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Regulation and Digital Financial Services

Protecting Customers' Mobile Money Funds

in Civil Law Jurisdictions

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Introduction

Mobile money is a payment and storage service that uses 'e-money'—a form of stored value that is not a bank deposit. This briefing note focuses on mobile money provided by non-banks, such as a mobile network operator (the 'provider').

In this non-bank model, customers exchange cash for e-money either with an agent or directly with the provider. The customers' cash (or funds) are held with the provider, and even if the provider deposits these funds with a bank, the funds are not generally protected by the depositor protection provisions that customers enjoy when depositing funds directly with a prudentially regulated bank. This briefing note explores how regulators can protect such customers' funds from loss in a civil law jurisdiction. An earlier briefing note dealing with the protection of funds in common law jurisdictions can be found here.

Unlike in common law jurisdictions where trusts are available to protect customers' funds, protection of customers' funds in civil law jurisdictions is relatively difficult and complicated because the trust concept does not exist. This briefing note considers the three main options (legal instruments) that regulators in civil law countries can utilise to protect customers' funds: **proprietary option** (fiduciary transactions), **contractual option** (mandate contracts) and **regulatory interventions** (direct regulation or insurance).[1] Analysis of the three options suggests that none of them can provide sufficient protection to customers' funds independently, thus regulators should adopt a mixed strategy—flexibly using a combination of the three instruments.

The common law trust regulates together rights *in personam* (e.g., customer rights against the provider of e-money services) and rights *in rem* (e.g., customer rights over funds), whereas the civil law makes a sharp distinction between the Law of Obligations (for rights *in personam*) and the Law of Property or 'Real' Rights (for rights *in rem*). Consequently, civil law institutions conceived to regulate one type of right may fall short on the protection of other rights. To provide customers' funds with similar protection to that provided by the common law trust, regulators should adopt strategies that flexibly combine private law solutions and regulatory institutions. On this basis, this briefing note examines three common legal instruments in civil law countries and analyses how each of them can help achieve the three functions (**fund isolation**, **fund safeguarding** and **protection of customers' interests**) provided by the common law trust.

Three main legal instruments to protect customers' funds

1. Proprietary option

The legal instrument that most closely resembles the trust in a civil law jurisdiction is the *fiducia*.[2] This briefing note refers to *fiducia* as 'fiduciary transactions' or 'fiduciary contracts,' and defines it as an arrangement under which one party (the 'settlor') conveys property to another (the 'fiduciary') and the latter agrees to use that property for a specific purpose. Under such a transaction, the fiduciary agrees to transfer the fiduciary assets to one or more beneficiaries upon fulfilment of the agreed purpose. When using the fiduciary assets, the fiduciary will be subject to a series of duties agreed upon with the settlor or determined by law.

Fiduciary transactions in the context of mobile money using stored value has two typical forms: the **third-party fiduciary model** and the **provider fiduciary model**. The former requires a third party to serve as the fiduciary institution, whereas with the latter the provider serves as the fiduciary to hold the assets for the benefit of the customers. Figures I and II demonstrate the differences between the two models.

1 This briefing note draws on the following article by David Ramos, Javier Solana, Ross P. Buckley and Jonathan Greenacre that can be found here: David Ramos and others, 'Protecting the Funds of Mobile Money Customers in Civil Law Jurisdictions,' GEG Working Paper 2015/102 (Oxford, United Kingdom, University of Oxford, June 2015), pp. 1–48. Note: Neither this briefing note nor the paper referred to above constitute legal advice.

2 It is generally understood that the beneficiary under a *fiducia* is not equivalent to the beneficiary under a trust. For a detailed analysis of the *fiducia* and the common law trust, see Dante Figueroa, 'Civil Law Trusts in Latin America: Is the Lack of Trusts an Impediment for Expanding Business Opportunities in Latin America?' *Arizona Journal of International and Comparative Law*, vol. 24, No. 3 (2007), 701–767; Rafael Sánchez Aristi and Nieves Moralejo Imbernón, *Property and Trust Law in Spain*, 2nd ed. (The Hague, The Netherlands, Wolters Kluwer Law & Business, 2014), para. 243.

