# The Financial System as a New Theoretical and Legislative Term

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**Abstract**

The aim of this paper is to define the basic characteristics of the term of the financial system as a legal term. In the paper, the author finds the absence of a general or a legal definition of this term in both the Czech scientific and practical environment as essential, as this term is already used in the Czech positive law. At the same time, he briefly defines the terms of the financial markets and the capital market as terms different from the term of the financial system. This objective is fulfilled by the author with the aim of the use of the term financial system (but also the financial markets or the capital market) in a labelling of the financial law sub-branch.

**Keywords**

capital market; financial markets; financial system

## 1 Introduction

In the last several years, we can be witnesses of an evolution of financial law terminology in its sub-branch of legislation on financial markets and relevant areas that include legal regulation of financial institutions, financial markets and financial assets, as well as a supervision over these branches. For the last twenty years, from the political and subsequent changes that began in 1989 in the Czech Republic, the original and traditional financial science preferred the term of the financial market as the fundamental

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term for labelling of such sub-branch of the financial law – therefore the prevailing Czech terminology used for the sub-branch was the financial market law (Bakeš et al., 2012: 13).

Presently other opinions[2] occur that found this terminology outdated and not in conformity with the actual legislation, practice and even theory of scientific institutions abroad. The main aim of the paper is to arrange the terms of the financial system, the financial market (or better the financial markets) and the capital market into mutual relationships and a cohesive system.

The reasoning contained in this paper is important not only from a point of view of financial law. Nowadays, it is very often a habit to label sets of legal norms as a certain law. This leads to the unsystematic and utilitarian creation of legal (sub-)branches of law, to the atomisation of the existing legal branches and sub-branches, when the names appear as sport law, medical law or gender law. In such cases, they are just a group of legal norms which do not have to have their own principles, their internal system, etc., which are otherwise definitional characteristics of each legal branch. This conclusion should not be conceived negatively, as this legal and other practice does not mind this relative unsystematicity and ignorance. On the contrary, it facilitates its activity, since it is not unnecessarily burdened by legal norms which are not need in its area. Even the general legal theory admits that even the basic distinction between the legal subsystems – private law and public law – has very limited practical significance and has always been and is unclear (Knapp, 1995: 68). The same applies to the subsequent breakdown into legal branches within these two sub-systems of law.

On the contrary, legal theory should address these issues in more detail. The internal systematics of legal branches within the system of law is an important problem that must be investigated so that individual legal norms can be classified (ideally) into an intrinsically non-intrusive system that is arranged according to the degree of similarity in sets and subsets of legal norms contained in individual legislation or defined by an authority acting in the case law. Therefore, between the terms the financial system, the financial market(s) and the capital market, mutual relationships should be found.[3]

## 2 The Financial System as a Legal Term

The youngest of the analysed terms, as to the tradition of its use, is the term financial system. This term has come to the forefront of law in particular because of legislative work that has responded to the global financial crisis that began in 2008 in the United States of America. The term started to be used first in the European Union's legislation and subsequently in the legal systems of its member states.

2 See Kohajda, 2016: 36–39.

3 This paper has been elaborated within the project of the short-term international stays of academics which is realised in the year 2018 at the Faculty of Law of the Palacky University in Olomouc.

When looking for the meaning of the legal term of a financial system, it is necessary to look at economic works, as the law reacts to and follows economics. Rejnuš reacts partly on this issue, he generally states that a financial system is always an integral part of an economic system; however, such a broad economic concept is in this case unsystematic in a legal point of view, as the author further states in the footnote that the financial system may include, inter alia, social security institutions (Rejnuš, 2014: 41), but it is impossible to agree with this concrete addition from the point of view of legal branches system and it is necessary to be more precise in the legal definition of the term financial system.

A wider view on the term of a financial system is in place only if it is limited to the legal relationships that arise, change and disappear and their elements that are the object of financial regulation, both purely public and legal regulation of extended segments of financial law, which have an overlap in private law branches.

The financial system is the broadest in terms of content in the examined terms of this paper. To better understand its content, it is necessary to define at least briefly the functions that the financial system should fulfil in a functioning market economy. The primary purpose of the financial system is to enable the handling of financial funds in all different forms. It involves collecting and storing surplus financial assets through financial institutions so that they do not stay with people experiencing their relative surplus. These funds are retained in their original form or more often converted into accounting records while using identical funds in their original form for other purposes, in particular, their subsequent use for lending. These funds may be converted into financial or real investment instruments. This investing of relatively redundant money through the financial system should avoid devaluing them, or at best to let them appreciate over time. The financial system should also provide general protection against the risk of sudden depreciation by allowing money to be deployed at both the site and the subject.

