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PUBLIC INTEREST AS A DETERMINANT OF STATE INFLUENCE ON THE FINANCIAL MARKET IN THE EUROPEAN UNION

Abstract

The article discusses the issue of the influence of public interest on the regulation of the financial market. The basic challenges for regulators associated with the dynamic development of this market are presented. A new regulatory paradigm aimed at introducing and implementing values necessary for the proper functioning of the financial market is discussed. The need to protect non-professional participants of this market is emphasized in particular. A new approach to the consumer model is taken into account where the rational consumer has become more susceptible to emotions and irrational behaviors. The special role of financial market stability is highlighted, which has become a kind of public good that is subject to special protection. The way in which public interest materializes in financial market regulations, not only in statutory law but also in soft law norms, is also discussed.

KEYWORDS

financial market, consumer protection, FinTech, behavioral economy, financial stability, financial education

SŁOWA KLUCZOWE

rynek finansowy, ochrona konsumentów, FinTech, ekonomia behawioralna, stabilność finansowa, edukacja finansowa

1. INTRODUCTION

The financialization of life increasingly affects the functioning of individuals and entities. It is important to take into account public interest, especially the core values that are necessary to maintain the stability of the financial market. The dynamic development of the financial market, associated with technological progress and the emergence of new, innovative financial institutions offering a wide range of innovative financial services in the borderless cyberspace of the globalizing world, creates new challenges for regulators. The aim of the article is to indicate the values that must be taken into account when creating proper regulations and the type of norms that would most effectively introduce them into the legal system. These norms should ensure freedom of competition and freedom to conduct business but also take into account public interest manifested in maintaining the greatest value, which is the stability of the financial market.

2. BASIC VALUES OF THE FINANCIAL MARKET

In general terms, the financial market is the place where, based on money and financial instruments, contracts for the purchase and sale of various forms of capital are made. It plays a key role in the economy by enabling the mobilization of capital, its allocation, monetary turnover, capital valuation, and risk management. Financial markets are becoming increasingly complex due to interconnectedness, globalization, significant and dynamic technological development, and the provision of new services by innovative institutions in the Financial Technology (FinTech) sector.¹

With a few exceptions, local financial markets are exposed to internal stressors arising from the characteristics of a given market, as well as difficult to predict and manage external risks that ‘infect’ structurally and institutionally related markets. The dynamic development of technology has had a huge impact on finan-

¹ D.W. Arner, J. Barberis, R.P. Buckley, *The evolution of FinTech: A new postcrisis paradigm?*, Georgetown Journal of International Law, Vol. 47, 2016, p. 1271.

cial markets. The possibility of almost cost-free global communication across the entire globe has marked the emergence of cyberspace, which is an important area of activity for financial institutions. It allows the provision of an expanded range of services without territorial boundaries, resulting in a significant reduction in costs.

The financial market is an element of the broader social system exerting significant influence on its functioning, co-determining the values within it, and satisfying social needs. For its proper functioning, it is necessary to adhere to a catalog of values without which the market could not exist and which it embodies. The very basis of financial markets, namely money, is grounded in socially accepted values, particularly trust (as 'fiduciary money' means 'faith-based money'). Trust is based on a unique social bond between members of a community. It plays a crucial role in ensuring the security and stability of market participants. These values may seem as abstract and detached-from-reality postulates that do not quite fit the financial market, which is largely based on information, knowledge, and often complex mathematical analysis. However, these values are the foundation and the *sine qua non* for the proper functioning of the financial market and its realization of the functions and tasks assigned to it. The financial market's functioning should be based on values that reflect the content of the public interest, highlighting the importance of their implementation by the legislator. Thus, it is necessary to view these markets in a broader axiological dimension.² Legal regulations of the financial market are primarily public in nature, containing the legislature's sovereign determinations on the rules for establishing, organizing, managing, financing, and protecting institutions operating within this market. Public interest creates the possibility of transferring to the law the instruments of expediency through which the state can affect the financial market's functioning. Thus, the state's actions in the area of legal regulations are taken in the public interest through the protection of the fundamental values of the financial market. At the same time, the dynamically changing financial market environment requires regulatory adaptations, which present new challenges for regulators.