Figure I

Third-party fiduciary model

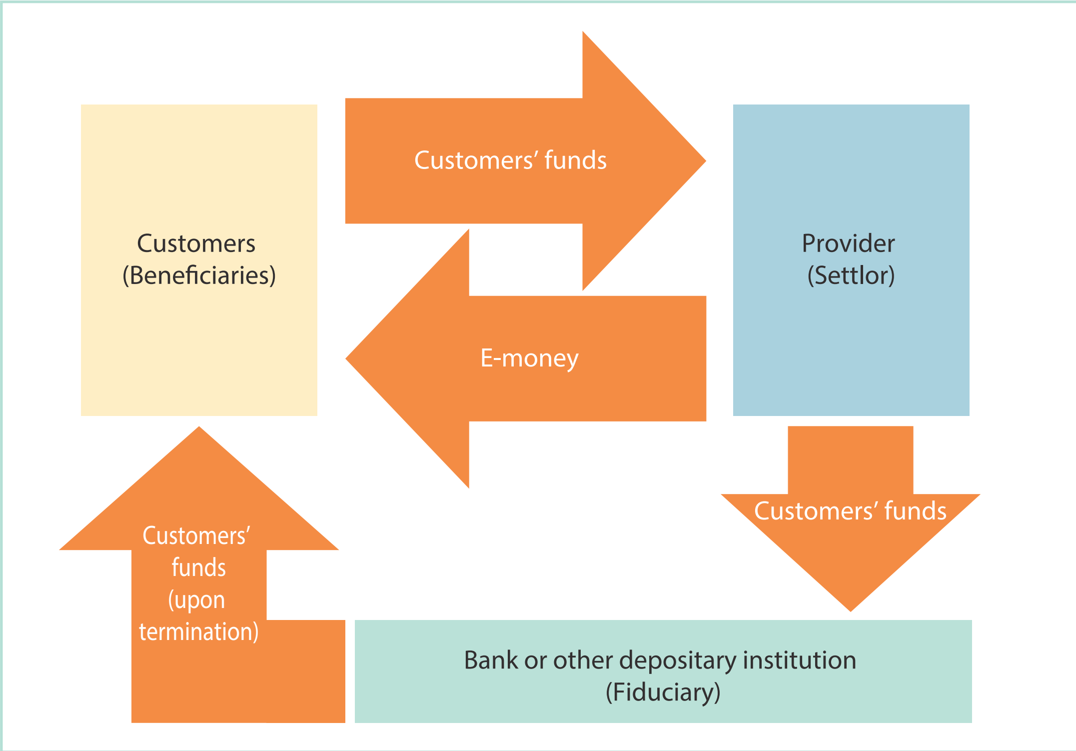
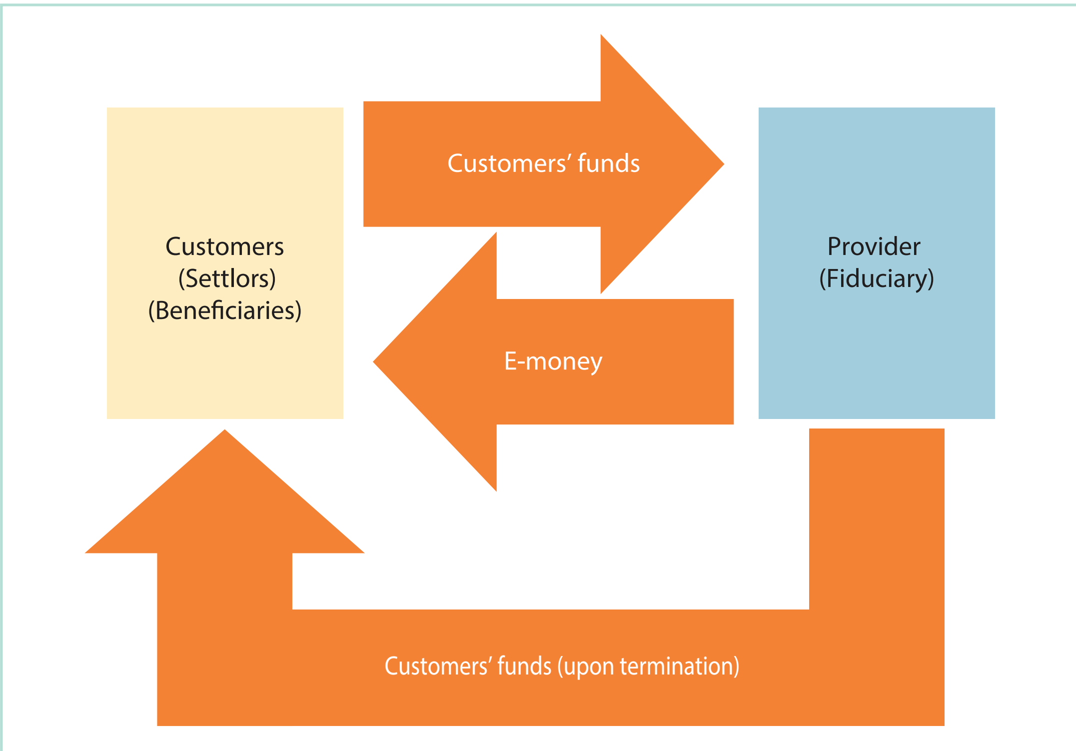


