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Rationale, Past and Future of Financial Consumer Protection

Jung, Hong Joo†

A B S T R A C T

This short artile, written by the President of the IAFICO, reviews philosophical rationales of financial consumer proection (FCP) and its past and future in general.
After introducing five different perspetives of the FCP, the author makes a comment on the evolution of the FCP to emphasize the importance of strengtheing traditioal way of FCP in spite of new technological development. Although technoloical advancement may reduce the need of FCP to some degree, the new wave of FCP cannot succeed wihout acomplishng the existing FCP system.

Keywords: Consumer protection. Finance, Philosophy, system. Financial consumer

Ⅰ. Review of the 20th century in the financial market

What is the meaning of the 4th industrial Revolution (automation or digitalization in other expressions[1]), which seems to be a growing issue in industrialized countries and to influence financial service industry more than any others? Although human being have developed nature and environment to their benefits and convenience, reducing their labor or effort, a few recent victories of cognitive computing over human beings both in West and in East[2] has brought serious concerns about jobless world beyond convenience. What is going to happen in financial market and what should be done in terms of financial consumer protection? This short article aims to the answer those challenging questions based upon my personal knowledge and option.

With the beginning of the 21st century, protection of financial consumers (FCP heareafter) has attracted unprecented public attention, probably due to its close relationship with financial crisis, globalization, income disparity, life expectancy, and household debt. The first decade of the 21st century observed an American and an European financial crisis, putting many individual borrowers in financial hardship while transmitting the burden rapidly across border owing to continuing globalization process which in turn contribute to growing income disparity within most of countries. Moreover, many industrialized countries undergo increasing longevity risk and increasing level of consumption, resulting in larger household debt, while developing countries strive to expand financial inclusion.

Back in the 20th century, financial restrictions had prevailed in most of decades prior to 1970s when the fixed foreign exchange regime, or the so called the Brettonwood system, was replaced by floating exchange

† jungprokorea@gmail.com

[1] http://industrie-wegweiser.de/von-industrie-1-0-bis-4-0-industrie-im-wandel-der-zeit/

[2] In the year 2011, IBM's supercomputer Watson defeated the best human player in the US TV gameshow Jeopardy, and in the 2016, British artificial intelligence, Alphago won the Go game with the best Korean player. IBM (2015), The Future of Insurance, IBM Software whitepaper.

rate and in turn free interest rate system. Beginning from the 1970s, financial liberalization has been deepened with internationalization in 1980s (regional liberalization), financial convergence, all finance or bancassurance in 1990 s[3] (sectoral liberalization, so to speak). All of these liberalization put financial consumers on more choices of financial products as well as their corresponding danger, whereas driving financial service providers to more competition, leading to low cost strategy or differentiation strategy for survival. That is, financial consumers begin to face more products with more complexity, lower prices, requiring protection system that used not to be necessary since after the 21st century.

A variety of schemes have been carried out in order to protect consumers' interest in financial service sector, by including enhancing financial literacy among consumers, business ethics among industries and salespersons, self-regulatory system in industry associations, and sophistication of official supervision system. Even international organizations have directly or indirectly been involved in the globally important agenda of financial consumer protection - International Monetary Fund, World Bank, United Nations Global compact, OECD INFE (International Network on Financial Education), OECD guidelines for multinational corporation, Asian Development Bank, and so on. Those intergovernmental organizations serve either for financial sectors in their nature or distinctly for promoting responsible business conduct in any kind. The ISO 26000 and Global Reporting Initiatives are also included in the latter initiatives to encourage ethical management or corporate social responsibility (CSR).

Ⅱ. Philosophical Backgrounds of FCP

Why should we protect financial consumers ? We may answer the question from economic standpoint or from moral fundamental philosophy encompassing the economic concept. While the former focuses on efficiency dimension, the latter may go over that to see the other perspectives covering equity or more. As financial consumer is a type of consumers, the reason for the FCP may be the same as the one for consumer protection in general, given though financial consumption is one of the most crucial, complicated, or fatal one that may be only comparable to health service consumption. Relying on the five different ethical theories[4], we may describe the reason d'etre of FCP as follows.