The values that operate throughout the single financial market of the European Union are primarily aimed at ensuring its proper functioning, stability, security, transparency, and market confidence, as well as protecting the interests of its participants, providing reliable information on its functioning and achieving the objectives set out in the laws regulating its various sectors. The European System of Financial Supervision (ESFS) has been designated to oversee compliance with these values in the financial market. Its main objective is to ensure consistent implementation of financial sector regulations in a way that preserves financial stability, increases the level of convergence of supervisory practices among

² T. Nieborak T., *Rynek finansowym jako dobro wspólne*, Poznań 2016, p. 167.

national financial supervisors, enhances confidence in the financial system as a whole, and provides adequate protection for consumers of financial services. The ESFS consists of the European Systemic Risk Board, the European Supervisory Authorities,³ the Joint Committee, and the supervisory authorities in each member state.⁴

The values indicated above are interdependent, intertwined, and complementary to each other. However, it should be noted that the stability of financial markets is a fundamental value and its importance for the economic situation of countries is so momentous that it has rightly been recognized as one of the public goods which is subject to far-reaching protection. The stability of the financial system acquired significant, even primary importance during the global crisis of 2007. It became necessary not only to identify its sources and take *ad hoc* measures to estimate losses but also, and primarily, to define programs for creating conditions for implementing strategic long-term projects. In place of the belief in the rationality of financial markets and the conviction that there is no need to intervene in the financial system, which is efficient and safe thanks to private risk management at the level of individual institutions subject to micro-prudential supervision, a new consensus has emerged. According to the new paradigm, the market is unstable, pro-cyclical, and prone to herd behavior. For the new consensus, the macro-prudential perspective and the protection of consumer rights and interests are essential.⁵

When analyzing financial market stability from a macroeconomic perspective, special attention should be paid to issues related to monetary policy, prudential supervision, ownership supervision, as well as legal and technological safeguards. Monetary policy, whose main purpose is to influence the money supply and regulate its circulation to ensure monetary equilibrium and maintain monetary stability, is carried out by central banks. It affects the money market and its proper implementation is necessary to ensure an adequate level of stability in this market, as well as in other markets related to it. The prerequisites for effective prudential supervision of financial market participants include autonomy to prevent influence from other entities, adequate norms and standards for implementation, and data for decision-making. Sound corporate governance is very important, as its effectiveness is necessary to maintain the stability of the entire financial system.⁶ Nowadays, it is not enough to simply know who the share-

³ European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA).

⁴ Financial Supervision Commission (KNF) in Poland, obliged to protect the above values in Article 2 of the Financial Market Supervision Act (Journal of Laws of the Republic of Poland: Journal of Laws 2022, item 660).

⁵ P. Błaszczuk, S. Zwierchlewski, *Stabilność finansowa jako dobro publiczne*, Zeszyty Naukowe Uniwersytetu Ekonomicznego w Poznaniu, Vol. 139, 2010, pp. 7-25.

⁶ P. O. Mülberr, *Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms*, ECGI – Law Working Paper No. 130, 2009, pp. 1-23.

holders of a financial institution are; it is also important to know who controls the shareholders and the degree of concentration of their control, how ownership rights are enforced against the entity, as well as who influences its strategy and how. It is also necessary to guarantee the security of transactions performed in the capital markets.

3. CONSUMER PROTECTION ON THE FINANCIAL MARKET

Although the 2007 crisis had many systemic sources, one of the most significant was the inadequate protection of consumers in relation to the provision of excessively risky credit, such as sub-prime credit.⁷ This prompted a paradigm shift towards regulation and supervision, emphasizing the need for regulatory and supervisory intervention in the financial market. It was recognized that the complex nature of financial services and the interconnectedness of market participants create risks that cannot be assessed by even the best-informed consumers. This has led to the expansion of regulations protecting not only consumers but also non-professional participants in the financial market more broadly,⁸ as well as the creation of a system of institutional protection for these groups.⁹ The architecture of security and protection of consumer interests in the financial services market has become one of the most important areas of social welfare.