Figure II

Provider fiduciary model



The three functions of protecting customers' funds can be achieved through fiduciary transactions:

- **Fund isolation**

Under the third-party fiduciary model, if property over the funds were transferred to the third-party fiduciary, customers' interests in the fiduciary assets would only be protected against insolvency risk if those assets were separated from the fiduciary's patrimony. If there is no transfer of property under the fiduciary contract, the protection of customers' interests in the fiduciary assets will require the segregation of those assets from the patrimony of the provider.

Under the provider fiduciary model, protecting customers' interests in the assets requires segregating the fiduciary assets from the personal patrimony of the provider. If the provider deposits the assets with a bank, protection of customers' funds would also require segregating the fiduciary assets from the bank's patrimony.

- **Fund safeguarding**

Fund safeguarding in civil law jurisdictions relates to the personal obligations imposed on the fiduciary by legal institutions. Most statutes and courts in civil law countries tend to limit a fiduciary's duties to the terms of the fiduciary contract and will not imply other duties unless the fiduciary is considered as acting expressly in the beneficiary's interests and not simply holding different interests in a patrimony.

For instance, under a common law trust, beneficiaries (customers) have an equitable right in the trust assets that allows them to trace the proceeds resulting from an unauthorised deposition by an agent.[3] Such a claim, however, would be problematic in civil law countries as the remedy of tracing is far less developed.[4] Therefore, the best available strategy is for the parties to a fiduciary contract to agree expressly on duties that will bind the fiduciary's use of the fiduciary assets.[5]

There are three ways fiduciary contracts could provide for specific rules to ensure fund safeguarding: (1) the parties could expressly restrict the provider's rights to use customers' funds; (2) the provider could be required to manage customers' funds within very narrow parameters (e.g., investing the cash in highly liquid assets such as bank deposits or highly rated government securities); and (3) the parties could agree that the provider will diversify the assets in which it will invest the customers' funds. These duties can be expressed explicitly in the fiduciary contract, in specific e-money regulation, or in fiduciary legislation.

- **Protection of customers' interests**

Fiduciary contracts can provide two mechanisms to reduce operational risk in relation to customers' funds: (1) the fiduciary can be required to keep records of the accounts where it keeps the fiduciary assets and to have those accounts audited by an authorised auditor;[6] and (2) the parties may provide for a third-party expert to monitor the fulfilment of the fiduciary's duties. Normally, parties will specify in the terms of their agreement whether the settlor or beneficiary can delegate their supervisory powers over compliance of fiduciary duties to a third party (the 'protector').[7]

In summary, fiduciary transactions can effectively achieve fund isolation but only provide limited comfort in terms of preventing liquidity and operational risks.