First of all, utilitiarianism tells us that the FCP provides larger net social benefit, which is total social benefit subtracted by total social cost, to all the stakeholders in society or in economy. The FCP enables both consumers and suppliers in financial market to conclude and sustain more transactions, as traffic light may increase traffics for both cars and pedestrians on the road. Without the FCP, as without traffic light, transaction cost for financial transaction could be untolerably so high that both financial and goods market cannot sustain. Any remaining issue in utilitarianism here may be how much or how the FCP should be conducted in order to maximize social welfare.

Second, (human) right theory or deontology says that financial consumer's right should be protected simply because it is right to do so. As a thing to do right, the FCP should prevail in the financial market, regardless of its outcome or utilitarian value, which is the core concept of the right principle. Although the right may be provided in reality by contract or law to consumer by supplier or government, it can be also considered to be born by nature or by human ration, in order to meet universalizability, reversibility, and respect to human being. As human right grows with economic or social development, the FCP also grows with society or economy, as consumption is an inevitable activity of mankind.

Third, justice is another ethical standard to support the FCP, in spite of the variety of the justice concepts. Included are, to name a few, a classical justice concept developed by the Aristotle, a greek philosopher, and modern justice concepts with respect to distribution, redistribution or compensation. Consumers should be equally treated as long as they are equal (non-discrimination principle or distributional justice), while some consumer group in need may be treated more favorably than other to make up for the difference in starting point (redistributional justice) for financial inclusion, for example. Rawlsian fairness can also explain how to exercise principles of equal liberty, difference, or fair equality of opportunity,

3 for instance, the Financial Modernization Act in the U.S.A. (1999)

4 Manuel G. Velasquez (2012)

when it comes to distributional justice.

Forth, ethics of care is another moral discipline to explain why the FCP is necessary in economic system. Financial consumers are so weaker or more vulnerable than financial suppliers, due to lack of knowledge, information, power, or size in general, that the former group should be specially cared for. As they are so close to the supplier group or as the latter cannot exist without the former, in addition, the latter should conduct the FCP as promoter of the ethics of care. Naturally, financial consumers do rely on financial suppliers too as the opposite relationship is also true.

Last but not the least, moral virtue can be a reason for the FCP. Unlike the others above, actions or decisions, moral virtue imply human disposition or mental orientation toward a certain value system. FCP are closely related to various human disposition such as honesty, hospitality, generosity, friendliness, respect, and so forth. The disposition should be acquired, cultivated or expanded by self training into habitual behaviour.

Ⅲ. Past and Future of FCP

Financial consumer protection seems to be a relatively young concept, probably just ten to forty years old one. As noted before, Financial liberalization and innovation began in 1980s in most industrialized countries, as a result of the end of the Brettonwoods system in 1971. Freely moving interest rates as well as free exchange rates did trigger price and quality competition among financial intermediaries, leading to development of numerous new financial products in banking, security, and insurance markets as well as risk management (derivative) products. Moreover 1980s observed many default of international loan or bank failures mainly mid- or south America. Globalization, as a form of foreign direct investment, became popular in the world in 1990s, in particular in Asian region where its economic growth exceeded Europe or North America, while the 2000s may be recorded as the decade of financial integration, convergence, or universal banking system (including the U.S. where the Financial Modernization Act was created to replace the traditional Glass-Stegall Act). The liberalization, globalization, integration process in financial service sector gave birth not only to the frequently happening financial crisis but also financial consumer protection, which was empowered also by information revolution.

Liberalization, Globalization, and Information revolution appear to play continuing key roles as the FCP's driving force as they were in the recent past. In addition to the liberalization described above, we may consider the globalization as increasing exposure of consumers to ever-increasing financial crisis, strengthening business ethics of financial intermediaries, highlighting the importance of financial literacy of consumers. Moreover, globalization has contributed to growth of cross border transaction or international remittance while also providing unprecedented valuable opportunities to consumers of international transaction. That is, globalization leads to expansion of arena, depth, importance and remedy of the FCP.

Doubtlessly, information revolution, equivalently information communication revolution, has been gaining more and more influence in daily life of people including financial transaction[5]. Having come into a noticeable existence since late 1990s, the internet is now an indispensable element of studying, working, playing, and resting activities of human being, while transforming from personal computer into mobile phone in device. Artificial Intelligence, Big Data, Cloud Computing, Internet of Things, Block Chain, Drone, 3-D Printers are a laundry list of the so -called information revolution, Digitalizierung (in German), or the 4th Industrial Revolution(in Switzeland).