The assumptions of behavioral economics that challenge the rationality of consumer choices are increasingly being taken into account. The subprime mortgage experience has provided three important insights into the consequences of consumer behavior for the economy as a whole. First, poor financial decision-making is a surprisingly common phenomenon. Second, such problems can go unnoticed for a long time before a crisis occurs. Third, the systemic effects and costs of maintaining stability can be significant, as evidenced by financial market turmoil and subsequent interventions. While modern consumers are becoming increasingly open to innovation and education, they may not always be well-informed about their rights and the scope of financial institutions. In fact, consumers often make decisions based on cognitive errors and heuristics, which can lead to wrong choices.

⁷ G. Dell'Ariccia, D. Igan, L. Laeven, *Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market*, European Banking Center Discussion Paper No. 2009-14S, CentER Discussion Paper Series No. 2009-46S, pp. 26-27.

⁸ L. Haim, *Rethinking Consumer Protection Policy in Financial Markets* (6 November 2015), *Journal of Law and Commerce*, Vol. 32, 2013, p. 23.

⁹ D. Cyman, *Zarys systemu instytucjonalnej ochrony praw konsumentów na rynku finansowym*, *Gdańskie Studia Prawnicze*, 2017, Vol. 38, p. 325.

One of the earliest concepts of bounded consumer rationality was the theory developed by Herbert Simon, who won the Nobel Prize in Economics in 1978. Simon believed that the expected utility theory was not applicable to everyday conditions as people usually lack the necessary cognitive abilities to make decisions based on the axioms of the expected utility theory. Moreover, people do not have all the information they need about the situation they find themselves in nor do they have a fixed set of preferences.¹⁰ People change their minds about what is worthwhile and what they want to achieve, even at the expense of logical consistency or violation of the principle of transitivity of preferences. When making decisions, people cannot assess the probability and utility of all alternative scenarios due to limited cognitive abilities. They also do not take into account all relevant issues and their decisions may not be consistent and can vary depending on the moment or context in which they are made.

In the 1970s, the research conducted by psychologists A. Tversky and D. Kahneman challenged the assumption of rationality in consumer behavior.¹¹ Their experiments and observations showed that consumer decisions are often more emotional than rational. They proposed an alternative model to the traditional *homo economicus* model to describe how people perceive events under uncertainty. According to their model, people often make decisions based on heuristics, which leads to numerous and systematic mistakes. The process of assessing value and forecasting changes in financial markets is particularly prone to errors and distortions.¹²

Consumer protection is critical for maintaining confidence in the financial market and this trust is based on three pillars. The first pillar is technological security which aims to protect transactions by imposing strict requirements for physical safeguards, such as replacing magnetic strips with microchips and encrypting data sent electronically. The second pillar is consumer protection which aims to grant consumers certain rights and develop appropriate procedures for asserting them. The third pillar is tort protection which guarantees the norms of both general and individual prevention against the unlawful use of electronic payment instruments.

¹⁰ H.A Simon, *Rational Choice and the Structure of the Environment*, 'Psychological Review' 1956, Vol. 3, No. 2, pp. 129-138.

¹¹ D. Kahneman, A. Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 'Econometrica', XLVII, 1979, pp. 263-291.

¹² D. Kahneman, *Thinking fast and slow*, Farrar, Straus and Giroux, 2011.

4. THE LAW OF THE FINANCIAL MARKET AND THE REALIZATION OF PUBLIC INTEREST IN ITS CREATION AND ENFORCEMENT

In the formation of trust, both the legislator and state institutions play an important role. When creating laws that regulate the operation of the financial market based on trust, the legislator must minimize elements detrimental to it, including excessive risk. Trust is also influenced by normative stability, which affects existential security and creates generalized trust, transparency of social organizations, permanence of social order, subordination of power to the rules of law, consistent implementation of powers, and enforcement of obligations by independent institutions that protect threatened powers (such as courts) and enforce the implementation of certain obligations (for example, supervisory authorities).¹³

When analyzing the influence of the state on the financial market through the introduction of legal regulations, it is necessary to take into account their special nature, which distinguishes financial market law from other branches of law. In financial market law, elements of public and private, national, EU and international, substantive, systemic, and procedural law intermingle. It contains legal regulations related to the influence of the state on the organization and operation of financial institutions to ensure the proper functioning and security of the financial market. This law is formed by legal norms regulating, among other things, the designation of entities authorized to perform financial services in the financial market, the conditions for undertaking activities by financial institutions, supervision of the market, as well as the principles of conducting activities.¹⁴

The doctrine distinguishes between the concepts of financial market law, which has a public-law character, and financial services law, which includes private-law regulations.¹⁵ However, such a division is not always clear and the influence of public law regulations on the provision of services is increasingly apparent, including the supervision of their provision. Effective and efficient regulations require research in other areas, particularly in the fields of economics, psychology, and sociology. A system based on safeguarding legal interests and related values, including the protection of consumer rights in financial services (which includes support for financial education and awareness), should be established while ensuring the unfettered operation of the financial market.

