirements, etc.

An example of safeguarding measures are those implemented in the European Union[2]: (i) to place client's EMI&PI funds in a segregated bank account opened by such EMI&PI on behalf of its clients and separated from its own funds[3]; (ii) to subscribe an insurance policy, (iii) and, as a last option, to invest the client's funds in safe and liquid assets[4].

These safeguarding mechanisms encompass:

✓ **Segregation of customers' funds**

This measure requires EMI&PI to separate funds received by clients from other funds of the EMI&PI by holding them

---

[1] By banks we considered other deposit taking institutions as well
2We have included as an example the European Union measures, but there are other safeguarding measures in different Jurisdictions like holding the client's funds in a Central Bank. These European Union safeguarding measures are regulated in the following legal provisions: (i) regarding electronic money institutions, in Article 7 of Directive 2009/110/EC of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions; and (ii) regarding, payment institutions, in article 10 of Directive (EU) 2015/2366 of 25 November 2015 on payment services in the internal market. See also, European Banking Authority (2021). Opinion of the European Banking Authority on the treatment of client funds under Deposit Guarantee Schemes Directive, 27 October 2021.
[3] In relation to E-money in Kenya, see Defina et al. (2021), p.5, where this type of safeguarding measures is indicated.
[4] Also, regarding the E-Money regulation in UK see Crosetta (2021), p. 4, where similar safeguarding measures as the ones described for the European Union are mentioned.

in a segregated bank account. This is often done through the use of beneficiary accounts[5].

- ✓ **Insurance**

This measure requires EMI&PI to contract an insurance policy or some other comparable guarantee from an insurance company or a bank (generally not belonging to the same group) payable in the event that the EMI&PI is unable to meet its financial obligations.

- ✓ **Investment of the clients' funds**

This measure requires EMI&PI to invest funds received from clients only in low-risk securities and liquid assets, such as government bonds.

This Fintech Brief focusses on analysing the first option, which is maintaining customer funds in a segregated bank account. It identifies the main challenges in case of insolvency of the EMI&PI (scenario 1 below) and, specially, in the case of failure of the bank where the funds of EMI&PI clients are placed (scenario 2 below), since this is the situation that would be more relevant from a DIS perspective.[6]

2 EMI&PI beneficiary accounts and DIS challenges

The following chart summarises the main challenges for DIS in case of insolvency of the EMI&PI (scenario 1) or of the deposit taking institution where the EMI&PI client's funds are placed (scenario 2). Below, the details of these scenarios are discussed.[7]

2.1 Failure of the EMI&PI (Scenario 1)

As most EMI&PI outside of banks do not adhere to a DIS[8], their failure does not usually trigger action by the DIS. Upon EMI&PI insolvency (but not of the bank holding funds of the EMI&PI's clients), the protection of clients' funds depends on the jurisdiction in question, and, in particular, whether a withdrawal or separation right or a preferential creditor treatment for the EMI&PI's clients[9] over such funds has been granted.[10] In the absence of that mentioned preferential treatment, clients' funds will become part of the EMI&PI's list of unsecured creditors.

2.2 Failure of the bank where the beneficiary accounts are placed (Scenario 2) [11]

In the case of failure of the bank where the beneficiary accounts funds are placed, the following main challenges are identified.

