

Analysis on Financial Risks from Regulatory Divergence between Big Techs and Financial Firms

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As big techs are expanding financial service offerings, some view their services as being beneficial while others raise concerns over growing financial risks. Compared to traditional financial firms, big techs are subject to alleviated regulations in terms of market entry, financial prudence and business conduct. A widening regulatory gap between big techs and financial firms is exacerbating concentration and reputational risks within the financial industry, which could intensify prudential and systemic risks. Furthermore, eased regulations on big techs' business conduct would pose a greater risk, thereby raising the possibility of mis-selling and unfair transactions. To mitigate such risks, efforts should be exerted to close the regulatory gap between them. The principle of applying equal rules to entities performing identical functions needs to be reinforced when it comes to regulating big techs' financial services. Furthermore, capabilities of implementing ex-ante, dynamic financial supervision should be enhanced. What is also important is to prevent fintech innovation from being undermined in the course of narrowing regulatory differences. Thus, the rule of applying regulations proportionate to risks should be established for the fintech industry. At the same time, it is necessary to constantly facilitate a financial regulatory sandbox and the Small License system.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Big techs' expansion into the financial services sector

Big techs refer to large ICT companies that offer a wide range of online services based on AI, big data and other advanced technologies and innovative platforms. America's Google, Amazon, Apple, and Facebook and China's Alibaba, Baidu and Tencent are included in the category of big techs. Their counterparts in Korea are Naver and Kakao. As manufacturing-driven industrial structure shifts towards the service sector and the Covid-19 has pushed up demand for contact-free services, big techs equipped with cutting-edge ICT and large platforms have expanded their business scope into advertising, distribution, information communications, media, transportation, leisure and education sectors without much difficulty. In their early years, big techs received positive responses in that they provided affordable, convenient services for many consumers. More recently, negative sentiment towards big techs has been bolstered since they adversely affect small vendors' business activities through growing market dominance and pursue excessive profit-seeking approaches by steeply pushing up prices. In her previous report titled Amazon's Antitrust Paradox,¹⁾ professor Lina M. Khan who was named the Federal Trade Commission (FTC) chair in June 2021 pointed out that technology giants adopted predatory pricing and vertical integration strategies to solidify their dominance at the expense of profits, which could threaten social welfare in the long run.

As major big techs operating businesses in Korea and abroad have recently accelerated their entrance into the financial sector, there is a growing concern that their presence in finance could have long-term adverse effects on the overall financial industry. The US tech giants such as Google and Amazon have offered payment services for many years, while Alibaba, Baidu, Tencent and Rakuten have engaged in a savings account service, a credit loan service, asset management and insurance policy sale in the financial sector (see Table 1). Korea as well has seen big techs such as Naver and Kakao provide financial services involving payment settlement, remittance, depository business, loans, and asset management directly or indirectly through affiliated firms. In particular, Korea's big techs have successfully attracted a lot of customers to their payment and banking services within a short period of time, expanding dominance in the financial market while considering branching out into financial investment and insurance businesses.

1) Lina, M.K., 2017, Amazon's Antitrust Paradox, The Yale Law Journal, January.

Table 1. Financial service offerings by big techs

	Deposit Taking	Credit Provision	Payment	Crowd-funding	Wealth management	Insurance
Google	Δ		○			
Apple			○			
Facebook			○			
Amazon		○	○	○		○
Alibaba	○	○	○	○	○	○
Baidu	○	○	○	○	○	○
Tencent	○	○	○	○	○	○
Rakuten	○		○		○	○
Naver		○	○		Δ	
Kakao	○	○	○		Δ	

Source: BIS (2021)²⁾

Building upon innovative ICT platforms, big techs' expansion into finance could deliver more benefits to financial consumers for the time being. As mentioned in Khan (2017), however, their predatory pricing and vertical integration strategies backed by growing dominance could increasingly create financial risks, thereby undermining financial stability. In the reports such as BIS (2021) and FSB (2019),³⁾ international financial supervisory institutions have also raised concerns over various financial risks arising from big techs' growing advance into finance, such as concentration and systemic risks. In this regard, this article tries to examine regulatory divergence between Korea's tech giants and financial institutions and to analyze financial risks accompanied by a regulatory gap. Furthermore, it would present the regulatory direction for big techs to achieve a balanced combination of innovation and stability in the financial sector.