3 See Geraint W. Thomas and Alastair Hudson, *The Law of Trusts*, 2nd ed. (Oxford, United Kingdom, Oxford University Press, 2010), 33.01–33.120. For tracing in general, see Louise Gullifer, *Goode on Legal Problems of Credit and Security*, 4th ed. (London, United Kingdom, Sweet & Maxwell, 2009), pp. 1–57, 41.

4 María Luisa Marín Padilla, 'La Formación Del Concepto de Subrogación Real,' *Revista Crítica de Derecho Inmobiliario*, 51 (1975), p. 1111; Lluís Roca Sastre, 'La Subrogación Real,' *Revista de Derecho Privado*, 385 (1949), p. 281; Juan Vallet de Goytisolo, 'Pignus Tabernae,' *Anuario de Derecho Civil*, 6 (1953), p. 783.

5 See e.g., Uruguay, Fideicomiso, Ley No. 17.703, 4 November 2003, art. 4.3; France, Code Civil Français, arts. 2018.6º, 2022, 2026; Luxembourg, Trusts et contrats fiduciaires du Luxembourg, 27 July 2003, art. 7(3).

6 Auditing can help ensure the integrity of the system. See Michael Klein and Colin Mayer, 'Mobile Banking and Financial Inclusion: The Regulatory Lessons,' Policy Research Working Paper, No. 5664 (Washington, DC, The World Bank, 2011), p. 13.

7 If the delegation of supervisory powers were to be challenged, a court could find that some default rules also allow the settlor to delegate those powers.

2. Contractual option

One option to help protect customers' funds in civil law countries is to use the mandate contract. Under a mandate contract, one party (the 'agent') commits to act on behalf of another (the 'principal') for a fee, unless otherwise specified.[8] However, in the context of mobile money using stored value, the mandate contract cannot be used as the sole mechanism to regulate directly the way in which customers' funds are disposed of by the provider. The reason is that the customer, by purchasing e-money from the provider, relinquishes proprietary rights over his/her funds in exchange for the e-money. The customer thus cannot mandate the provider to dispose of funds since he/she no longer owns the funds as such in a legal sense.

Unlike fiduciary transactions, the mandate contract cannot provide protection against the risk of the provider or the bank becoming insolvent. The segregation of funds would require an express legal mandate or the creation of a separate patrimony from that of the provider or the bank. However, at a minimum, mandate contracts can provide an important body of default rules that regulate the duties of the provider towards the customer, arising from the statutory duties of an agent to act in the interest of the principal,[9] and to exercise due care and skill.[10]

In other words, although the mandate contract cannot protect customers' funds from insolvency risk, it can help prevent liquidity and operational risk. The mandate contract, therefore, can fill a gap by providing general rules to regulate the fiduciary's duties towards the customer.

3. Regulatory interventions

The respective insufficiency of the proprietary and contractual options demonstrates the difficulty of providing a single solution for the effective protection of customers' funds in civil law jurisdictions. In response, policymakers have two options: **imposing direct regulation** or **requiring insurance**.

Imposing direct regulation means introducing specific legislation or regulation to require providers to adopt protective mechanisms that can achieve the three main functions of protecting customers' funds. Such regulation can also grant e-money customers the right to monitor the provider's compliance with the regulator-imposed duties, or require the appointment of a protector to do so. The European Union's 2009/110/EC E-Money Directive of 16 September 2009 is an example of direct regulation in this regard.[11] Likewise, the European Union's 2007/64/EC Payment Services Directive of 13 November 2007 also provides for specific safeguarding requirements (in case the provider undertakes other activities), with a specific direction to avoid commingling of funds, and protection against the provider's other creditors in the event of insolvency.[12] Imposing direct regulation, however, is not without challenges. For example, the imposed regulations may not be flexible and forward looking enough to accommodate new situations as the market and technology evolve and new problems arise.

8 See e.g., France, Code Civil Français, art. 1984 et seq.
9 See e.g., Spain, Código de Comercio, art. 225; Spain, Supreme Court decision of 5 February 1964.
10 See e.g., Germany, Bürgerliches Gesetzbuch, s. 276.
11 For duties applicable to e-money issuers, see arts. 10–13 of the E-Money Directive.
12 See arts. 9(1)(a) and (b) of the Payment Services Directive.

