

PUBLIC INTEREST IN FINANCIAL SYSTEM LAW¹

MICHAEL KOHAJDA²

Abstract

This paper deals with issues related to public interest and financial system. He brings several general arguments regarding the actual legal regulation of financial system, asks about reasons for such detailed regulation and discovers the public interest in financial system law. In addition, the author defines the term “financial system” and “financial stability” in the paper because there can be found a lack of their broadly accepted definition in recent legal scientific literature, therefore the author offers his own definition of these terms. In the middle part of the paper, there can be found several important reasons in behalf and against the actual high level of legal regulation of the financial system. In concrete, namely a high level of risk, a high profitability of undertaking business in financial services, an asymmetry of information in the relationship between a financial institution and its client, a protection of clients, restriction of the competition of financial institutions or costs of regulation requirements fulfillment are mentioned and analyzed.

Keywords

Financial system; financial stability; legal regulation

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2 Associate Professor for Financial Law and Financial Science, Department of Financial Law and Financial Science, Faculty of Law, Charles University, Czech Republic. The Author specializes in financial system law, capital market law and banking law. He is the author or co-author of 5 books and more than 40 reviewed articles in prestigious journals.orcid.org/0000-0001-7235-0921. Contact email: kohajda@prf.cuni.cz.

1 Introduction

The financial system is a branch of social life that is broadly and in detail regulated by law. But the question what the reason for such level of regulation is can be asked. This question is more important when an existence of the public interest is analyzed in different branches of law comparing the importance of legal relationships in such branch for the public. According to opinions of many Authors the actual progress in legal regulation of the financial system is determined by the complexity of the financial services and the relationships between financial institutions and their clients (Cooley, 2010: 73).

It can be found surprising why the field of demand and supply for financial assets shall be regulated in such Broadway. Where else than in this branch shall the invisible hand of the market (i.e. autoregulation) take effect? But in the real world, this concept does not prevail, and it shows just as a theoretical and not relevant idea, on the contrary, practical experiences ask for detailed legal regulation of financial system for many reasons and the public interest is one of the most important ones.

The general need for the existence of binding rules of behavior in the financial system arises from the fundamental fact which can be also found in all other branches of social life, i.e. the fact that in the financial system subjects enter social relationships which must be regulated by legal rules for their functionality and public enforceability. Respecting the complexity of legal relationships in the financial system and general inequity of subject entering legal relationships in knowledge and possession of information, it is necessary to put public law requirements onto the primarily private law relationships that in the financial system are not much different comparing to any other, ordinary private law relationships in general social life. The public law regulation establishes second, the upper layer of legal regulation above the fundamental private law regulation of legal relationships, the second layer contains much detailed regulation which is usually composed by mandatory legal rules regulating rights and duties in the concrete legal relationship. It is important to realize that in fact in relationships in the financial system there cannot usually be found proper equity between subjects which, in general, is the fundamental principle of private law relationships, therefore the secondary regulation by public law is needed.

The example of a concrete public interest can, of course, be brought from the conduct of business regulation in the financial system (it shall be mentioned that the public interest can be also found in the prudential regulation of the financial system). The mentioned inequity is, for example, obvious in the relationship between the financial institution and its possible client who is the natural person not undertaking any business. There is no equity there regarding the amount of information,

therefore there is very small possibility of the possible client to make an informed decision according to real will. The financial institution has expert knowledge, high practical experience, and ability. On the contrary, the possible client has nothing of this but usually has a necessity to enter the relationship with a financial institution (for example he needs to have a payment account). In fact, such possible client must choose among several concrete financial institutions on the local market, but every of them starts negotiation process with a previously prepared agreement of concrete content, very often so-called form agreement, and it does not allow to negotiate about any particular provision of it, the possible client can only decide to accept the prepared agreement or to refuse it and try to find out other financial institution (which unfortunately probably will offer him very similar agreement conditions as the previous one). In fact, the possible client has no real choice and he will sooner or later accept an offer of a financial institution because he needs a concrete financial service.

On the other hand, it must be admitted there is no other reasonable possibility of financial institution's position because of legal regulation of its behavior as well. An allowing of negotiation with every person who is interested in its financial services would mean high costs because it would require quite complicated and formal process of approval of every made change to fulfill all requirements of legal regulation on internal process inside the financial institution. The aim of the public legal regulation is not to change the process between a financial institution and its possible or existing client, but to set conditions that will adjust the unequal position between them to allow establish a fair legal relationship.