However, the essential function of the financial system is also the mobilisation of money, especially the provision of payment, which is organised both by a public body, usually in the form of a central bank, and by private financial institutions. The organisation and implementation of the payment system is a very important function of the financial system that distinguishes it from financial markets, which focus on the functions of depositing or investing surplus financial assets with entities with their relative surplus and their use by entities feeling their lack.

All of these functions are important not only from the point of view of private persons, individuals of non-business and corporate and commercial corporations, but also from the point of view of public bodies, especially every state itself. The state is dependent on a properly functioning financial system, both in terms of its budget revenues, which flout through the financial system, it earns the revenue from the mandatory monetary fulfilment it authoritatively leverages, as well as the means of credit financing its deficit management and its budget expenditures, distributing money through the financial system to its employees and persons as retired people or people in social needs through the financial system, makes payments for purchased goods and services or distributes money to other public entities.

From a theoretical point of view, it is necessary to come out from the general understanding of any system as a set of individual elements and relations between them, which are realised through certain objects. Applied for the financial system: its components are individual entities, namely those from whom funds originate, those to whom financial funds are directed, and those who allow and organise the movement of those funds. All these entities are organised through smarter subsystems, which we usually refer to as individual types of financial markets (i.e. money, capital or foreign exchange).

Over all these entities there are entities that have the right to compare the concrete actions of all these entities with the actions required by the provisions of the applicable legal norms, or in the case of a discrepancy detected, to interfere with such situation, to enforce the correction of this negative state and the remedy or to impose a sanction, the resulting negative state was punished. Subjects through which the relationships in the financial system are made are not only the original form of money, but all money-back instruments that can be exchanged to better perform the functions of the financial system.

Finally, it is possible to define the financial system as a sum of all types of financial markets including those subjects who are confronted with the supply and demand for relatively disposable funds in such markets, as well as entities providing financial services, especially to those subjects that engage in the markets. These entities and the financial services provided by them together create an infrastructure enabling the establishment, modification and termination of legal relationships dealing with the handling of financial funds, in particular their deposit, exchange for other forms of instruments tradable on markets, even lending to other entities and transfers of such funds between entities, and the sum of these legal relationships should be included in the financial system. Subsequently, the financial system is complemented by secondary regulators and supervisors, mostly of a public law nature, exercising powers consisting in the creation of legal regulation, in authoritative decision making and comparing of the situation requested by law and actual behaviour of the entities involved in the financial system with possible consequential deduction of the implications of the envisaged legal regulations.

Given the novelty of the use of the term financial system in legal regulation, it is appropriate, without being a direct subject of this paper, to briefly define also the term of stability of the financial system, for example, in the abovementioned case, the provisions of the Act on the Czech National Bank. This term also does not have its legal definition and therefore needs to be defined by the doctrine, but there is so much agreement among the various authors that they do not agree on a uniform definition so far.[4]

4 See Theissen, 2013: 1133.

The stability of the financial system should be seen as a state of the financial system where the financial system is free from serious disturbances and is resilient to current or future systemic fluctuations where the primary interest lies in the care of the stability of the local currency which is achieved through the proper fulfilment of monetary policy through monetary policy instruments and the stability of individual entities performing there, significant activities of the financial system, in particular financial institutions. A part of achieving the stability of the financial system is also preventive actions of the competent authority, which should prevent those situations that are likely to generate fluctuations that threaten financial stability in the future.

## 3 Financial Markets and Capital Market as Different Terms

Much more traditional terms in labelling of legal sub-branches are the terms of the financial market and the capital market. In the Czech legal theory, the financial market (but I consider the designation of financial markets more appropriate) is a concept that refers to a system of relationships, instruments, entities and institutions that allow collecting, concentrating, distributing and deploying temporarily free financial assets on the basis of supply and demand, the financial markets allow the redistribution of available financial assets resources on a voluntary, contractual principle. This definition includes the determination of the main purpose of the existence of the financial markets, which is the redistribution of disposable financial funds from entities experiencing their relative surplus to entities experiencing their relative deficiency. It is therefore allowed to use free financial funds for the activity of other persons than their current holders, with the supposed benefit to both sides of the relationship. The debtors of these relationships can be entrepreneurs who will use the financial funds obtained for the development of their business, but also non-entrepreneurs who use the obtained funds to meet their current needs, which are not currently available to be covered for them.

