



# Retail Payments Advisory Committee

## End-user Fund Safeguarding Expectations

October 28 – October 29, 2020

This note is provided to assist participants in preparing for the fifth Interim Retail Payments Advisory Committee (RPAC) meeting. In previous sessions, the Bank of Canada engaged participants on various aspects of end-user fund holding and safeguarding, and received valuable feedback. Material in this note reflects the Bank of Canada's preliminary views on possible expectations for safeguarding end-user funds and is provided to elicit feedback from RPAC participants on any part of these expectations, particularly on:

- (i) structural or practical barriers that may hamper a PSP's ability to meet these expectations; and
- (ii) how the listed expectations may not be sufficient to meet the policy objectives of end-user fund safeguarding.

**Please note, these expectations have been drafted by the Bank and are still in development.** Specific details are provided solely to make the expectations clearer and to facilitate discussion. **These expectations are subject to change based on future consultation and policy considerations. Ultimately, the Government is responsible for proposing legislation and regulations to implement the new oversight framework.**

Unlike previous RPAC meetings, no specific discussion questions are outlined in this note, as the intent of this session will be to walk through the possible expectations and identify concerns participants may have.

### In Trust, In a Trust Account

A PSP could hold end-user funds in trust, in a trust account to protect those funds from its insolvency event. A PSP using this option would need to:

- Use the trust account solely for end-user funds (i.e., a separate account must be used for its own funds); and
- Obtain the trust account from a prudentially regulated Canadian financial institution (i.e., regulated by the Office of the Superintendent for Financial Institutions or by a provincial regulator).

End-user funds could be held in the original currency denomination (i.e., the currency that the end user expects their funds to be in) or in CAD-equivalent values.

To verify that a PSP is accurately using this safeguarding approach, the Bank could ask for the following documentation or other reports annually or more frequently as requested and following a significant change:

- Documentation that demonstrates end-user funds are being held in trust for end users (e.g., trust agreement) and information about the financial institution providing the trust account (e.g., name, prudential regulator);

- Documentation that demonstrates the correct amount of end-user funds are held in the trust account, separate from an account used for PSP's own funds;

For PSPs that hold end-user funds denominated in currencies other than the Canadian dollar, it is possible that there are ways to make end-user funds bankruptcy-remote by: holding the funds on behalf of, or for the benefit of, end users and having these funds in a specific account type provided by a financial institution. In other words, there could be an approach in foreign jurisdictions that is equivalent to holding funds in trust, in a trust account provided by a Canadian financial institution.

In such cases, the PSP may be expected to provide documentation that demonstrates end-user funds are indeed protected from its insolvency event due to the contractual relationship between the PSP and its end users, in combination with the account type provided by a financial institution that is prudentially regulated in limited jurisdictions.<sup>1</sup>

## Private Insurance

Private insurance could be one way in which a PSP safeguards end-user funds from its insolvency. If a PSP were to use this safeguarding method, it would need to ensure the terms and conditions of the insurance policy clearly indicate that the payout is triggered by the PSP's insolvency event and does not form part of the PSP's general estate.

- End users would need to be reimbursed in full, and in priority to all other creditors. Hence, the PSP would need to calculate this amount on a daily basis.
- The proceeds of the insurance policy could be in CAD-equivalent values or in the original currency denomination (i.e., the currency an end user would expect to receive their funds in).

The insurance provider should be prudentially regulated in one of the limited jurisdictions<sup>2</sup> to provide assurance that its obligations would be fulfilled in the event of the PSP's insolvency, and PSPs may need to conduct due diligence with respect to wrong-way risk.

A PSP holding end-user funds would presumably need to have these funds in an account with a financial institution. To have confidence in ensuring that these funds are accessible, this financial institution should be prudentially regulated in one of the limited jurisdictions. End-user funds should also be segregated from PSP's own funds.

A PSP safeguarding end-user funds with a private insurance policy could also be expected to review its insurance policy and provider at least annually to ensure all end-user funds safeguarded under this option would be protected in the event of the PSP's insolvency.

To verify that a PSP's insurance policy for end-user fund safeguarding correctly reflects these concepts, the Bank could ask for the following documentation or other reports at least annually and following a significant change:

- The agreement, terms, and conditions of the insurance policy, including the name and contact information of the insurance provider;

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<sup>1</sup> For discussion purposes, a sample list of jurisdictions could include: Canada, US, UK, Euro Area, Norway, Switzerland, Australia, New Zealand, Japan, Republic of Korea, Singapore, Hong Kong.

<sup>2</sup> For discussion purposes, a sample list of jurisdictions could include: Canada, US, UK, European Union, Norway, Switzerland, Australia, New Zealand, Japan, Republic of Korea, Singapore, Hong Kong.

- Information about how and where end-user funds are held, including information about the financial institution itself (e.g., proof of segregation from PSP's own funds, financial institution's name and prudential regulator); and
- If a PSP estimates the amount of end-user funds to be safeguarded, how this is done and how the PSP ensure its insurance policy would cover the necessary amount at all times.

## Financial Guarantee

If a PSP uses a financial guarantee to safeguard end-user funds from its insolvency event, the guarantee's terms and conditions should clearly indicate that the payout is triggered by the PSP's insolvency event and does not form part of the PSP's general estate.

- End users would need to be reimbursed in full, and in priority to all other creditors. Hence, the PSP would need to calculate this amount on a daily basis.
- The proceeds of this payout could be in CAD-equivalent values or in the original currency denomination (i.e., the currency an end user would expect to receive their funds in).