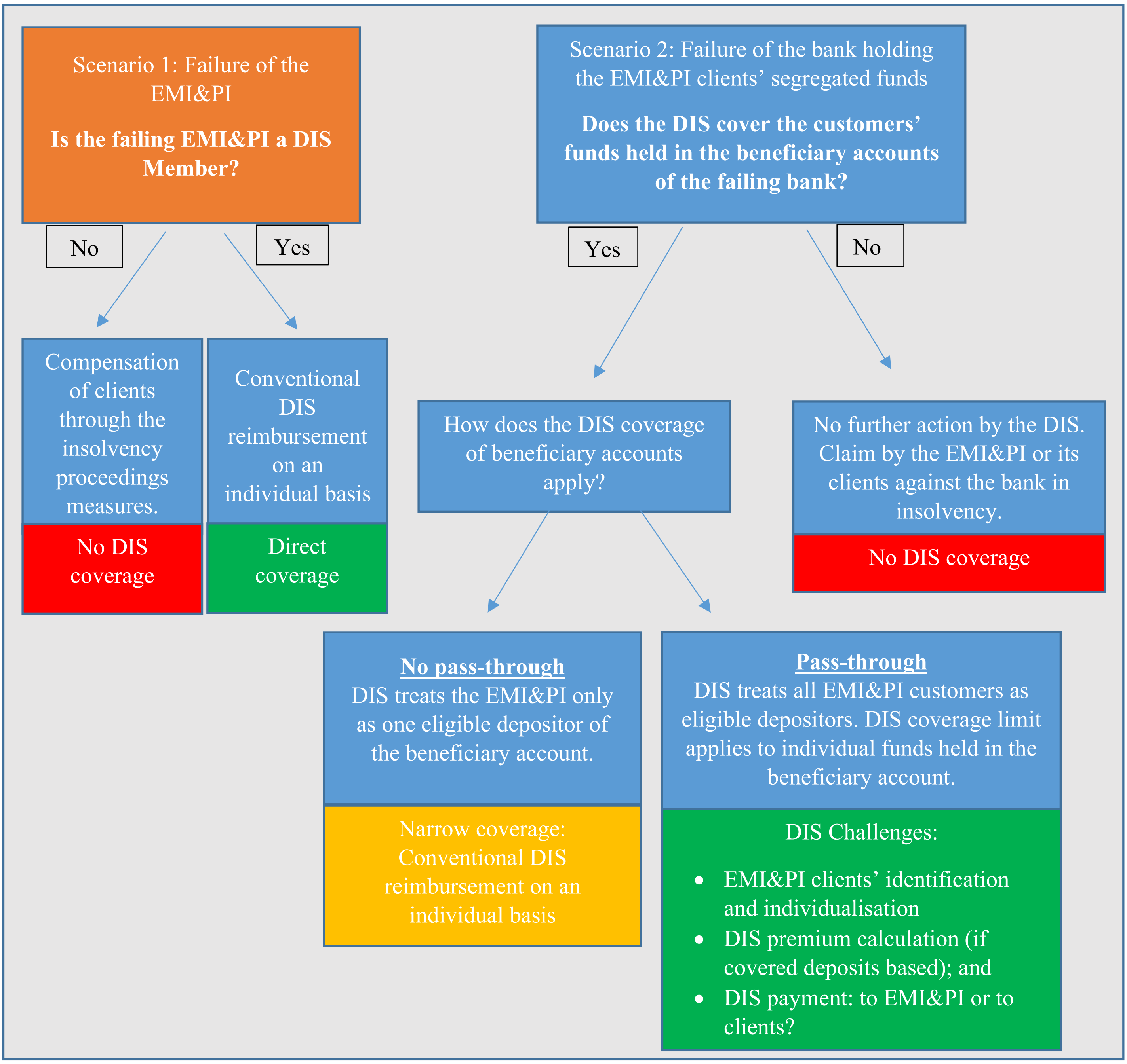
2.2.1 If no DIS coverage

If EMI&PI beneficiary accounts are not eligible to be covered by the DIS, funds placed in the beneficiary accounts will become part of the unsecured credits of the bank, unless: (i) such funds are considered to have a preferential creditor treatment before the rest of unsecured creditors or (ii) more unlikely those customer's funds are recognize with a withdrawal or separation right, segregated from the assets of the bank, as it could happen when there is a fiduciary relationship between the EMI&PI and the bank[12]. It would also be necessary to determine who is entitled to claim the

---

[5] Also known with different terms such as float account, pooled account, trust account (in common law jurisdictions) or custodial account (in civil law jurisdictions) which are used to achieve the segregation of the funds from the EMI&PI.
[6] This brief paper does not intend to give or endorse any recommendation or opinion and only intends to address the main challenges related to DIS regarding beneficiary accounts.
[7] Whatever is the approach followed by the jurisdiction in question, public awareness is crucial.
[8] There can be cases like the DIS from Colombia, Fogafin, where electronic money institutions must be a member of Fogafín and thus enjoy full protection. See Izaguirre et al. (2019), p.10. Under this situation and since EMI&PI would be treated as a member DIS bank, in principle, no additional challenges are foreseen different from banks.
[9] There could be cases where the EMI&PI have in place a trust mechanism that ensures that client's funds are protected in the insolvency of the EMI&PI
[10] See Crosetta (2021), p.4 where it is mentioned that in case of failure of the E-Money institution clients profit from preferred creditor treatment.
[11] As for an example, according to the European Banking Authority (2021), there are 13 Member States out of 27 Member States of the European Economic Area (27 of the 30 Member States of the European Economic Area responded to the Survey) where beneficiary accounts of e-money institutions are DIS covered while in other 13 Member States they are not DIS covered and one Member State was not sure. Regarding the case of payment institutions, there are 16 Member States where Beneficiary accounts of payment institutions are DIS covered, 10 Member States where it is not DIS covered and one Member State that was not sure.
[12] See Ramos et al (2015) p.18 for "Protecting Mobile Money Customer Funds in Civil Law Jurisdictions", where it is mentioned this possibility.

funds of the beneficiary accounts in the bank insolvency procedure; i.e. whether this is the EMI&PI (as holder of the account) or its clients (as beneficiaries).



