BANK OF CANADA
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Retail Payments Advisory Committee

End-User Fund Safeguarding

July 29 – July 30, 2020

This note is provided to assist participants in preparing for the second Retail Payments Advisory Committee (RPAC) meeting in July. This meeting will have three primary objectives:

1. Clarifying and ensuring a common understanding of "holding end-user funds".
2. Continuing discussion from the February 12th RPAC meeting on the mitigation of insolvency risk.
3. Understanding how retail payment service providers (PSPs) manage liquidity risk.

Questions are provided to help guide preparation for the meeting. Questions should not be viewed as mandatory, nor as exhaustive. They are a starting point for discussion to assist the Bank in gathering information on holding of end-user funds as well as how this retail payment activity could be part of a PSP's broader business model.

Session 1: Holding End-User Funds

The purpose of this session is to provide clarification on what it means to hold end-user funds.

As outlined in the Department of Finance Canada's 2017 Consultation Paper, *A New Retail Payments Oversight Framework*, a PSP is holding funds when it "enables end users to hold funds in an account held with a PSP until it is withdrawn by the end user or transferred to a third party through an electronic funds transfer".

At present, the Bank interprets this definition to capture two scenarios:

- Where PSPs are indebted to their end users for those end-user funds (i.e., the end user funds are a liability of the PSP in its financial statements); and
- Where PSPs hold end-user funds on behalf of end users (i.e., the end-user funds are held off the PSP's balance sheet).[1]

Identifying when a PSP's "holding of end-user funds" begins and ends, will have implications for when end-user fund safeguarding requirements would apply to that PSP and is discussed below.

1. **Does the interpretation of holding funds as a being indebted to, or holding funds on behalf of, end users capture what it means to "hold funds"?**
    a. Are there situations where PSPs should be considered to be holding funds but are not currently captured through this interpretation?
    b. Would the suggested interpretation above capture PSPs that should not be considered as "holding end-user funds"?
2. **Are there further clarifications required for "holding end-user funds"?**

[1] The interpretation of this payment function speaks to the relationship between the PSP and its end users with respect to the end-user funds. Bank staff anticipate that funds held for the benefit of end users would be reflected in this interpretation.

a. Is additional clarity required with respect to "indebted to" or "on behalf of"?

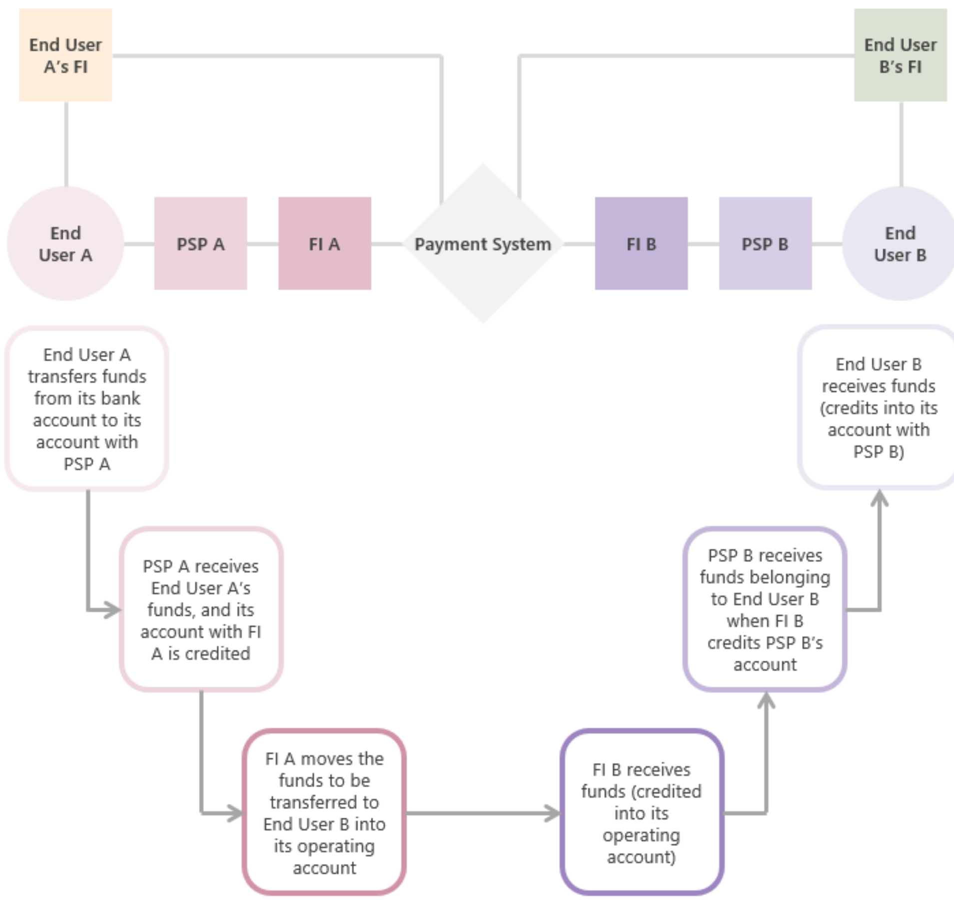
b. Is additional clarity required on other elements of holding funds?