The guarantor should be a financial institution that is prudentially regulated in one of the limited jurisdictions, in an effort to ensure the guarantor would be able to honour the terms of the guarantee and thus make the PSP's end users whole, and PSPs may need to conduct due diligence with respect to wrong-way risk. The guarantor could be the one to directly transfer the appropriate amount of funds to each end user, or a third party could be used to facilitate the "payout".

A PSP holding end-user funds would presumably need to have these funds in an account with a financial institution. To have confidence in ensuring that these funds are accessible, this financial institution should be prudentially regulated in one of the limited jurisdictions. End-user funds should also be segregated from PSP's own funds.

To verify that a PSP's financial guarantee correctly reflects these concepts, the Bank could ask for the following documentation or other reports at least annually and following a significant change:

- The agreement, terms, and conditions of the financial guarantee, including the name and contact information of the guarantor;
- Information about how and where end-user funds are held, including information about the financial institution itself (e.g., proof of segregation from PSP's own funds, financial institution's name and prudential regulator); and
- If a PSP estimates the amount of end-user funds to be safeguarded, how this is done and how the PSP ensure its financial guarantee would cover the necessary amount at all times.

## Other Safeguarding Concepts

### Use of multiple safeguarding approaches

A PSP could rely on several safeguarding methods to protect end-user funds from its insolvency event. For example, a portion of end-user funds could be safeguarded by holding them in trust, in a trust account provided by a prudentially regulated financial institution in Canada, while the remainder of end-user funds could be safeguarded using a financial guarantee.

### Tiered arrangement

If two PSPs captured in the framework are working in a tiered arrangement, both PSPs may need to ensure that all funds ultimately belonging to end users are appropriately segregated and protected from their insolvency events. For example, if PSP A is relying on PSP B to have access to banking and hold end-user funds (a tiered arrangement), PSP A may need to rely on private insurance or a financial guarantee to protect its end-user funds from its insolvency event, while PSP B could choose to hold end-user funds in trust and in a trust account. The need to segregate end-user funds from a PSP's own funds could apply to both PSPs – that is, PSP B may need to ensure both PSP A's and B's end-user funds are segregated from PSP B's own funds, while PSP A may need to ensure accounts are indeed structured in this manner by PSP B.

### **Pre-funding end users' payment requests**

If a PSP pre-funds an end user's payment by using its own funds to complete an electronic funds transfer (EFT) before it receives funds from its end user (the payor), the PSP would not be holding end-user funds with respect to that transaction and would not be expected to safeguard that payment. In other words, it may not make sense for the PSP to protect the sender's funds after the payment has been initiated because by the time the PSP receives these funds, the PSP's obligation to its end user has been extinguished and the funds now belong to the PSP.

It is important to note that a PSP may pre-fund only some of the transactions initiated by end users and not the rest. This would imply that the PSP should have end-user fund safeguarding measures in place for the transactions that are not pre-funded (i.e., the sender's funds are sent to the PSP before it is sent to the recipient).

### **End-user fund holdings in multiple currencies**

For PSPs that hold end-user funds in multiple currencies, these funds could be held in CAD-equivalent values at a prudentially regulated Canadian financial institution or in the correct currency denominations at one or more regulated financial institutions licensed/authorised in a limited jurisdiction. Since end users must receive their funds in full following a PSP's insolvency event, the PSP could manage the foreign exchange risk associated with holding end-user funds in a currency that is different from what the end user expects them to be denominated in.

## **Common Concepts Regardless of Safeguarding Approach**

There could be common expectations that may apply to all PSPs irrespective of the selected safeguarding approach.

For example, a PSP could be expected to have a plan that enables the insolvency administrator, financial guarantor, or insurance provider to ensure end-user funds can be accurately returned to end users in the event of the PSP's insolvency. This plan could be supplemented by an up-to-date ledger noting how much funds belong to each end user and information that allows the PSP to contact its end users.

In line with protecting end-user funds, it would make sense that a PSP is restricted from using end-user funds to pay for corporate expenses, or any other expenses not related to an end user's request to make a payment. This is not to say that end-user funds could not be invested; investment could be permitted if it is in safe assets that ensure a PSP continues to meet its end users' payment demands in a timely manner. Exposure to foreign-exchange risk, however, would not be permitted, unless the purpose of investing in such assets are to mitigate any foreign-exchange risk arising from holding end-user funds in a different currency.

To encourage and verify compliance with a PSP's end-user fund safeguarding obligations, a PSP could be expected to assign a sufficiently senior individual with the accountability for the PSP's compliance with such obligations, and an external audit of a PSP's end-user fund safeguarding practices could be warranted on an annual basis.

In addition to the information that could be sought specific to the safeguarding option that is being used as outlined in previous sections of this note, the Bank could also ask for the following documentation or other reports at least annually and following a significant change:

- Statistical information about the amount of end-user funds held by the PSP;
- Documentation that would enable relevant parties to return end-user funds to the right end users, in full, in the event of the PSP's insolvency (e.g., how the insurance policy or financial guarantee would be triggered and paid out to end users, end users' contact information);
- Due diligence of account provider and, where applicable, insurance or guarantee provider;
- Description of the IT infrastructure, as well as any relevant policies, processes and procedures, that allow for proper record keeping;
- If a PSP invests end-user funds, information about its investment policy, where end-user funds are being invested (e.g., financial institution name) and in what assets, and how the PSP ensures its investments do not prevent end users from making payments; and
- The external auditor's results of a PSP's compliance with its end-user fund safeguarding obligations.