

Capital Market and its Prospective Contribution to Growing Competitiveness of Firms

Antonín Kubíček ^{a*}

^a *Vysoká škola finanční a správní, Katedra financí a finančních služeb, Praha 10, Estonská 500 101 00, Česká Republika - e-mail: antonin.kubicek@vsfs.cz - telephone: +420 210 088 814*

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* corresponding author

Abstract

*The intention or the necessity of increasing the competitiveness level of Czech firms calls strictly for using all possible ways of ensuring its realization. Using capital market or only its specific segment – alternative trading system plus firm bonds including their special kind, e.g. commercial papers, represents an interesting possibility to obtain additional funds which are from this point of view its indispensable condition. **Key words:** Financial markets; Integration tendency; Regulation and supervision; Specifics of integration of regulation and supervision*

Introduction

Maintaining or increasing the competitiveness of Czech firms is a permanent and finance demanding process. It is indisputably more demanding after CR entered the EU. At the same time, the possibilities of getting financial funds out of the relatively small Czech market not abounding in money have increased by entering that incomparably bigger and richer EU market and its particular segments. Although this entry is possible and a lot of our firms put it into practice long before our entering the EU, for many reasons it is not simple and easily coping with for all segments. It is relatively complicated to enter national capital markets of EU members, especially as an issuer of chosen kinds of investment instruments. There is a bit less complicated way for the issuers of bonds, which I am going to deal with in my contribution in detail, namely to foreign bond markets existing in individual EU member states, as well as to eurobond markets. However, this is a suitable way almost exclusively for big companies highly internationally recognised, and it is also cost and negotiation demanding. There is nevertheless space left for other companies, and I am not meaning it badly in any case, on the national bond market or, what is possible to create and use from it in a relatively short time. And I want to draw attention to it in the following text, more precisely from the point of view of the use of short-term debentures – commercial papers.

1

Czech capital market in its development went through a number of phases, which were substantially different, and not any of them were simple and without problems. Naturally I am not going to give its description and evaluation here because in that case I would have to ask for several times longer time period for my speech and for the whole conference as well. I will take as sufficient to characterize contemporary stage as “slightly befornormal” in comparison to the markets of more developed “old” EU members. The way to it is slowly made by both foreign institutional investors and issuers, too, though by the later mentioned in a much lower rate.

The realized positive shift is not only a reaction to our EU entry but also much more a reaction to things coming before the entry and those enabling it, e.g. the change of our regulating legislation and its compatibility with ES law. It is necessary to underline in this connection that what you can find in the preamble of our laws which came into force to 1 May 2004, I mean, “This law determines in compliance with the law of the European societies...”¹, is not in any case only an empty phrase. However, this positive assessment does not mean that we should be

¹ *E.g. zákon č. 256/2004 Sb., o podnikání na kapitálovém trhu, resp. zákon č. 190/2004 Sb., o dluhopisech (Capital Market Trading Act No. 256/2004 of the Coll., more precisely Bonds Act No. 190/2004 of the Coll.)*

satisfied with everything included in these new laws. In number of cases, you can see results of making them too quickly, in others, we followed strictly the recommendations which were not obligatory and again in others we were not venture enough to do something which the legislators considered too risky.

I would like to stop at the last mentioned matter. There was a law proposal of doing business on capital market which contained a special part called "Alternative trade system". This trade system was characterized as "...the market where you can trade in investment instruments, organized by a trader in securities". The market organizer, who needs a permission of the Securities Commission for this activity, should set up the rules for trading in this system containing especially:

- a. the conditions of taking part in the system
- b. the rules of accepting investment instruments for trading in an alternative trading system and the rules of their excluding from trading in that system
- c. data registered in the system
- d. the way of satisfaction of supply of and demand for investment instruments
- e. the way of price determination of an investment tool
- f. the way of assuring equal treating the participants of the system
- g. settlement rules for trades made in the system
- h. fees for services provided by the alternative trade system
- i. the rules to avoid abusing internal information, manipulation with the price of investment instrument and disturbing the compact market, as well as the way how to control observing these rules
- j. the procedure rules for the organizer of the alternative trade system if there is a suspicion of abusing internal information, manipulation with the price of investment instrument or disturbing the compact market and imposed sanctions
- k. the way of opening trade rules changes to public

The request for a permission of organizing an alternative trade system should have contained apart from other things expected number of participants and an annex should have been created by a description of the way of liquidity assuring as well as of technical, organisational and personal conditions for operating and specification of investment instruments expected to be traded in the system, too.

Ministry of Finance, the presenter of the law, excluded the above mentioned regulations from the final law proposal, which was in my opinion a great

error to the detriment of capital market and its integrated functioning as well as its possible contribution to the development of our economy and its individual subjects. It would have been possible not only to subscribe smaller issues of until now not used investment instruments, I mean especially short-term bonds as e.g. commercial paper, or medium-term corporate bonds of small and medium-sized businesses and subsequent trade in them with considerably lower costs than on regulated stock or curb markets, but – and it is in my opinion the of same importance – these markets could have been organized by specialized traders, whose property or at least organizational background could have been created by chambers, associations or other forms of professional, self-regulatory² organizations.