3. **What documentation would a PSP have that demonstrates it is indebted to an end user or is holding funds on behalf of an end user?**

4. **Are you aware of potentially conflicting interpretations of what it means to hold end-user funds in other jurisdictions?**

When funds are transferred from one end user to another, these funds "go through" one or more financial institutions (FIs) via a payment system (e.g. the LVTS in Canada), i.e., debited and credited. As a result, there can be several persons or entities involved in a payment chain. [2]

Figure 1. Payment chain



The 2017 consultation paper states that a PSP is holding an end user's funds until they are withdrawn by that end user or transferred to a third party. However, identifying the discrete point in the payment chain where withdrawal or transfer occurs is complex.

Based on the simplified payment flow provided, an interpretation of when the act of "holding end-user funds" begins and ends could be as follows:

[2] Figure 1 presents a simplified payment flow that represents funds transferred from end user A to end user B, and assumes that end user A's FI is different from PSP A's FI.

- PSP A begins holding End User A’s funds as soon as it receives those funds, i.e., when FI A credits PSP A’s accounts with End User A’s funds (to “deposit” End User A’s funds into PSP A’s account at FI A).

- PSP A continues to hold those funds until FI A debits PSP A’s account and credits an operating account, so that these funds could be “transferred” (via the payment system) to FI B.

- PSP B begins holding End User B’s funds once FI B credits PSP B’s account with End User B’s funds.

Funds would be considered “in transit” as they are transferred from FI A to FI B via a payment system.

Below is a more granular outline of a payment flow, based on the structure illustrated in Figure 1. For discussion purposes, items in green text indicate when PSP A is holding end-user funds (specifically for End User A) and thus should safeguard those funds, while items in blue text indicate when PSP B is holding end-user funds (specifically for End User B) and thus should safeguard those funds. Note that cases where a PSP provides credit to end users (i.e., pre-funding their payment request) are not contemplated in the outline below.

- End user A transfers funds from its bank account to its account with PSP A

[Funds are debited from End User A’s bank account, cleared and settled through the payment system if End User A’s FI is different from PSP A’s FI]

- PSP A’s account (with FI A) is credited with those funds
- PSP A segregates those funds into an account for end users

[End User A initiates payment to End User B]

[PSP A instructs FI A to transfer funds to meet End User A’s payment request]

- FI A debits funds from PSP A’s account and credits its (PSP A’s) operating account
- FI A transfers funds to FI B via payment system
- FI B’s operating account is credited with funds for PSP B (and ultimately End User B)
- FI B credits PSP B’s account with those funds
- PSP B credits End user B’s account with those funds