2 Financial System as Legal Term

When the term “financial system” was already mentioned several times, it is necessary to bring a definition of it, at least for the purpose of this paper. The term is quite broadly used in the legislation of the European Union and its member states, but (and it can find out as a relative surprise) there is no real legal definition of it. Only exception is the Regulation (EU) no. 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union Macro-prudential oversight of the financial system and establishing a European Systemic Risk Board that in Art. 2 defines the financial system as all financial institutions, markets, products and market infrastructures – but this cannot be considered as enough in-depth definition of this term.

When it is being looked for the meaning of the term “financial system” it shall be started in economics because in this case law follows the economics, it regulates economic phenomenon. Therefore, for reaching the definition it is important

to briefly describe functions that shall be fulfilled by the financial system in the economy. The primary aim of the financial system is to allow to treat with financial assets in different forms. The relatively redundant financial assets are collected and deposited through financial institutions with the aim to do not let them stay at the subject with their surplus. These financial assets do not be usually kept in their original form, but they are transformed into a form of accounting records with the simultaneous use of the same assets in the original form for different purposes, mainly for the purpose of lending. The monetary assets can be changed for financial or real investment instruments. This deposition of redundant financial assets through the financial system shall protect them from depreciation, or (in better case) it shall bring their appreciation in time. The financial system shall offer a general protection against a sudden depreciation (a loss) as well enabling dislocation of assets in place or object.

Another important function of the financial system is a mobilization of money, particularly an enabling of payment services, i.e. settling financial transaction through the transfer of monetary value, that is organized by the public (usually a central bank) or private (financial institutions) subject. This function is very important one which differs the financial system from financial markets that particularly enable investment of redundant financial assets.

These functions of the financial system are important not only from a perspective of private subjects, natural persons or commercial entities but from a perspective of public subjects including a state itself as well. Every state is very dependent on properly functioning financial system from the budgetary incomes point of view, the state gets obligatory levies through it, from the credit financing point of view, the state borrows financial assets in the financial system, or from the budgetary expenses point of view, the state distributes financial assets to relevant subjects or makes payments for acquired goods or services through the financial system.

Every system consists of elements and relationships among them. In case of the financial system, subjects can be considered as elements (subjects having redundant financial assets, subjects with the need of financial assets, subjects allowing and organizing transfers of such financial assets and subjects acting as oversight authorities) and these subjects enter legal relationships according to general binding legal regulation.

In summary and particularly, the financial system can be defined as the sum of all kinds of financial markets including their subjects who meet with their demand for and supply of disposable financial assets and subject who provide their financial services mainly for the previously mentioned subjects and the relationships among them, at the same time in summary these subjects and financial services provided

by them create infrastructure enabling constitution, change and termination of legal relationships concerning a treatment with financial assets (deposit, transfer, exchange for instruments traded on markets, lend to others etc.) as their object and the sum of these relationships shall be included into the financial system as well. Further, authorities of secondary regulation and supervision, mostly public origin authorities, who use their powers to produce legal regulation, to decide in individual cases and to compare behaviour required by legal regulation with actual behaviour of concrete subjects with possible subsequent inference a penalty from a breach of legal regulation shall be included in the financial system as well.

3 Financial System Stability as Public Interest

The most important reason for legal regulation of the financial system in actual quantity and quality of legislation consists in the interest of a state in well-functioning, sound, healthy and stable financial system that has lack of negative deflections caused for example by the bankruptcy of more important financial institutions or dysfunction of infrastructure used for financial services.

Financial institutions, mainly the biggest of them as banks, insurance companies or fund management companies, can impact the whole financial system by their behavior. It is necessary to realize that the well-functioning financial system is the fundament of the economy of each economically developed state, therefore the well-functioning financial system is the economic and legal interest of every state and the state protects the financial system by its best possible legal regulation. The public interest can be in general found in the financial system as the aim to do not allow subjects included in the financial system to behave just according to their will, but to regulate their behavior to reach a protection of the financial system and all subjects within.

As was mentioned in the introduction, the legal regulation of financial system can be differed into two parts according to two main aims of such regulation, i.e. regulation of conduct of business requirements and prudential requirements, public interest can be found in both, but general aim of the public interest in the financial system is the stability of the system itself, i.e. the financial stability.

The term “financial stability” is not legally defined, but broadly used in the legislation of the European Union as well. The financial stability can be found as the situation in the financial system when the financial system fulfills its above-mentioned functions properly, without any serious malfunctions or undesirable results for the actual or future development of the economy and when it is resistant to any serious problems.

