

Ruminate the Significance of Internal Capital Market to enterprise capital control

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Abstract. Internal capital market theory is one of the most essential theories for studying the internal management of enterprises. It fundamentally solves the problem of information asymmetry in the external market and optimizes the internal resource allocation of enterprises while reducing transaction costs. This paper analyzes the impact of internal capital allocation and endogenous financing from the perspective of internal capital market theory which improve the centralized management of corporate capital and enhance the overall value of corporate groups.

Keywords: Internal capital market, Resource allocation, Management Implications.

1. Introduction

Internal capital market theory is the most fundamental theory for studying the internal capital allocation patterns of large firms. In a world where firms are strongly constrained in obtaining financing from external capital markets, the ability of internal capital markets to efficiently reallocate limited resources among projects becomes even more important[1]. If a firm wants to maximize its profits, it needs to invest its limited assets in the highest-yielding marginal projects. In this case, the internal capital market is the external environment in which a conglomerate absorbs other funds in order to achieve its business activities in the course of its development. In this context, resource allocation plays a very important role. It can be divided into two parts. First, the company itself, which consists of two main components: financing and investment. Second, the investors provide a constant flow of funds to the market. For a conglomerate, the internal capital market is an important capital management tool for a successful company, which can improve its competitiveness through the resource allocation advantages and capital advantages brought by the internal capital market[2]. Therefore, applying theoretical knowledge of the internal capital market can serve the purpose of analyzing the capital management of SME groups and provide meaningful reference for the operation and management of internal capital of enterprise groups[3].

2. The Concept of Internal Capital Market

As traditional capital markets have gradually become ineffective due to information asymmetry and inefficient resource allocation caused by agent problems in capital markets, companies have turned to internal financing. There has been a wave of innovation and diversification of corporate governance structures in modern enterprises, which has given rise to a new academic term, internal capital market. Based on various definitions and analyses of internal capital markets, capital markets can be defined from the following two perspectives.

Firstly, starting from the definition of the scope of the capital market, the experts concerned have considered the scope of the capital trading market, transactions initiated by financial intermediaries such as commercial banks outside the borrowing enterprises are called external capital markets, and conversely, places with internal capital transactions formed by corporate institutions are called internal capital trading markets. Williamson's description of the internal capital market was the earliest, but not comprehensive[4]. It only exposes the scope of capital market activity and does not include the mechanisms by which capital operates.

Secondly, it is defined from the perspective of asset allocation mechanisms. It is suggested that economists are predominantly concerned with the allocation of resources across the organization's boundaries through contracts or markets. Some researchers start from the perspective that the internal capital market is somewhat different from the external capital market in terms of investment allocation mechanism, and they define the internal capital market as a way to share capital among corporate headquarters and corporate companies. They suggest that although the internal capital market operates in the internal area of the firm, it is not the internal area characteristics that really best reflect the characteristics of the internal market of the firm, but simply the fact that the internal trading market of the firm has its own completely different capital allocation system from the external capital market. In terms of capital allocation, foreign capital markets use the capital value to guide the flow of capital through the market pricing system.

According to the academic view of transaction cost economics, all kinds of transaction markets have certain transaction costs, so rational business government managers must measure the size of transaction costs in various markets when choosing resources, and the information that can be generated by the provision of services in the market makes the complementarity generated between markets, and the company is fully capable of generating value through the complementarity of the market[5,6].

3. Functional Advantages of Internal Capital Market in Fund Management

3.1 Improve the Efficiency of Resource Allocation

The capital sources between the enterprise group and its affiliated units are all open and flowing, and data sharing and complementary advantages are one of its most important features. Corporate decision makers can make full use of complete and real internal data resources to select the most optimal projects among many competing projects, invest limited resources in these projects to maximize overall corporate profits, achieve the winner selection effect, and make the internal capital market reach a smarter-money effect[7].