5. **Are there any “fatal flaws” in the simplified payment flow outlined above?**
    a. Are there any concerns with the interpretation of when a PSP begins and stops holding end-user funds?
    b. A PSP may not be expected to safeguard end-user funds while it is “in transit” through FIs and the payment system, given that other supervisory frameworks are in place for FIs and payment systems. Would this be a cause for concern?
    c. Are there payment systems (e.g., unregulated) where funds could be cleared and settled, that would give rise to the need to safeguard end-user funds as it goes through such payment systems?
6. **In the payment flow example outlined above, for how long (typically) would PSP A and B hold end-user funds? For how long (typically) would these funds be considered “in transit”?**

a. What actions would trigger "holding of end-user funds" to begin? What record(s) would be associated with this trigger (e.g., receipt, payment message, payment instruction, etc.)?

b. What actions would trigger "holding of end-user funds" to end? What record(s) would be associated with this trigger (e.g., receipt, payment message, payment instruction, etc.)?

7. **Are there payment flows/chains that are different from the illustration above, therefore requiring a different interpretation of when the action of "holding funds" begins and ends?**

   a. If so, what are these flows/chains and how do the interpretations of when the action of "holding funds" begins and ends change as a result?

8. **What clarifications would you find helpful to better understand when holding of end-user funds starts/stops?**

Session 2: Safeguarding End-User Funds

The key objectives of safeguarding end-user funds as proposed by the Department of Finance are to mitigate the following risks for end users:

- **Liquidity risk**: where a PSP fails to hold sufficient funds in safe and liquid investments to fulfil its payment obligations or end-user demands to withdraw their funds; and
- **Insolvency risk:** where a PSP fails to properly isolate end-user funds from its own assets, which could result in these funds being made available to other (senior) creditors should the PSP become insolvent.

2a. Investing End-User Funds

The 2017 consultation paper indicated that funds should be held as cash held on deposit or in highly secure financial assets that can be readily converted into cash. From previous engagements with PSPs, it is the Bank's understanding that some PSPs invest end-user funds and retain the interest earned on these investments. The Bank has received feedback that preventing PSPs from investing end-user funds would be prohibitive to their businesses, and would like to better understand what may be feasible to meet the objectives of end-user fund safeguarding.

Given the consultation document, any investment of end-user funds should be in:

- Secure assets (denominated in the same currency as that of the end-user funds) of minimal credit risk; and
- Liquid assets to ensure PSPs can honour their end users' payment obligations.

This would be in line with the UK's Financial Conduct Authority's (FCA's) approach, and the Bank could provide additional guidance on which assets would be considered as "secure and liquid". More specifically, the FCA's guidance allows payment institutions to invest in the following assets:

- Exposures to the European Central Bank;[3]
- Exposures to member states denominated and funded in its domestic currency;

[3] The Bank's understanding is that exposures to governments and central banks (including ECB) refer to assets issued or backed by these entities, however an official definition has not been found.

- Exposures to central governments[4] and central banks with a credit quality step 1 rating from a nominated External Credit Assessment Institution (ECAI), for example:
  - Fitch's assessments: AAA to AA-;
  - Moody's assessments: AAA to AA3;
  - S&P's assessments: AAA to AA-;
  - DBRS assessments: AAA to AAL; etc.
- Exposures to central governments and central banks denominated and funded in the domestic currency where the competent authorities of this country apply supervisory and regulatory arrangements at least equivalent to those applied in the Union; and
- Units in an undertaking for collective investment in transferable securities (UCITS) which invests solely in the assets mentioned previously (i.e., certain government-/central-bank-issued debt).[5]

An institution may request that the FCA approve other assets; these decisions are made on a case-by-case basis.

