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EBA proposes EU-wide deposit protection of client funds under the Deposit Guarantee Scheme Directive

The European Banking Authority (EBA) has recommended that clients' funds in e-money institutions (EMIs), payment institutions (PIs) and investment firms (IFs) deposited with credit institutions should be protected by a deposit guarantee scheme (DGS) in all EU Member States in the next chapter of the European Commission's ongoing review of the Deposit Guarantee Scheme Directive (the Directive).

Why is deposit protection relevant for client funds?

EU law requires the safeguarding of client funds that EMIs, PIs and IFs receive from clients to ensure that these funds are safe. EU law allows safeguarding to be done in different ways but – as the Opinion highlights – depositing funds with a credit institution is the dominant safeguarding method used. Other safeguarding methods (such as investing in secure, liquid, low-risk assets or coverage by an insurance policy) are rarely used.

Requiring EMIs, PIs and IFs to hold client funds with credit institutions is intended to protect clients from a potential insolvency of the EMI, PI or IF. Deposit protection, in turn, becomes relevant where it is the credit institution that fails. While an EMI, PI or IF may still be required to return client funds to a client even where the credit institution has failed, affording deposit protection to client funds would limit the risk that the EMI, PI or IF is unable to do so if the credit institution has not repaid the funds to the EMI, PI or IF.

What does the EBA recommend?

The Opinion sets out a total of five recommendations to the European Commission to change the Directive. Below is a short overview of the recommendations most relevant for credit institutions in relation to client funds held for an EMI, PI or IF. The Opinion also touches on a number of additional aspects (such as the protection of client funds held by a credit institution with another credit institution), which are not in the scope of this overview.

Deposit protection of client funds

As discussed in an earlier blog post, there is currently no uniform approach to the treatment of client funds under the Directive across the EEA. Instead, Member States interpret the Directive differently. While a number of Member States protect client funds that EMIs, PIs and IFs hold with credit institutions, others do not. In at least half of Member States coverage depends on the type of entity that places the deposit with the credit institution.

The centrepiece of the Opinion is, therefore, the recommendation that clients' funds deposited with a credit institution by EMIs, PIs and IFs are covered by the DGS in case the credit institutions fails. The EBA proposes three conditions that must be met to protect these deposits:

- deposits are placed on behalf of clients who are not themselves excluded from coverage under the DGSD;
- deposits are deposited for the purpose of segregation them from the account holder's own funds; and
- the clients are identifiable.

The proposal is an attempt to address the different approaches to the protection of client funds mainly resulting from the opaque wording of Article 7(3) of the Directive which states that "the person who is absolutely entitled shall be covered by the guarantee, provided that that person has been identified or is identifiable …". Rather than clarifying the meaning of "absolutely entitled", the Opinion instead proposes to address client funds directly.

Reimbursing client funds: direct or indirect payments?

The Directive currently does not prescribe how client funds are reimbursed. Member States follow different approaches. Based on the survey carried out by the EBA as part of the Opinion, there is an even split between regimes: approximately 50 per cent of Member States reimburse the account holder (ie EMI, PI or IF), while 50 per cent reimburse the ultimate beneficiary (ie the client) directly.

The difference is more than a mere formality.

- If a DGS reimburses the ultimate beneficiary directly, it would first need to know whom to pay. As the Opinion demonstrates, only a minority of Member States currently require credit institutions to include the relevant information on underlying beneficiaries in their SCV file submitted to the DGS. Further, requiring a DGS to pay funds to underlying clients rather than the account holder might have repercussions for the broader firm-client relationship: once the funds have been reimbursed to the client, the client would have to make the decision to re-deposit funds with the firm – a decision a client may be hesitant to make following a failure of the credit institution with which the firm had deposited the client's funds.
- If, however, the DGS were instead obliged to repay the account holder and the account holder fails, clients may face the risk that they are not able to take out their funds and become general creditors in the insolvency of the account holder – precisely the risk that the safeguarding requirements are intended to protect clients against.

Given the complex considerations at play, the EBA recommends in its Opinion that a DGS is free to choose between two options:

- reimburse client funds to the underlying clients directly; or
- pay out to a beneficiary account of the account holder in another credit institution.

In 'exceptional circumstances' the DGS shall be prevented from repaying client funds directly and instead be required to repay to a beneficiary account of the account holder in another credit institution. It is as yet unclear how these 'exceptional circumstances' will be defined, and the EBA proposes that the exact circumstances will be developed in Level 1 or Level 2 legislation at a later stage.

Calculation of contributions to the DGS

The Directive requires that a credit institution's contribution to a DGS shall be based on the amount of covered deposits and the degree of risk incurred by the respective member. If client funds benefit from deposit protection, they should, in principle, also count towards the contributions that credit institutions have to make to the DGS in which they participate.