Rising financial risks from regulatory divergence in market entry

The financial authorities in Korea have adopted less strict entry regulations than those applied to traditional financial firms for ICT firms who intend to operate a financial business in an effort to facilitate financial innovation. The revision to the Act on Special Cases Concerning Establishment and Operation of Internet-only Banks (the "Internet-only Banks Act") grants ICT firms special benefits regarding their entry into the banking sector. For instance, the

2) BIS, 2021, Big techs in Finance: Regulatory Approaches and Policy Options, FSI Brief No 12.

3) FSB, 2019, BigTech in Finance: Market Developments and Potential Financial Stability Implications. Research Paper (Dec 2019).

minimum capital obligation for operating an internet-only bank has been reduced to KRW 25 billion, one quarter of the capital amount required for a commercial bank (or KRW 100 billion). Furthermore, non-financial investors may hold 34% of the total outstanding shares of an internet-only bank, whereas they are allowed to own only 4% of the total outstanding shares of a commercial bank. In addition, under the Special Act on Support for Financial Innovation, firms recognized to engage in innovative financial services may be exempted from the Banking Act, the Insurance Business Act, the Specialized Credit Finance Business Act, and the Financial Investment Services and Capital Markets Act for a certain period of time. Accordingly, they have been permitted to conduct primary or additional businesses currently operated by financial companies without obtaining a financial business license. My Data, My Payment and Comprehensive Payment Settlement Business have been introduced to enable ICT firms to offer credit information management, payment order and other financial services excluding banks' depository service and loan provision. Also, those participating in My Data, My Payment and Comprehensive Payment Settlement Business can benefit from market entry-related incentives like eased capital requirements, compared to when they conduct unauthorized financial businesses.

A widening difference in the regulatory treatment of big techs and non-bank financial institutions is likely to exacerbate concentration and reputational risks within the financial industry. Big techs can swiftly analyze consumers' needs with accuracy by capitalizing on abundant non-financial information collected by themselves or their affiliates. With no need for operating branches, they also can offer convenient financial services at a lower cost compared to commercial banks. With this approach, big techs have attracted a substantial number of customers in a short period of time through innovative platforms based on AI and big data. A case in point is Kakao Bank—Korea's representative big tech—whose number of customers reached 17 million as of the end of September 2021, greatly surpassing customer bases of Korea's major commercial banks who boast a long history of 50 years or longer only in five years from its incorporation. The increasing dominance of big techs may expand a concentration risk within the financial sector. For instance, big techs tried to reinforce their dominant positions with an underpricing strategy that they adopted in the early stages. However, if they suddenly raise lending rates or cut deposit interest rates, financial consumers are likely to suffer huge losses, which may contribute to reducing social welfare. With a sufficient mass of users, big

techs may be exposed to governance-related risks due to loose internal controls, or any system malfunction could have adverse effects on their reputation.

Rising financial risks from divergence in prudential regulations

Big techs offering financial services are subject to slightly eased financial requirements. Commercial banks, insurance firms and securities firms are required to comply with strict capital adequacy standards including the BIS ratio, the RBC ratio and the net capital ratio. Furthermore, they need to retain the net liquid asset holdings in excess of a certain amount to avoid insolvency risks and deal with the possibility of massive redemption requests coming from customers. In addition, financial firms selected as SIFIs (systemically important financial institutions) should observe LCR (Liquidity Coverage Ratio) and NSFR (Net Stable Funding Ratio) as well as rigorous capital requirements introduced by BCBS (Basel Committee on Banking Supervision). Also, tougher leverage ratio regulations are applied to commercial banks, securities firms and credit card companies to hinder them from holding excessive levels of debt compared to their proprietary capital. On the contrary, tech giants providing financial services are not supposed to adhere to such stringent prudential regulations. Compared to commercial banks, internet-only banks regulated under the Internet-only Banks Act are subject to more relaxed prudential regulations. Also, big techs being subject to the Credit Information Use and Protection Act and the Electronic Financial Transactions Act should comply with relatively more relaxed prudential requirements than traditional financial firms.

Big techs subject to eased prudential requirements could prioritize attracting new customers over protecting financial consumers, which may expand the potential systemic risk as well as the risk of going bankrupt. If prudential risks posed by big techs' assets and debts are not properly controlled, such firms could suffer massive losses in their asset holdings in the event of any crisis, which may be passed on to service users. A case in point is Wirecard, Germany's big tech company whose market cap surpassed that of Deutsche Bank. In the first half of 2020, Wirecard went bankrupt due to accounting malpractices including poor asset management, inflicting huge damages on consumers. Korea has recently witnessed a similar scandal involving a large fintech company that arose from an inappropriate asset management practice. In the Mergepoint scandal, Mergeplus—the Mergepoint prepayment card service provider—failed to manage financial prudence of its assets and debts and defaulted on payment. This triggered

the equivalent of a bank run on the firm and its customers ended up bearing heavy damages.

