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CEO Brief is a report highlighting key current issues the insurance industry faces.

Modernizing financial regulation for the digital age

ABSTRACT

Recent spreads of digital innovation in the financial industry not only changed market structure but also brought new products and services. However, this trend is vulnerable to regulatory loopholes and may negatively affect fair competition, consumer protection, and financial stability. Therefore, in order to respond to changes towards the digital environment, financial regulators should make financial regulatory system more flexible, closely monitor abuse of market dominance, assign legal responsibilities proportional to economic substance for consumer protection, and examine new channels of potential systemic risks.

1. Impact of changes in the digital environment on the financial industry

Recently, as innovation based on digital technology is spreading in the financial industry and non-financial companies enter the insurance market, both cooperation and competition are intensifying and market structure is changing. The number of non-financial companies that provide financial services increases, as well as the range of services they provide, which indicates quantitative and qualitative roles of non-financial companies in the financial market are expanding. In response, financial companies are likely to expand the cooperation with external tech companies to enhance their digital competitiveness, and the use of third-party services and outsourcing is likely to expand in the future as the value chain of financial market is further fragmented. As a result, the competition structure in the financial market is expected to change from a simple form centered on incumbent companies to a complex form centered around “ecosystem” or cooperating group of companies.

Products and services developed as a result of the digital transformation of the financial industry are characterized by functional unbundling, decentralization, high spreadability and convenience. As tech companies replace the comprehensive services provided by financial companies with differentiated individual services, financial services are unbundled by the function, and the digital platform of the financial sector is enhanced. With the development of distributed ledger technology along with the unbundling of financial services, decentralization and disintermediation in which financial services are separated from the existing financial system are underway. Financial services based on digital platforms are expected to spread faster than those provided by financial companies because there are mutual amplification effects among the number of consumers, the amount of data acquisition, and the quality and scope of product and service. New financial services can contribute to enhancing consumer welfare due to their strong customer-centric nature.

2. Main Regulation Issues

In terms of market competition, regulatory arbitrage, unfair competition, and data monopoly may occur. Regulatory arbitrage may occur, undermining the basis of fair competition, due to the different regulatory methods and levels applied depending on the type of business operator, such as between incumbent financial companies and new non-financial entrants. Digital platform makes it easier for platform companies to establish market dominance so that platform companies can monopolize the social welfare from efficiency gain excluding business partners or consumers. Online-centric business models deepen the concentration of consumer information both financial and non-financial, which may reduce the information efficiency of the financial system.

In terms of consumer protection, regulatory gap, data leakage, and fairness breach may occur. In terms of business conduct regulation, regulatory gap causing insufficient monitoring may result in consumer loss, and in the event of consumer loss, liability may be ambiguous and the effectiveness of consumer relief can be

compromised. Data-based financial services increase the possibility of large-scale leakage, misuse or abuse of personal information, which can lead to a sharp decline in the confidence of the financial market. Financial exclusion may occur for those who are weak to technology, and in digital technology-based financial services, fairness issues may arise due to high information asymmetry of embedded technologies such as algorithms and low comprehensibility.

Risk-taking by financial companies and new systemic risk-generating mechanisms may negatively affect financial stability, and increase the risk of money laundering and terrorist financing. Financial companies whose profit base has been compromised due to excessive competition with non-financial companies may pursue excessive risk to compensate for the decreased profitability. Systemic risks may arise through mechanisms different from those of existing financial systems and financial companies, such as operational risk management failure. Inadequate Know Your Customer (KYC) or Customer Due Diligence (CDD) procedures and complex market structures can increase money laundering and terrorist financing risks.

3. The Direction of Financial Regulations

In order to fundamentally resolve regulatory arbitrage caused by regulatory gap, it is necessary to review the transition from entity-based, sector-specific regulation to more flexible financial regulatory system. It is necessary to faithfully apply the principle of same regulations for same function to non-financial companies entering and operating in the financial market, while also faithfully applying the proportionality principle so as not to undermine the increase in consumer welfare through market innovation. In the short term, it is necessary to rationalize the definition of business in the existing financial law and set up a regulatory system for small-licenses. And in the mid- to long-term, it is necessary to change the current financial regulations based on sectors and positive system to the ones based on functional and negative system.

It is necessary to closely monitor the process through which a specific company, such as Big Tech, expands its dominance in the financial market. And the coordination on competition policy between financial and competition authorities is also necessary. In the financial market, careful monitoring and analysis of the effects of predatory pricing and vertical integration strategies on market competition is necessary, and communication with competition authorities is also necessary in that business can compete across business boundaries.

It is necessary to reflect self-responsibility as well as market dominance and compensatory power and increase the effectiveness of consumer relief by preparing an appropriate dispute mediation procedure in granting legal responsibility for consumer loss. As the financial market structure and business model become more complex, the relationships between market participants can be diversified. Therefore, it is necessary to assign legal responsibilities reflecting the economic substance in relation to consumer protection.

It is necessary to monitor the risk-taking of financial companies due to intensifying competition and closely review the mechanisms for generating new types of systemic risks due to changes in the structure of the financial market. In order to prevent the occurrence of new types of systemic risks, such as operational risks, it is necessary to further strengthen the internal control framework (Pillar 2) and market discipline (Pillar 3), while current regulation is mainly based on capital requirements (Pillar 1).

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