¹³ T. Nieborak, *Tworzenie i stosowanie prawa rynku finansowego a proces ekonomizacji prawa*, Poznań 2016, p. 115.

¹⁴ A. Jurkowska-Zeidler, M. Olszak (ed.), *Prawo rynku finansowego. Doktryna, instytucje, praktyka*, Warszawa 2016.

¹⁵ D. Wojteczak, *Usługi bankowe w regulacjach Unii Europejskiej*, Warszawa 2012, p. 15; W. Srokosz, *Pojęcie usług finansowych w regulacjach prawnych Unii Europejskiej*, *Prawo Bankowe* 2000, Vol. 9, pp. 79–81.

The degree of regulatory interference in the financial market's operation is crucial. The fundamental value of this market is the freedom to conduct business in it and any restrictions should be justified by the protection of other values. Thus, the principle of proportionality of this interference,¹⁶ which sets the limits of state interventionism, is crucial. It relates to the adequacy, necessity, and proportionality of regulation. It boils down to whether the regulation is necessary, whether it achieves its intended goals, and whether its effects remain proportional to the burdens or restrictions it imposes. To answer these questions, it is necessary to develop an appropriate model of the participants in this market, particularly taking into account their actual behavior (and thus considering the behavioral approach to the non-professional financial market participant).¹⁷ It is also important to adopt an appropriate set of values and assess their relevance to the functioning of not only the financial market but the entire social system in which this market operates.

In the pre-crisis financial markets of 2007, the regulatory paradigm known as the Washington Consensus was dominant. This paradigm was characterized by an unwavering belief in economic liberalism and the rationality of financial markets. It was believed that financial markets were fundamentally efficient, although subject to short-term turbulence, and that their proper functioning required only full access to market information by all participants. The role of regulation was limited to ensuring the smooth operation of market mechanisms based on a free-market economy, with the main role assigned to internal market discipline. However, the 2007 crisis challenged this consensus, proving that even the largest and most innovative financial institutions were vulnerable to risks.

The new consensus, known as the Basel Consensus, assumes that financial markets are fundamentally unstable. This instability is increased by the excessive complexity of financial systems and the introduction of financial innovations that create additional risks. Therefore, state intervention is necessary to ban certain business models, restrict the sale of certain financial services, and regulate not only individual financial institutions but also the entire financial market. Public authorities must assess and review the internal corporate governance and risk management of financial institutions. Additionally, the internal crisis management structures utilized by supervised institutions must also be subject to supervisory scrutiny.¹⁸

¹⁶ S. Karasiewicz, L. Kurkliński, W. Szpringer, *Zasada proporcjonalności. Przełom w ocenie regulacji*, Warszawa 2014, p. 39.

¹⁷ A.F. Lefevre, M. Chapman, *Behavioural economics and financial consumer protection*, OECD Working Papers on Finance, Insurance and Private Pensions No. 42, OECD 2017.

¹⁸ J. Monkiewicz, M. Monkiewicz, *Ochrona konsumentów w nowym paradygmacie regulacyjno-nadzorczym rynków finansowych*, (in:) J. Monkiewicz, M. Orlicki (ed.), *Ochrona konsumentów na rynku ubezpieczeniowym w Polsce. Współczesne wyzwania*, Warszawa 2015, pp. 13-14.

Questioning the rationality of consumer choices has led to a shift from the regulator's passive role in the consumer market to an active one, with interventions addressing both market behavior and the structure of the market itself. This shift also places more responsibility on financial institutions to consider the choices made by consumers. The idea of the rational consumer has been replaced by the idea of the rational regulator and financial market participants who prioritize fair play.