3.2 Increase the Proportion of Endogenous Financing

Endogenous financing is the process of converting internally financed funds (from retained earnings, etc.) into investments. State-owned asset regulators can guide private enterprises to use their own capital in investment projects with long project cycles and large scales. Finance companies and clearing houses are one of the main ways to realize the internal capital market.

3.3 Reduce Internal Transaction Costs

Large companies with the ability to combine industry and finance can use their financial services license to create a relatively independent business closed loop, thereby reducing the company's internal and external trading costs and achieving self-sufficiency. The company's group headquarters can make separate investments based on its reputation, using domestic capital markets to invest directly in key supporting strategic business sectors. In this way, the company's holding company also has access to low-cost investments. Through various related party transactions within the company's group companies, including payments, acceptances and discounts for purchases made in the domestic business exchange model to the middle and lower reaches of the chain, reasonable savings in transaction costs and expenses are achieved, thereby effectively improving the efficiency of investments and overall capital gains between the parent and subsidiary companies and maximizing their returns[8].

3.4 Effective Breakthrough of Financing Constraints

Banks prefer to serve their customers as a whole and implement a "total-to-total" approach, using the integrated resources of the corporate headquarters to invest in the bank's credit, than a single SME

that has difficulty in grasping the current state of operation and financial situation, so that financing will be more secure. Due to the invisible guarantee mechanism and risk management requirements of group companies, financial institutions tend to further increase their support to SMEs included in the cooperation framework, giving them a higher investment guarantee than single-client SMEs.

3.5 Prevent Capital Chain Risks

The capital chain was first proposed as a fundamental to keep the company operating. Broken capital chains are a major reason for the collapse or bankruptcy of many companies. In the event of a financial crisis or the release of bankruptcy information such as a broken capital chain of the company in which the group of companies is located, the company can implement a bailout of the company through the internal capital market, thus reducing the incidence of the collapse of the company in which it is located in order to avoid adverse effects on the overall group of companies.

3.6 Information Advantages

Stein (1997) argues that capital allocation is more efficient in the internal capital market. Capital markets are more efficient because of the amount of information available. In terms of transaction costs, the advantages of internal capital markets are shown by;

a) internal capital markets, in which all departments are part of the same company, have access to more truthful and transparent information, which can reduce trading risks;

b) Internal traders know each other well and trade frequently, so they generally have better credit, which can greatly reduce opportunistic tendencies;

c) the department manager can coordinate the collective cooperation of all departments when signing contracts as well as executing them, and get sufficient and cheap information to save capital;

d) Internal capital markets can be used to effectively reflect the efficiency of each member and all operating costs with the help of cost recognition transaction prices.

3.7 Resource Allocation Advantages

Internal capital markets can loosen the credit constraints of companies, and for a given amount of capital, internal capital markets can allocate capital better than external capital markets. When faced with multiple investment projects, the departments in the internal market belong to the same company, and corporate managers have more information advantages that external capital markets do not have. Therefore, the internal capital market can improve the efficiency of resource allocation through merit-based selection. In the course of the project, the capital income does not flow automatically to its production department, but is reallocated by the head office through internal competition, based on the return on investment of the capital.

3.8 Corporate Governance Advantages

While external capital markets can also provide effective corporate governance in optimizing capital allocation, internal capital markets can optimize corporate governance and the effectiveness of a company's internal controls. In some cases, it can also effectively replace the governance function of external capital markets. If a business operator is in the internal capital market, the operator can be grounded in his own purpose and can better supervise his subordinate companies and avoid unnecessary risks by means of internal controls such as information checks and internal audits of himself and the external environment[9].

4. Analysis of the Improvement of the Internal Capital Market for Centralized Capital Management

The internal capital market plays a decisive role in the allocation of resources within the company. Internal source financing is a company that centrally finances its projects with its own resources or externally raised funds. The advantage of internal capital markets is that they do not require access to

external financial markets or financial intermediaries when making investments in individual projects. Therefore, the development and improvement of the internal asset trading market can compensate for the deficiencies of the external asset trading market and thus improve the internal asset management of the corporate company.