The defining characteristic of the financial markets is to enable indirect financing of business activities and the current needs of non-business entities. They are an alternative to direct financing where there is a direct relationship between the creditor and the debtor without the activity of any third party. On a broader scale, however, it is unrealistic that financing of business activities would be directly financed because the creation of a direct financing relationship is very difficult (finding the appropriate entities to enter into a specific contractual relationship, negotiating the terms of this relationship, reinsurance, etc.) and involves low liquidity. Therefore, the existence of a functioning environment for indirect financing is necessary for the proper functioning of the market economy. Financial markets are precisely those environments in which indirect funding can be effectively carried out.

Financial markets are further treated with financial funds that cannot be considered financing, such as the exchange of individual world currencies on the foreign exchange market. This function of the financial markets is essential for the proper functioning of international trade relations when it allows the goods or services supplied to be redeemed abroad.

These fundamental functions of the financial markets distinguish them from the financial system of which they are part (subset); the financial system, as mentioned above, has a broader function – it ensures the stability of local currency funds or the movement of funds not only for the purpose of indirect financing even for direct financing or for current payments for the provided services or delivered goods or for any other transfers of funds between entities, whether on an equivalent or non-equivalent basis.

The capital market is then one type of financial markets. The general theory is that the financial markets are divided according to the instruments traded in these markets (considering that the primary function of financial markets is the implementation of indirect financing – from the point of view of the lender of investment, it can be said of financial investment instruments). The usual division of markets is based on the maturity of the financial investment instruments when the relevant period of maturity is one year. The financial investment instruments with a maturity of one year or less (short-term loans or short-term securities such as bills of exchange or treasury bills) are traded on the money market, financial investment instruments with longer maturity are traded on the capital market (long-term loans or bonds, mortgage bonds, etc.) or equity securities (shares or stock certificates).

The capital market is therefore a market of medium-term or long-term loans, medium-term or long-term securities or equity securities that do not mature as a character of theirs.

The primary function of the capital market is to allow indirect long-term financing of entities wishing to develop their business activities, relatively surplus investors' money is the source of such financial funding. It is the primary market where newly issued financial investment instruments are exchanged for investors' money. However, the capital market also makes it possible to monetise purchased financial investment instruments as soon as their holders feel the need for more liquid money. Thus, the capital market provides for the desirable liquidity of financial investment instruments, when it organises contractual relationships, the subject of which is previously issued financial investment instruments, this part of the capital market is designated as the secondary market.

Thus, the capital market is one of the financial markets whose purpose is to organise and regulate the establishment of legal relationships whose primary objective is to obtain financial funds for the development of business activities on the one hand and to enable the available funds to be valued over time on the other, to allow the disposal of already held financial investment instruments by selling them to another investor. Thus, the capital market enables the activation of capital in favour of the economic development of individuals or, in the aggregate, the entire society, on the principle of long-term investment of funds.

# 4 Conclusion

The term of the financial system is recently a new term in legal terminology, both in theory and in the recent Czech legislation. Its most important legislative use is in defining the fundamental aims of the Czech National Bank in the Act on the Czech National Bank,[5] whereas this term also came into this act for reasons of harmonisation with the EU legislation. However, neither in the EU legislation nor in the Czech legal order there cannot be found a definition of what the financial system means (except for the general definition contained in the regulation which established the European Systemic Risk Board, which only defines the financial system for needs of this concrete regulation as all financial institutions, markets, products and market infrastructures). Because of the lack of a legal definition, the interpretation of this term is particularly important for legal science.

The author of this paper offered such definition to readers as a sum of all types of financial markets including those subjects who are confronted with the supply and demand for relatively disposable funds in such markets, as well as entities providing financial services, especially to those subjects that engage in the markets.

The author also justified the relationship between the terms of the financial system, the financial markets and the capital market. From the point of view of today's utilitarian labelling of sets of legal norms, the author does not consider it erroneous if the denomination of financial market law or capital market law is used, but he insists on the necessity to emphasise that precisely because of the content context among these different terms.

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[5] More precisely, provision sec. 2 Art. 1 of Act No. 6/1993 Coll., on the Czech National Bank, according to which the Czech National Bank "[c]ares on financial stability and on the safe operation of the financial system in the Czech Republic".