It is a usual aim of central bank's or any relevant authority's activity to reach and maintain the financial stability besides its other main aims, but some authors are quite skeptical about real action readiness in this field. For example, Goodhart called the Bank of England's commission that was responsible for issues related to the financial stability as "talking shop" (Goodhart, 2009: 31).

According to Theissen the term financial stability can be interpreted many ways, but he connects this term mainly with stability of banks and founds it as caring about prevention of risk of infection in case of run on bank that does not put just such bank in jeopardy but can be a threat for other banks and all system too (Theissen, 2013: 46). And for example, Crockett defines the term of financial stability as a situation when financial institutions and markets are able to mobilize savings, offer liquidity and allocate investments effectively without any disruptions (Crockett, 2003: 44).

4 Selected Aspect of Financial System Regulation

There can be found several relevant reasons for a broad regulation of the financial system. A potentially high profitability of services provided as the business in the financial system can be found as one of them. It is necessary to realize that money of customers is directly handled by financial services providers and it is very easy to transfer money all over the world in our highly globalized world or it is possible to invest a huge amount of money by one click on keyboard and to lose them.

The potentially high profitability of financial services attracts even subject who are not lead by positive intentions of honest business but by crooked thoughts for quick getting rich. Therefore, a stricter legal regulation of entrance to the financial system and providing of financial services shall be imposed, especially requirements of authorization on subject or requirements on capital used for establishment of such business. Other very relevant reason in behalf of a strict legal regulation of financial institutions' activity is an asymmetry of information in the relationship between a financial institution and its client. Asymmetry of information can be defined as a situation when theoretically equal parties of legal relationship dispose of the diametrically different sum of information necessary for the decision about such legal relationship, this difference can be in quality or quantity of such information. When a person, especially a consumer, enters into a legal relationship with a financial institution his contractual partner is very well equipped with knowledge, experience, professional staff or advisers. Therefore, the theoretical civil equity of contractual parties is not reflected in practice. The public legal regulation shall equalize this inequality between the parties by enforcement of obligatory contractual conditions in rights and duties of such legal relationship, by enforcement of a financial institution to provide its client relevant and understandable information

regarding to the legal relationship or providing a client by concrete contractual rights in his favour, for example a right to terminate the contract in concrete period after its conclusion or a right to use a mechanism existing to protect rights of clients (e.g. deposit insurance scheme).

Without the public legal regulation that is a superstructure of private legal regulation as the base for legal regulation of mutual rights and duties between a financial institution and a client, it would not be fulfilled even fundamental principles of private law, especially the principle of equality of contractual parties. Furthermore, for example, Gray and Hamiltons say (2006: 199) that in case of consumers their bad decisions, if and which financial services are suitable for them, arise under influence of lack of relevant information; often the lack of relevant information is the reason why consumers do not use concrete financial service at all. The related reason for broader legal regulation in the financial system is the protection of clients (or in narrower meaning consumers).

Gleeson's opinion in the branch of banking can be considered as appropriate for all financial system (Gleeson, 1999: 6) – banks do not act in behalf of their clients but enter with them business relationships (e.i. trade with them for the creation of profit). And the financial system is based on trust of clients in the sound functioning of the financial institutions and financial system that they are part of. Carnell, Macey a Miller appositely state (2013: 291) that for long ages there was only one binding rule in banking protecting clients – the ban of usury. But this minimalistic regulation is already overcome and nowadays we are in the completely opposite situation where banking, as well as the rest of the financial system, is overregulated. According to Bonneau (2014: 330) the protection of client is rationalized not only by his weaker position as a party who shall be protected but its aim can be found as improvement of client's confidence into the financial system and financial institutions, because only with this confidence the system can be more effectively functioning. Particularly the European Union single system where the financial services are provided over borders and concrete financial institutions do not have to be well known in a country of financial service providing (and therefore not enough credible, because in general people do not trust things they do not know), and without proper legal regulation and following supervision the confidence into unknown institution shall not have to be sufficient to let these financial institutions compete with local financial institutions on fair market.