According to the Opinion, 13 of 26 Member States currently count client funds placed with credit institutions when calculating contributions to the DGS fund, while 13 Member States do not. In order to create a level-playing field between credit institutions that hold significant levels of client funds among their deposit base and those that do not, the EBA recommends that clients funds are taken into account when calculating contributions to DGS. What is not yet clear is how the basis for contributions will be established in practice, and the EBA considers different options:

- credit institutions could be required to provide a breakdown of amounts by ultimate beneficiary in each beneficiary account;
- the Directive could provide for an assumption that all funds held in a beneficiary account are covered, leading to a potential overestimation of covered deposits and, therefore, contributions to the DGS; or
- the Directive could provide for an assumption that all funds held in a beneficiary account are covered unless a credit institution can provide more detailed information to perform a more precise calculation.

The Opinion does not yet provide a definite answer on the approach and the EBA instead intends to provide details in the revised EBA Guidelines on methods for calculating contributions to DGSs. Interestingly, the EBA also hints at the possibility that the approach may in addition take account of the volatility of funds held in the beneficiary accounts, which may, for example, lead to a different approach for PIs (which typically hold client funds for a short period of time) and EMIs (which hold client funds that have been exchanged into electronic money for a longer period).

What are the consequences?

The EBA expects that the proposed changes will only have a small impact on the overall deposit protection landscape. While pointing to certain issues with the reliability of the data, the EBA arrives at this conclusion based on the view that the overall amounts of client funds relative to covered deposits appear to be small, and that client funds are already covered in a number of Member States.

Nevertheless, a number of potential consequences are worth highlighting in case the Opinion does indeed lead to a revision of the DGSD.

- **Cross-border safeguarding of client funds**. Removing the uncertainty of deposit protection may lead to an increase of safeguarding client funds on a cross-border basis in other Member States which – according to the Opinion – is still a relatively rare instance. As we have shown in an earlier blog post, the complex interplay of safeguarding requirements and deposit protection in cross-border scenarios may have been a contributing factor that has led to market participants only making limited use of the ability to hold client funds with credit institutions or their branches in another Member State.
- **Follow-up changes to Payment Services Directive, E-Money Directive and MiFID**. Deposit protection is not the only issue relating to client asset protection in cross-border scenarios, and it remains to be seen if the push for harmonisation in the Directive will lead to further changes to the safeguarding requirements laid down in the Payment Services Directive (PSD), E-Money Directive (EMD) and MiFID. There is, for instance, currently no requirement on an EU level to ensure that client funds benefit from deposit protection, even if they are held with a credit institution. The Opinion states that DGS protection would be consistent with the logic of safeguarding and that other parts of EU law, including the PSD and EMD may require alignment, without however making specific recommendations. If introduced to MiFID, such alignment may, for example, remove the option for IFs to hold client funds with third country credit institutions.
- **Operational complexity in DGS reporting and contributions**. The Opinion may lead to increased operational complexity, both for credit institutions in Member States that have not yet protected client funds and, also for credit institutions in Member States which already provide protection for client funds.
  - The requirement that 'clients are identifiable' and that coverage depends on whether the underlying clients rather than the account holder are excluded from coverage will potentially make DGS reporting more burdensome in the majority of Member States where credit institutions are not currently required to prepare SCV files to the DGS on an underlying-client basis.
  - In practice, credit institutions sometimes do not know the identity of underlying clients for funds held in a safeguarding account. The ESA Risk Factor Guidelines specifically allow credit institutions to refrain from identifying underlying clients in relation to funds held on pooled accounts from an AML perspective, provided that certain conditions are met. Any new requirements for identifying the underlying clients to ensure deposit protection may, therefore, also mean revisiting established 'know your customer' (KYC) processes.
  - It is not yet clear whether the Opinion will mean that DGS will opt for direct reimbursement of clients as a rule, and whether contributions to the DGS will require an individual breakdown of client funds held in beneficiary account on a per-beneficiary basis.
- **Knock-on effects for credit institutions**. The classification of all client funds as eligible/covered deposits may have knock-on effects on other aspects of the regulatory framework for credit institutions accepting such deposits, not of all which may come as a disadvantage to institutions. As the EBA points out, covered deposits do not count towards the base amount when calculating the annual contributions to the resolution fund, and such deposits are privileged when calculating the net liquidity outflow for the purpose of determining the liquidity coverage ratio (LCR) requirement under Article 412(1) CRR. Credit institutions will, therefore, have to take the aggregate effect of the proposed revisions into account when determining the potential costs and benefits for their business setup and the acceptance of client funds.

Next steps

The Opinion serves as a final report to the Commission to inform the Commission on potential proposals for a revised DGSD as part of the ongoing DGSD Review. The Commission currently intends to publish proposals for a revised DGSD in Q4 2021.

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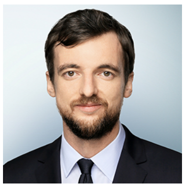

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