Soft law norms are playing an increasingly important role in modern financial market regulation.¹⁹ They serve to promote a consistent and uniform understanding of European Union financial market law and compliance with it. These regulations deviate significantly from traditional soft law, exhibiting features that are much stronger and more binding on addressees. This is particularly evident in the recommendations of supervisory authorities issued to financial institutions.²⁰ The effectiveness of soft law is largely ensured by normative instruments that enforce certain actions and sanction the failure of supervised entities to carry out the intentions of their creators. As a result, they are, in fact, a new form of acts of public authority. The legislator, unable to ascribe a directly binding character to them, seeks to force the addressees of this law to comply with certain legal effects relevant to the objectives of the regulations they create.

In addition to direct regulation, promoting financial education and improving the financial skills of financial market participants are important aspects of pursuing the public interest in the financial market. OECD has made significant contributions to this area by conducting international surveys of citizens' financial skills and forms of financial education.²¹ Based on the results of these studies, representatives of OECD member governments have developed recommendations on principles and good practices in financial education and financial awareness.²² These recommendations emphasize the role of financial institutions in providing objective information about the services they offer, as well as the responsibility of employers in providing employees with information about retirement savings opportunities and methods.

Financial education is also crucial for the proper functioning of the European Union's financial market. In 1975, the European Commission put forward the

¹⁹ A. Nadolska, *Soft law w regulacji rynku finansowego w Polsce: rekomendacje, wytyczne i lista ostrzeżeń publicznych KNF*, Warszawa 2021.

²⁰ M. Federowicz, *Nadzór nad ryzykiem finansowym Unii Europejskiej*, Warszawa 2013, pp. 162-163; Z. Ofiarski, *Rola soft law w regulacji rynku finansowego na przykładzie rekomendacji i wytycznych Komisji Nadzoru Finansowego*, (in:) A. Jurkowska Zeidler, M. Olszak (ed.), *Prawo Rynku Finansowego*, Warszawa 2016, p. 137.

²¹ *Improving Financial Literacy. Analysis Of Issues And Policies*, OECD 2005.

²² *Recommendation on Principles and Good Practices for Financial Education and Awareness*, OECD 2005.

right to education as one of the five fundamental consumer rights.²³ According to Article 165 TFEU,²⁴ the European Union shall contribute to the development of quality education by encouraging cooperation between the Member States and, if necessary, by supporting and supplementing their activities. This applies fully to financial education, which is recognized as important for enabling European citizens to make informed decisions about the acquisition of financial services and to understand the basics of private finance, thereby ensuring that the single market can directly bring benefit to them.

5. CONCLUSIONS

The financial market law has undergone significant changes since the crisis of 2007. The previous assumption of the self-regulating stability of the market, which led to significant liberalization and deregulation, turned out to be incorrect. It has become clear that the financial market is not stable and does not automatically return to the state of equilibrium in the event of disturbances. Intervention by regulators and state institutions is necessary to maintain the stability. The financial market plays an extremely important role in the functioning of society and, therefore, all regulations should take into account the public interest. It is reflected in the identification and consideration of basic values that are necessary for the proper functioning of the financial market. Beside the stability of the financial market, which can be considered a public good, other essential values, like safety and trust in the financial market and consumer protection have to be introduced to financial market law. The dynamically changing financial market, innovative financial institutions and services make it difficult for statutory law to keep up with the changes on the market. Therefore, the role of more flexible soft law norms is particularly important.

The implementation of effective solutions to ensure the realization of the public interest in the financial market requires an increase in institutional protection, particularly, in terms of safeguarding non-professional market participants. This can be achieved by expanding supervisory powers, not only over financial institutions but also over services provided in the market. Active intervention by state institutions promotes market safety, provides consumer protection, and introduces supervision over the stability of individual institutions, as well as the financial services market as a whole, ultimately increasing stability and reducing systemic risks. Self-regulation of the market is also increasingly important,

²³ Council Resolution of 14 April 1975 on a preliminary programme of the European Economic Community for a consumer protection and information policy, OJ C 92, 25 April 1975, p. 1–1.

²⁴ Treaty on the Functioning of the European Union (consolidated version), [2012] OJ C 326/47.

involving the creation of norms by market participants, as well as norms targeted at financial institutions created by supervisory authorities.

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