Mandatorily requiring insurance of e-money customers' funds, against any of the three risks, can serve as either a complementary mechanism (used to strengthen the protection an existing legal instrument has provided) or a standalone mechanism (used in jurisdictions where no legal instrument is available). However, there are at least four drawbacks to consider if requiring insurance:

(1) The e-money market conditions may not be ideal for the viability of an insurance scheme, as the number of potential e-money customers may be small.[13]

(2) Providers may pass on the cost of mandatory insurance to customers, which may have a serious impact on the demand for e-money services and on their potential as a tool for financial inclusion.

(3) In the event of a provider's insolvency, insurers may refuse to compensate customers until the end of the insolvency proceedings, which may impose hardship on e-money customers. Also, insurance will only give customers a personal claim for damages against the insurer in the event of the provider's insolvency. This protection is not as strong as that provided by other mechanisms where customers remain the owners of their funds or where those funds, despite being owned by the provider, are separated from their personal patrimony.

(4) Insurance may introduce moral hazard, as providers would have less incentive to comply with existing protection rules. Effective monitoring by regulators would be essential.

Table 1 provides a summary for each legal mechanism.

Table 1

Protection of customers' funds under civil law

Function	Specification	Fiduciary transaction	Mandate contract	Regulatory interventions
Fund isolation	Segregation from the provider's funds	If customers are beneficiaries, funds are protected	Customers have no legal capacity to mandate the provider to dispose of funds, as they no longer own the funds in a legal sense	Depends on coordination with insolvency rules—can be achieved with appropriate rules
	Segregation from the depositary institution's funds	Depends on the fiduciary arrangement and whether the provider accounts are fiduciary accounts	As above	As above
	Segregation from other customers' funds	Depends on the terms of the fiduciary structure: if each fiduciary arrangement is contemplated as a separate transaction where the customer is the beneficiary, funds are protected	As above	As above
Fund safeguarding	Liquidity	Can be achieved by specifying explicit fiduciary duties in the fiduciary contract	Can complement fiduciary transactions by providing general background rules to regulate the duties of the fiduciary towards the customer	Achievable with appropriate rules
Protection of customers' interests	Fiduciary duties	As above	As above	As above

13 Insurance companies require large numbers of clients in order to avoid the risk of facing numerous simultaneous payouts that would deplete their resources in a short period of time.

Analysis of the three legal instruments demonstrates that none can serve as a standalone mechanism to protect customers' funds in civil law jurisdictions. Fiduciary transactions, while reducing insolvency risk, provide limited protection against liquidity and operational risks. Mandate contracts, while unable to achieve fund isolation, lay out the basic scope of the provider's duties toward the customer. Direct regulations can bridge the gap between the foregoing two instruments but are not themselves immune from drawbacks. Therefore, it is expected that any comprehensive regulatory strategy would include a combination of the three different mechanisms.

Summary of options available to protect customers' funds

Figures III and IV illustrate how regulators can choose from different policy options to achieve protection of customers' funds. Figure III summarises options to achieve fund isolation, and Figure IV shows policy options for achieving fund safeguarding and the protection of customers' interests against operational risk. When implementing the options, regulators should give careful consideration to the interaction of new regulation with existing statutes and private law rules, and should bear in mind issues of regulatory capacity and customer vulnerability.