There are many positive effects of the revolution. Once sufficiently developed in technology, for example, driverless car can reduce road accidents enough to lower automobile insurance premium to hopefully lower level than now, while block chain technology may enormously cut down errors and omission that man used to make, contractual (insurance) fraud. Moreover, accidents at road, factory, office, sea, and air could be reduced[6], coupled with smart underwriting and claim adjustment process, by automation, resulting in lower risk management cost comprising of insurance premium amount but higher profitability of insurers over time.

On the other hands, the information revolution may influence human life and society in a negative way. It may curtail job opportunity of people through replacing

5 See Wolter et al(2016) for its overall impact on economy.

6 See CRO forum (2015)

it by robots or machines[7] to widen income disparity in a society, which in turn motivates the insured moral hazard or fraud to make up for the reduced income. On top of that, accurate forecasting of risk or accident can undermine equity by charging unaffordable rate to the high risk and low income group, although enhancing efficiency of insurance system through reflecting in a scientific pricing system. This can be an opposite outcome of the well-known adverse selection problem that high risk group can be fully insured while low risk group can be driven out of the insurance market or only partially insured. This structure of insurance market may not be so socially viable or desirable as to affect social insurance system too.

Another issue related to the information revolution is on individual privacy or right to dispense personal information. A lot of private information is available or accessible nowadays in internet, social media, or email, which reaps and bounds day by day to be collected, traded, and used for business without getting official consent of the information owner. The private information is a such a double-edged sword that, if reasonably combined and transferred, can be an invaluable social asset, but also a source of catastrophe or crime. Banks, credit card companies, insurers handle huge amount of personal information, exposed to the unintentional or malicious disclosure of the information.

Interestingly, speed and size of the information revolution is being perceived differently by countries or societies. Germany seems to be the one of the early adopters to introduce the big technological change in manufacturing industry, under the name of 'industry 4.0', in early 2010s. U.S.A. has been innovating every industry in a slow and steady manner by a newly developing technology, while hesitating to call the change as 'a revolution', but rather 'automation' so far. Switzerland, which the annual Davos Forum hosts, promotes the expression of the 4th Industrial Revolution, after importing from Germany, to transmit to other countries including Korea and Japan. [8]

To adopt a technological change is one thing, and to adapt people or system to the change is another. The U.S. financial system, for example, seems to be the one of the most advanced one in terms of technological development, but with keeping traditional floor way in security transaction until recently, whereas some newly developing countries have introduced highly automated security trading system without relying on human traders. Insurance market shows something similar to that. Although internet sales of insurance is a strategic focal choice for several insurers, they also have a well functioning real-time advisors with sufficient knowledge and expertise that could complement their automated system. That is, competent human advisors work not only with traditional insurers but also with contemporary automated insurers when intensifying their customer relationship management[9].

Despite that automation in financial market may facilitate information transmission without errors, omission, or exaggeration to financial customers, financial consumers do still need simplified financial products, qualified salespersons and their education, an consumer oriented supervision system. That is, automation should not function as a mechanism to bring financial consumers to a worse off position otherwise than before. The technological change may enhance consumers' welfare in some respects, but still leave them in the need of hands-on protection. Therefore, those countries or societies which have not been developed in terms of FCP but can catch up with developed ones with emerging technologies, should not forget what should be done and served for consumers today or tomorrow.

To sum up, on-going globalization and information revolution may reshape the FCP to some degree in style, depth or width, consumers should be still provided with informed advices, quality products, reasonable contracts, impartial infrastructure, transparent counterparties, and reliable grievance mechanism as before. Level of FCP may not be expected to elevate to a satisfactory level for those unsatisfactory societies or countries in traditional standard, while that level for satisfactory societies may be maintained even after adoption of new technology. If that is the case, we will have to keep going for the FCP in the evolutionary or revolutionary era of financial markets, irrespective of its size or speed. Refraining from hustle-bustle instability, experts or the empowered in financial system should ponder what to do for the sake

7 See CEDA (2015) and Accenture (2016), Digital Disruption, Accenture Strategy. Unlike conventional wisdom, employees are not a barrier to digital progress, yet they expect it to improve their work experiences and job prospects and proactively seek out the skills they need.

8 http://m.heise.de, (13 November 2016), Studie: Nicht weniger aber andere Arbeitzplaetze in der Industrie 4.0

9 CRO forum (2015), op.cit, p.14,

of both consumers and providers, comparing social costs and benefits, to help reduce financial divide inter nations or intra nations.

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