4.1 Analysis of Capital Financing in the Internal Capital Market of an Enterprise Group

The analysis of the financial information of each subsidiary and the conversion of free funds into intra-group investments to maximize the efficiency of capital utilization is what is known today as internal financing. With the internal financial coordination effect (corporate groups require that the objectives and actions of the business activities of different internal members be aligned as much as possible with those of the parent company), the relatively stable flow of funds supported by a large internal capital market, and the advantage of information not available on external capital markets, internal financing has more autonomy while reducing financing costs and risks. The following section will illustrate the positive role of internal capital markets in the financing and operation of corporate group companies by analyzing the contribution of internal capital markets in endogenous financing[10].

The first is the financial coordination effect. Huge group companies have considerable capital scale and a relatively stable flow of funds. When individual subsidiaries face investment problems, the headquarters can activate its coordination capabilities to maintain the financial stability of the company as a complete unit by performing different functions in the capital markets, reducing the possibility of the company as a whole falling into risk, while using the subsidiaries to attract capital where there are relatively few restrictions on local corporate investment. Such diversification's consolidation of future capital flows helps improve the borrowing capacity of individual companies and reduce the volatility of internal capital flows, thereby enhancing the corporate group's debt financing capacity.

The second is the information advantage effect. Internal capital markets have more information advantage in financing than the trend of information asymmetry in external capital markets. With the addition of the internal coordination effect, the information disclosure mechanism within the group is further enhanced, and the financial information of each group branch is more transparent and consistent financing within the internal capital market not only provides access to more realistic information, but also offers significant advantages in the exchange of information between the financing parties as well, thus reducing financing costs[11]. Therefore, the mutual insurance company system, while being recognized by the international banking system, also allows corporate groups to expand their investments in the field of foreign financing.

The third is the capital scale effect. The size of the capital invested by the owner refers to the ability of the conglomerate to achieve major project investments at a lower cost through the domestic financing market. Especially in the case of foreign investment, the presence of a large conglomerate can enhance the credit heart of the capital provider, such as banks, thus reducing the friction between the conglomerate and the external capital market and lowering transaction costs[12]. Also, it can reduce the agency costs that increase due to the excessive involvement of factor companies and creditor groups.

From the above analysis, it can be seen that there are financial synergy, scale effects and information advantage effects within the enterprise group. Therefore, when an enterprise group invests in the internal capital market, it can reduce the risk and investment cost to a certain extent. When enterprise groups invest in the external capital market, they usually appear in the form of business alliance, have better reputation, and are more likely to gain trust from the external capital market than individual enterprises. Since large enterprise groups usually obtain more external financing, the scale effect enables large enterprise groups to consolidate funds of corresponding size at a lower cost than other enterprises.

4.2 Analysis of the Role of Capital Allocation in the Internal Capital Market of an Enterprise Group

Internal capital allocation, in which the corporate headquarters plays the role of an external financier and allocates resources appropriately to each branch that requests financing, plays an important role in the internal capital market. First, in the internal capital market, the group can evaluate the capital utilization rate by knowing its subsidiaries and thus allocate assets to the division with the highest return. This centralized arrangement facilitates the planning of projects by the group headquarters and prevents unreasonable financing by each company. Business groups typically diversify their investments and operations and can compensate for their shortcomings by coordinating their services, including fundraising activities. As a result, corporate groups can implement staggered remuneration among their diversified companies. Group companies offset negative net cash flows from investments that are not viable within the company to offset stable long-term capital flows from mature construction projects.

5. Conclusion

In general, the advantages extended by the existence of internal capital markets, such as resource allocation advantages, reduce the company's financing constraints. However, easy access to capital for company managers often leads to poor choices for the company, leading to risks such as possible inefficient resource allocation and over-investment, which negatively affects the company as a whole. Thus, internal capital markets are a double-edged sword that requires effective governance of the company to maximize the advantages of internal capital markets due to the difference between owners and users of capital.

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