Insufficient management of financial prudence by big techs is likely to increase potential systemic risk. Systemic risk can be defined as the possibility that an individual company-level loss would have a ripple effect on other financial firms, triggering severe instability. It has been widely recognized that larger company size, greater leverage and stronger interconnectedness and complexity could intensify potential systemic risk.⁴⁾ Big techs tend to be large because they have secured a huge number of customers in a short time span and their heavy dependence on borrowed capital leads to high leverage. In addition, big techs are platform-based so they are closely interconnected with other financial firms while services offered through complicated algorithms such as AI, big data and cloud necessarily entail a high level of complexity. In other words, big techs are likely to outstrip traditional financial firms in terms of size, leverage, interconnectedness and complexity, which could increase their exposure to potential systemic risk.

Rising financial risks from divergence in business conduct regulations

For consumer protection, financial firms are subject to stricter business conduct requirements in a wide range of areas including prevention of conflicts of interest, interference in information exchange, investment solicitation, ban on unfair transactions, asset management, corporate disclosure, and obligations of reporting and documentation. In contrast, somewhat eased regulations on business conduct are applied to big techs, a policy direction designed to facilitate financial innovation. For instance, special cases regarding corporate disclosure and written reports are granted to internet-only banks, which plays a role in relaxing regulations on a wide range of business conduct. The same is true for big techs subject to the Credit Information Use and Protection Act and the Electronic Financial Transactions Act. In particular, tech giants who offer unauthorized financial services without obtaining a financial business license are rarely constrained by regulations on key business conduct.

Alleviated regulations applied to big techs' business conduct could exacerbate risks of mis-selling and unfair transactions, from which financial consumers could suffer serious damages. This would pose higher risks to a big tech's business operation while threatening the stability

4) Lee, H.S., 2020, *Analysis on systemic risk of securities business and relevant challenges*, KCMI Issue Report 20-13.

of the financial system. A good example is a big tech who engages in unauthorized business conduct by placing online banner ads without a license needed to mediate financial investment products. Under these eased business conduct regulations, big techs are likely to solicit their customers to invest in high-risk products accompanied by higher sales charge or brokerage fees to maximize profits, rather than putting a priority on the interest of financial consumers. There is also a possibility that big techs carry out insider trading or price manipulation by capitalizing on the information advantage they gain over consumers. Furthermore, if only modest obligations of corporate disclosure, reporting and documentation are imposed on big techs, issues regarding IT security and information misuse could erupt, potentially jeopardizing their business operation.

To sum up, big techs are subject to more eased regulations than traditional financial firms in terms of market entry, financial prudence and business conduct. Divergence in entry requirements between big techs and financial firms could give rise to concentration and reputational risks within the financial industry. There seems to be a huge difference in prudential regulations between them, which increases the risk of insolvency and potential financial instability. Furthermore, a somewhat larger disparity in business conduct regulations could pose higher risks to big techs concerning mis-selling, unfair transactions and business operation.

Regulatory direction for big techs' financial services

Higher financial risks could arise from widening regulatory divergence between big techs and financial firms. Thus, the desirable approach is to narrow the regulatory gap between them to improve financial stability. The first step toward closing the gap is to stick to the principle of applying equal rules to entities performing identical functions, and this should be applied to big techs who hope to expand into finance. However, as boundaries between the financial and non-financial industries are collapsing due to ICT innovation, it is necessary to reasonably specify the scope of financial business and financial services. Second, as mentioned in Khan (2017), thorough monitoring needs to be conducted on predatory pricing and vertical integration strategies to minimize side effects coming from the growing dominance of big techs in finance. Third, the current ex-post financial supervision on big techs should be shifted towards the ex-ante oversight system. What is also necessary is improvement in dynamic

supervisory techniques to predict the route of expanding financial service offerings.

Meanwhile, fintech innovation should be consistently facilitated to prevent financial innovation from being impaired in the course of lowering regulatory differences between big techs and financial firms. In this regard, the adoption of regulations proportionate to risks is essential to ensure that small-scale fintech companies materialize innovative ideas. To this end, a financial regulatory sandbox needs to be utilized to encourage entrepreneurs to seek innovation. Also necessary is to examine whether incentive-compatible regulations should be applied to small-scale fintech companies through the Small License system.