9. **Do you currently invest end-user funds or do you have plans to invest end-user funds in the future?**
10. **What factors (e.g., credit, FX, liquidity risks) do you consider to ensure your investment strategy remains safe for end users?**
11. **Operationally speaking, how do you invest (e.g., through another institution)?**
12. **For the portion of end-user funds that are invested, how are PSPs currently safeguarding these funds to protect end users from the PSP's insolvency?**

Depending on the PSP's business model, and the amount of volatility of payments made, it is possible that not all end-user funds invested in secure assets need to be highly liquid (i.e., available immediately, such as through cash held at an FI).

If there is historical evidence of end users having their funds be held at a PSP for a longer period of time, there may be room to allow for investments in less immediately available – but nonetheless secure – assets. If this approach were to be allowed, PSPs would be expected to monitor and forecast their liquidity needs to determine the amount of end-user funds that could be invested in assets with a longer term to maturity.

Regardless of what the activity level has been in the past, PSPs would be expected to meet any end user's request to withdraw or transfer funds as it is the end users' right to have their funds available. Hence, if PSPs investing end-user funds cannot immediately liquidate those investments to meet end users' requests, there would need to be other avenues to access liquid funds.

13. **How do you forecast your liquidity needs?**
    a. How far does your forecast extend?
    b. How volatile are your liquidity needs?

[4] Central government refers to the federal-level government (i.e., rather than provincial or municipal).

[5] This compares to a mutual fund in Canada.

c. Do you add a buffer to your estimated liquidity needs?

d. What are some challenges you face when forecasting your liquidity needs?

14. **If you do not currently forecast your liquidity needs, is there a structural or operational barrier in doing so:**

    a. What challenges would there be to begin forecasting?

15. **What factors should be considered when determining if a type of asset is 'secure' and 'liquid'?**

    a. Are there benchmarks or guidelines issued by other Canadian authorities that you would recommend the Bank to leverage?

16. **Do you have access to funds or credit lines to draw on, if the demand for liquidity is higher than what you had expected based on your forecasting methodology? If not, how would you deal with instances where there is higher demand for payments than what you hold as liquid funds?**

2b. Estimating End-User Funds to be Safeguarded

As discussed at the 12 February RPAC meeting, end-user funds must be safeguarded to ensure that, in the event of a PSP's insolvency, the end-user funds are isolated from the PSP's own assets so that the funds would not be made available to other creditors. This could be achieved in several ways: by holding end-user funds "in trust and in a trust account", with a private insurance policy, with a financial guarantee, etc.

It is the expectation that all end-user funds held by the PSP would be required to be protected from the PSP's insolvency event. With respect to the options for private insurance or a financial guarantee, this would likely require PSPs to estimate the amount of end-user funds that are anticipated (i.e., forecasted) to be held, so that the safeguarding method's capacity is sufficient to cover the amount of all end-user funds.

In the UK, PSPs are permitted to estimate, using historical data, the amount of funds that would need to be safeguarded with an insurance policy or comparable guarantee if that amount is unknown.

17. **Are you able to monitor and keep a record of how much end-user funds you are holding in aggregate at all times?**

    a. If so, how is this done?

    b. If not, why not? What are some challenges that would prevent you from doing so?

18. **Do you have a mechanism in place to forecast the amount of end-user funds you hold, so that this could form the basis of the size of end-user funds that may need to be safeguarded?**

    a. If so, what do you account for in your forecast?

    b. How far in the future does your forecast extend?

    c. Generally, how accurate is your forecast? What are some of the challenges that could impact the accuracy? How do you deal with these challenges?

    d. How volatile is the amount of end-user funds you hold?

19. **Would it be difficult to forecast the amount of end-user funds? If so, why? What challenges would there be?**

20. What guidance would a PSP need to support the estimation of end-user funds to be safe-guarded?

a. What requirements would be reasonable?

b. What metrics and factors would you expect to see in such guidance?

c. How prescriptive would you prefer such guidance to be with respect to the methodology of estimating the amount of end-user funds to be safeguarded?