Figure III

Summary of policy options to achieve fund isolation

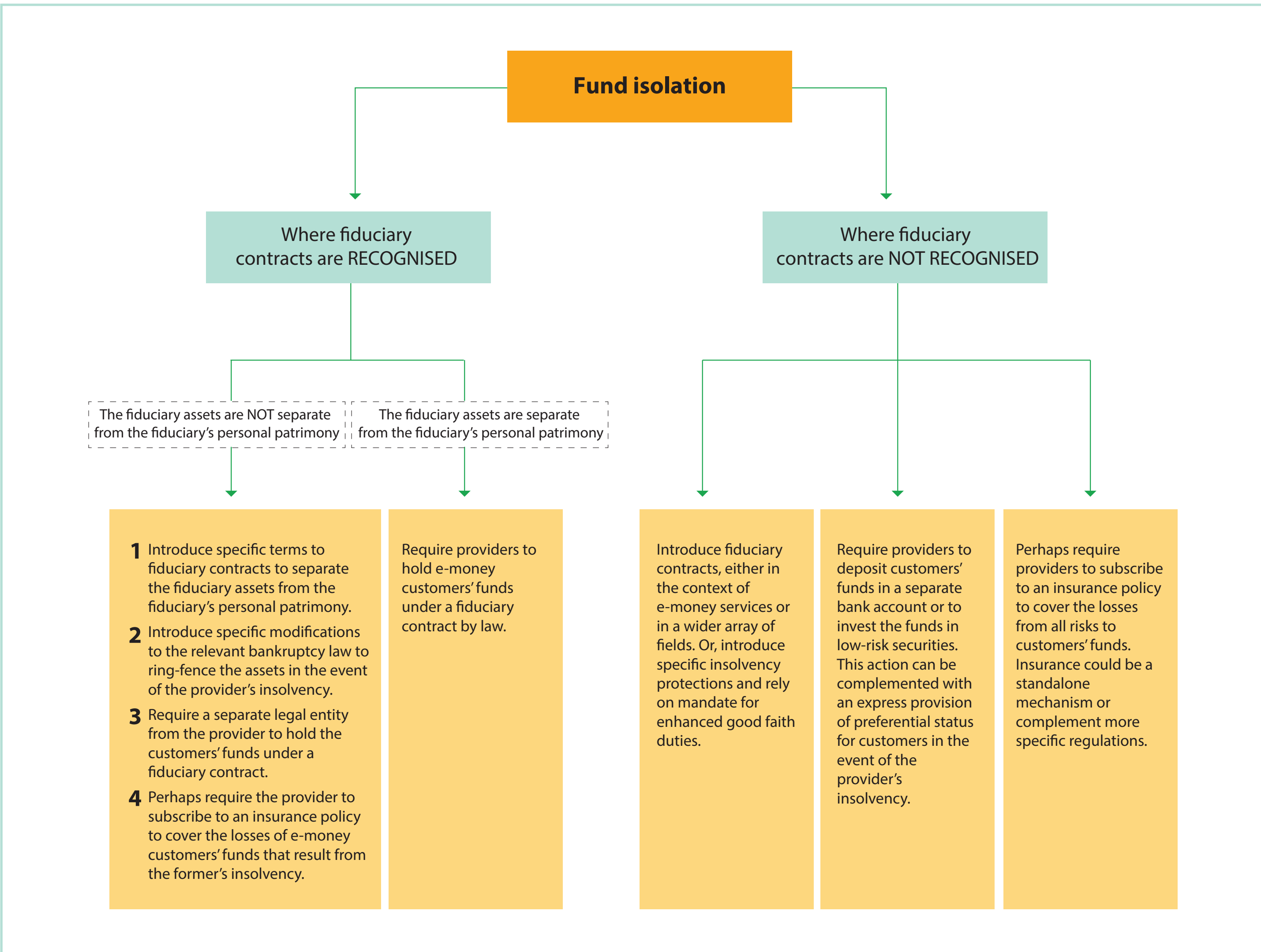


Figure IV

Policy options for achieving fund safeguarding and protection of customers' interests

Fund safeguarding and protection of customers' interests

Imposing statutory rules:

Use specific statutory rules to provide minimum standards to regulate the relationship between provider and customer (either to substantiate the fiduciary's duties or to set forth default background rules for the mandate contract). Such rules may include specific safekeeping duties for providers, such as the following:

- To deposit customers' funds in a separate bank account
- To invest customers' funds in safe, low-risk securities
- To invest customers' funds in the name of the customers.

Requiring insurance as a standalone option:

Require providers to subscribe to an insurance policy that covers the losses of customers' funds in the event that the provider becomes insolvent or is not able to return the customers' funds for any reason other than insolvency. Regulators need to be aware of whether the cost of insurance will damage the potential of mobile money to increase financial inclusion.

Requiring insurance as a complementary option:

Combine the use of specific statutory rules and mandatory insurance.

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