On example of banking, it is possible to illustrate the importance of client's confidence for sound functioning of the whole system. The business activity of commercial bank is based on voluntary deposits of the public, the gained financial assets are further lent for higher interests that are paid to depositors whose financial assets are used. Furthermore, it is typical for banks that the financial assets are

borrowed from depositors for short time period but borrowed to bank's debtors for the long time period, this time imbalance cannot be found in different kinds of business than banking. For this functioning of banking, it is necessary that the depositor have adequate confidence in banks to provide them with their money, not to keep them at home or to invest them in another way. In this situation, the quite broad legal regulation of the relationship between depositor and bank takes place with the aim to increase depositors' confidence. This aim can be reached by several ways. One of them is a limitation of subjects allowed to accept the deposits from the public, requirements of the fulfillment of more strict conditions to run a business as a bank can be the second one. This legal regulation is usually supplemented by a special regulation of the situation when a bank is not able to pay back the accepted deposits, e.g. by a creation of deposit insurance scheme.

In case of the Czech Republic, actual system of deposit insurance scheme (which is harmonized in all EU countries) is so generous that it covers the majority of existing deposits from the public (it ensures to recover 100% of deposits by the limit that is higher than the majority of existing deposits from the public). It is even so generous that it can distort a basic investor's triangle – to eliminate a risk of the non-returning deposit back. A depositor who knows this fact, therefore, can only choose among interest that is offered by banks. This could be an example where it can successfully be doubted correctness of legal regulation of such social relationships. Now, it can be mentioned several reasons against this high level of legal regulation of the financial system, i.e. negative aspects of such regulation. One of the fundamental reasons against the actual level of regulation is a restriction of the competition of financial institutions or subjects willing to undertake business in financial services. It is necessary to agree with Goodhart (Goodhart, 2012: 321) that if the regulation of financial system shall be effective it simultaneously imitates regulated subjects in achieving of preferred and unlimited position and often decreases their profit and has the bad influence on their capital. In his different work (Goodhart, 2009: 101) can be found the conclusion that regulated subjects willing to reach a protection of their business look for any possibility how to enter non-regulated areas of similar activity to use more profitable opportunities.

Restriction of competition is mainly caused by strict requirements of the entrance of business subjects into providing of financial services. Usually, there are more strict conditions regarding a minimal capital, personal and technical apparatus or establishing of internal processes. Sources of capital are examined very often as well to find out a real owner of the subject or to eliminate a risk of criminal activity or terrorism origin of the financial assets. Because the fulfillment of such criteria is usually very complicated and demanding the entrance into the business is restricted just on several subjects who later do not have to have, especially in small

economies, stronger motivation to compete on the market of financial services. In case of the EU, this negative can be overcome by cross-border provision of financial services which is very common activity in this area where a concept of the single European passport for financial services exists.

It shall be mentioned that there can be found different opinions on the relationship between legal regulation and market competition. According to Crockett (Crockett, 2003: 55), well-functioning market environment in the financial system shall eliminate badly functioning financial institutions or markets and at the same time to stimulate development of prudential and effective practice. Another negative aspect of broad legal regulation of the financial system relates to the market competition, this aspect consists of the high cost of fulfillment of requirements stated by such regulation.

The fulfillment of the very high number of legal regulation costs regulated and supervised subject high amounts of money. It comprises a necessity to set up all processes, to prepare contractual documentation etc. according to regulation requirements, later to fulfil continuous information obligation towards a supervisory authority or authorities that on their basis and after their evaluation find activity of supervised subject as according, or against the legal regulation and possibly deduce other conclusions (sanctions, penalties etc.). Resultant amount of information obligation of the financial institutions undertaking their business in several branches of financial system depends on the used model of institutional organization of the financial system supervision, i.e. number and system of supervisory authorities.

The connection between costs and the market competition in the financial system can be considered even in more concrete aspects. The caused costs for the fulfillment of regulatory requirements are included into the price of financial services by financial institutions and the price is (of course) paid by clients of such financial institutions (or they are calculated as cost and have an impact to interest paid to depositors). Different branches of business or concrete financial services legally not regulated in such way gain an advantage of lower costs and can be provided for lower prices or bring higher interests. Therefore, even traditional financial institutions try to discover how to avoid concrete legal regulation and to create similar financial services or schemes that would bring advantages for customers, profit for the institution but would not belong under the regulation.

5 Conclusions

The main aim of this paper was identified a public interest in the financial system law. The public interest is the immanent component of every legal regulation

because otherwise any concrete relationship would not be regulated by law if it was an interest just of an individual.

The general and the most important public interest in the financial system regulation and simultaneously the most important aim of this regulation is the stability of the financial system itself. The stability has many aspects and an aim to reach it can be found in the regulation of majority of legal relationships in the financial system.

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