Decision tree of main challenges on EMI&PI Fintech beneficiary accounts

If clients may claim, it is also important to determine if the clients can claim directly to the EMI&PI and to the bank, or to both for the reimbursement of their funds[13]. In the former case there could be a contagion risk for the EMI&PI, and this could lead to a subsequent failure of the EMI&PI as financing the reimbursement to the clients with its own funds (instead of using the funds from the beneficiary account) will likely reduce its solvency.

Finally, it is relevant to consider that there could also be a lack of confidence risk for the EMI&PI in the case that even after the clients receiving their funds back, either from the EMI&PI or from the insolvency receiver of banking failure

[13] As a general rule, clients will usually have the right to claim the EMI&PI of the reimbursement of the funds, so in such case and taking into account the EMI&PI contagion risk, this could be a reason for having in place additional regulatory requirements, like segregating the client's funds in different bank accounts, etc.

process, they may decide to put an end to the commercial relationship with the EMI&PI, which will negatively affect its business continuity.

2.2.2 If DIS coverage

If EMI&PI beneficiary accounts are covered by the DIS, we can identify two main alternative scenarios: (i) the EMI&PI is entitled to receive DIS compensation as an eligible single depositor, so all customers would be treated as one guaranteed depositor (the "n**o pass-through approach**") or (ii) the clients of the EMI&PI are entitled to receive the DIS compensation on an individual basis as a guaranteed depositor ("**pass-through approach**")[14].

2.2.2.1 No pass-through approach (Narrow DIS coverage)[15]

In this case, the DIS coverage would apply to the EMI&PI as an account holder on behalf of its clients.[16] Therefore, all the EMI&PI's clients would be treated as one single depositor within the limit therefore established in the corresponding jurisdiction[17]. Under this situation, clients of the EMI&PI are unlikely to receive full protection since the recovery of their amounts would be limited to the maximum guaranteed amount that would be provided by the DIS to the account holder (the EMI&PI) considered as a single depositor. The remaining amount held by the EMI&PI's clients that exceed the DIS guaranteed limit would go with the rest of unsecured creditors of the failing bank, unless a specific credit preference for those funds has been established in the jurisdiction.

This situation could also have a contagion effect on the EMI&PI, similar to the one described above for the DIS no coverage situation (see section 2.2.1), although maybe to a lower extent. As the EMI&PI would only be partially reimbursed up to the maximum guaranteed amount applicable per depositor, and depending on the amount of the beneficiary account, it could potentially affect the solvency of the EMI&PI, but only in the cases where the jurisdiction allows for the clients of the EMI&PI to claim for such amounts directly to them, because the EMI&PI would have to reimburse its clients for such not covered amounts with its own funds.

2.2.2.2 Pass-Through Approach[18]

In this case, the funds from each of the clients of the beneficiary account would be guaranteed by the DIS up to the maximum guaranteed amount per depositor since they would be considered as an individual eligible depositor, unless such clients are not eligible for DIS coverage (e.g., if they are an insurance company, investment firm, etc. and such institutions are excluded from DIS coverage in a given jurisdiction).

Remaining amounts in the beneficiary account not covered by DIS, would follow the process of the rest of unsecured creditors, unless they have a credit preference recognised over those funds in the respective jurisdiction.

Although this case implies greater protection for the EMI&PI' clients, it can also pose significant challenges for the depository bank, the EMI&PI and the DIS.

---

[14] As for example, in the European Directive the maximum guaranteed amount is 100,000 €, per bank and per depositors, so in the case where there is a beneficiary account from an EMIS&PI with 5 clients with 100,000 € each (500,000 € in total): under the "no pass-through approach" customers of the beneficiary account would be treated as one eligible depositor and together, they would be entitled to receive only 100,000 €. Whereas under the "pass-through approach" customers of the beneficiary account would be treated each as an individual depositor and would be entitled to receive 100,000 € each (500,000 € in total).

[15] In relation to this approach, see p. 5 of paragraph 16 of European Banking Authority (2021) with further detail.

[16] The coverage would apply to the EMIS&PI, but only as a beneficiary account holder of its clients. Therefore, the coverage would not be applicable to the accounts open by EMIS&PIs on their own behalf.

[17] This is different from the situation where the EMI&PI have a bank account on their own behalf since as a general basis this type of accounts are not DIS coverage.

[18]As for example, regarding the "Pass-Through approach" in UK, see Crosetta (2021), p. 8 and Defina et al. (2021), p.6 for the treatment in Kenya.

The most relevant challenges include:

- **Identifying and individualising the beneficiaries of the beneficiary accounts in the bank's depositor register that is used by DIS to make the payment of the guaranteed amount**

In the case of insolvency of the bank, and in order to make the payment of the guaranteed amounts, the DIS needs to have all necessary information of the clients of the beneficiary account to be able to reimburse the guaranteed deposits as soon as possible and, in any case, within the pay-out deadline set in the respective jurisdiction. This is important since beneficiary accounts can have a large number of clients where the related balance amounts can evolve rapidly (high volatile data). There could be as well situations where the client of the beneficiary account can be as well a depositor in the failing bank, and this will lead DIS to have to clearly identify the level of protection in such cases (e.g. aggregating both amounts in the maximum guaranteed amount to be paid by DIS to the client/depositor or treat them independently). In order for DIS to obtain this information, it can be provided directly by the EMI&PI or by the adhered banks where the funds are placed. If this information comes directly from the account holder (EMI&PI) who is not usually a member of the DIS, this could pose more validation challenges for DIS than when coming directly from the banks, where DIS would have more capacities in order to review the accuracy of such information.[19] As an example, this could be tested by DIS on a regular basis by means of the data that banks may be obliged to provide to DIS regarding covered deposits and depositors. For these latter reasons, DIS that receive the data directly from its banks could be in a better position to be able to reimburse depositors in a more effective manner.

- **The calculation of contributions/premiums from the bank to the DIS**

If covered deposits are included in the calculation base for premium/contributions by banks to the DIS, it may be considered to include funds held in the beneficiary account into these calculations. In some cases, the EMI&PI's clients could at the same time have an individual deposit account with the failing bank. This would need to be considered if the applicable legal framework in the jurisdiction states that the DIS coverage is set per depositor and entity basis. In that case, individual deposits of EMI&PI clients at the failing bank must be added to those in the beneficiary accounts in the calculation base within the maximum guaranteed limit.[20] There could be situations as well where the client of the EMI&PI is not an eligible depositor.

If individualized beneficiary accounts are included in the DIS premium calculation base, it is crucial that banks can duly identify these accounts. For this reason, banks should be able to receive all necessary information from the EMI&PI on a regular basis. In practice, this could be challenging for commercial or competition reasons between EMI&PI and banks, and also because of the volatility of these funds as mentioned above. Hence, DIS would need to assess how to deal with situations in which the bank does not have the aforementioned information. To tackle this problem, some jurisdictions have explored an approach of including the whole amount (including the part that is not covered) of the beneficiary account in the contribution/premium calculation base.[21]

- **Determining if DIS should proceed to pay the guaranteed amount directly to the EMI&PI or to its clients.**

This last issue is equally relevant, because if the DIS proceeds to pay the guaranteed amount directly to the EMI&PI's clients, this may also involve a risk for the EMI&PI. In this case, clients reimbursed by DIS could decide not to continue the relationship with the EMI&PI, which therefore could affect its business continuity[22]. On the contrary, if the guaranteed amount is paid directly to the EMI&PI, this may reduce the risk that clients decide to end the commercial relationship, and may not affect its business continuity.[23] However, if the repayment period for the DIS to reimburse the EMI&PI is too long this could increase the risk that clients (in case such right is granted in the jurisdiction) claim the due amount directly with the EMI&PI. This could cause insolvency risks for the EMI&PI.

---

[19]About the importance of having real time data about the ultimate beneficiaries, see Defina et al. (2021), p. 6.

[20] In the European Directive 2014/49/EU, the DIS guarantees as general rule 100,000€ per bank and per holder. Under this situation, if the client of the EMIS&PI has at the same time an individual account in the failed bank, both amounts in the individual and beneficiary account need to be aggregated. If the client has 100,000€ in the beneficiary account and 50,000€ in an individual account, coverage would be limited at 100,000€ and this would be the amount to include in the calculation base.

[21] Regarding this issue see European Banking Authority (2021), p. 20, paragraph 68.

[22] This could also be more problematic in the cases where the EMI&PI has spread customer's funds across several beneficiary accounts at different banks.

[23] Regarding reimbursing directly to the EMIS&PI or the client's and the contagion risks effects, see European Banking Authority (2021). p.14, paragraph 48.

Additionally, and if the purpose is not only to protect the funds of the clients but also to preserve financial stability by avoiding the insolvency risk of the EMI&PI, it would seem reasonable, if necessary for safeguarding financial stability reasons, to consider the possibility for clients of the EMI&PI to claim any remaining uncovered amounts only to the bank and not to the EMI&PI.

3 Impact on EMI&PI Clients

The impact on clients of a failure of the EMI&PI or of the bank holding EMI&PI clients' funds would depend on the level of protection established in each jurisdiction for EMI&PI beneficiary accounts and also in the reimbursement period of such funds.

In this respect, upon failure of the EMI&PI (scenario 1) or if beneficiary accounts are not covered by the DIS upon failure of the bank holding these (scenario 2), the protection level of the clients depends on the safeguarding measures established in the particular jurisdiction. These may include:(i) creditor preference, withdrawal or separation rights, (ii) or indirect measures, such as the requirement for the EMI&PI to invest the funds received by the clients in safe and liquid assets, need to have an insurance policy or safeguard such funds by keeping them segregated in a bank account.

If, upon the failure of the bank holding EMI&PI's client funds (scenario 2), beneficiary accounts are protected by DIS, in addition to the safeguarding measures already mentioned, the level of protection would rely on whether a pass-through approach is applied if the EMI&PI's client funds are segregated into a bank account. If so, clients' funds would be individually guaranteed up to the legislated limits. If not, the clients would likely not benefit from full protection.

It is important to mention as well that in the case of failure of the bank holding the EMI&PI's client funds in most of the cases the clients would not even know that their funds are deposited in such bank, so this could come as something unexpected for the client that could lead at the same time in creating certain level of distrust in the financial system.

For these reasons, whatever is the approach followed by the jurisdiction in question, public awareness is crucial, so clients can be well informed of the level of protection offered in the particular jurisdiction. In this vein, it is very relevant to clearly specify the person who would be entitled to claim the amounts not covered by the DIS in the bank insolvency procedure, the EMI&PI or its clients.

4 Conclusions

Beneficiary accounts are acquiring more relevance in recent years due to the increase of fintech activities, which includes not only the appearance of new players in the financial market but also an expansion of payment channels based on innovative technological solutions. All this poses new challenges and risks to stakeholders. The development of these products could be accompanied with the implementation of public awareness measures so customers can be fully aware of the level of protection offered, and in particular about DIS protection.

DIS are exposed to two main major regulatory and operational issues: (i) from a regulatory perspective, the role that the applicable regulatory framework gives DIS regarding fintech products, particularly, in relation to clients' protection in beneficiaries accounts; and, (ii) from an operational perspective, in case the applicable regulatory framework sets forth a DIS coverage of EMI&PI's beneficiary accounts, the need to determine how DIS can respond effectively to the operational challenges that arise from the treatment of such accounts.[24]

Upon use of pass-through coverage, it is important to have clear reporting rules and oversight of compliance in place to ensure that EMI&PI and/or banks submit reliable data related to these beneficiary accounts to the DIS. This is essential for (a) calculating the premiums/contributions to DIS when based in covered deposits, and (b) determining EMI&PI clients' eligibility for coverage and calculating the individual guaranteed amount in a pay-out event.

[24] In relation to these operational challenges see European Banking Authority (2021), p. 18, paragraphs 61 and 62.

5 Resources

Crosetta, P. (2021). E-Money in the United Kingdom, A Case Study. *International Association of Deposit Insurers, Fintech Brief No. 4.*

Defina, R., Van Roosebeke, B. and Manga, P. (2021). E-Money and Deposit Insurance in Kenya, *International Association of Deposit Insurers, Fintech Brief No. 6.*

European Banking Authority (2021). Opinion of the European Banking Authority on the treatment of client funds under Deposit Guarantee Schemes Directive, 27 October 2021.

Izaguirre, J.C., Dias, D. and Kerse, M. (2019). Deposit Insurance Treatment of E-Money: An Analysis of Policy Choices. *Consultative Group to Assist the Poor (CGAP).*

Ramos Muñoz, D., Solana, J. and Buckley, R.P. and Greenacre, J. (2015). Protecting Mobile Money Customer Funds in Civil Law Jurisdictions. Global Economic Governance Programme Working Paper 2015/102, *UNSW Law Research Paper No. 2015-79.*

Kerse, M. and Staschen, S. (2018). Safeguarding Rules for Customer Funds Held by EMIs, *Consultative Group to Assist the Poor (CGAP) Technical Note.*

Previous issues in this series