Following the above mentioned reasons I believe that the struggle for reincluding the enactments about alternative trading system into the law of doing business on capital market should be one of the most important parts of the proposal and its amendment preparations passing now. Positive things, which can be brought by alternative trade systems, are definitely more unambiguous than fears of their "non regulativeness". The possibility of using foreign experience in this area is evident.

2

Czech capital market is especially a bond market, though there was a sharp decrease recorded in 2003 and 2004. The volume of bond and share markets on regulated markets reached CZK1,376.9 bl in 2003 and CZK1,176.8 bl in 2004 while the bond markets dominated – CZK1,113.2 bl and CZK690.8 bl although comparing with previous years it was a fall down by more than 30% in the first case and in the second one even 38% more. This drop is connected especially with the new issuing policy of Ministry of Finance, which consists firstly in strengthening bond issue with over one year maturity, and secondly in a rising volume of state bonds while postponing their maturity at the same time. The decrease was also evoked by state bond issue abroad. In 2003 60 issues of registered bonds, state bonds, EIB bonds, unregistered bonds, new tranches of registered stock were issued in the total value over CZK158 bl. In the area of bonds they were in concrete terms 10 issues of registered bonds in the value of CZK26.3 bl, 10 issues of state bonds in the total value CZK110 bl, i.e. nearly 70% from the total value of issues, 12 issues of EIB bonds in the total value CZK 15.8bl, 19 issues of unregistered bonds in the value CZK4.42 bl. We can consider as really newly issued registered corporate bonds those of the following three companies: ČEZ,

² Carmichael J., Pomerleano M.: *The Development and Regulation of Non-Bank Financial Institutions*, 2002, p. 66

a.s., Spoby, a.s., Fortuna Hotels, a.s. issues in the total value CZK3.6 bl, i.e. about 13% of the whole volume of these issues, so only a negligible part of them. Although the total volume of the trade with bonds as well as the value and share of their issues on the whole amount is relatively high, their real importance for covering needs of additional business capital is negligible in fact. There is a clearly relevant request of our firms to increase the extent and importance of bonds issues, I mean long-term as well as medium-term ones, and especially short-term bonds. This conclusion is completely in compliance with the selection of the most important measures realized by the Commission. It belongs among them: "to support issuing activities of firms and getting funds on capital market; to include financing through capital market into the subsidy programmes of small and middle enterprise and to allow a registration, doing business and a settlement in special segments of public market".

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Concerning short-term bonds, which I am going to deal with above all, there are in our country, according to The Law of Doing Business on Capital Market, § 3, par. 1, lett. c "investment instruments which are usually traded on money market (money market instruments)". According to the methodology "The Licence of a Trader in Securities and a Branch of a Foreign Trader in Securities (LOCP)" which was approved by the board of The Commission for Securities on 14 May 2003, we: "Generally understand as money market the market of instruments with the maturity up to one year. Money market instruments are especially: short term bonds with the maturity shorter than 12 months, treasury bills, commercial papers, some kinds of drafts etc." Though it would be possible to stir up a controversy, I think above all in its second part, about the clearness and unequivocalness of the mentioned enactment, we must admit that especially short-term bonds system, in our country exclusively that of government treasury bills and the Czech National Bank (ČNB) treasury bonds, which is completely organized by ČNB, creates in my opinion the most consolidated and with its extent and importance the most significant part of the Czech capital market with securities. This is also sustained by the fact that in 2003 39 issues in the short-term bonds system were issued – 2 by ČNB, 3 by Česká konsolidační agentura (Czech Consolidation Agency) and 34 by the Czech Ministry of Finance. These 39 issues of short-term bonds were altogether 1,842,000 pieces of securities in denomination CZK1,000,000. In 2004 there was a further increase in the number of issues and the value of the issued short-term bonds went up as well and reached about CZK 2,500 bl.

As opposed to government treasury bills and ČNB treasury bonds **commercial papers**, even though referred to in the above mentioned methodology, are on our money market, as I noted at the beginning, an unknown thing, in fact. For that reason here is a few words to their substance and use in developed economies.

P. Musílek characterizes in his publication "Securities Markets"³ commercial papers as promissory notes usually issued by big corporations. However, he adds at the same time that also small and unknown firms have penetrated this market in recent years, and it has been so thanks to commercial papers with loan support – secured banker's guarantee, and commercial papers with pledged assets – getting into existence by the securitization of firm's receivables, which enabled to issue their own commercial papers. Although according to him the secondary market is much smaller for these short-term bonds than for government treasury bills or certificates of deposit, the primary market e.g. in USA is highly developed because firms are able to get funds there cheaper than through direct bank loan. The total value of circulating commercial papers in USA rose from \$4.5 bl in 1960 to \$124.4 bl in 1970 and in 1990 it reached \$566.9 bl. The author says that we can divide commercial papers according to the way of issue to direct and dealer ones while smaller companies issue the latter mentioned and they use intermediary services to place them on the market. Low volume of secondary trade in these instruments is the result of their usual holding until their maturity date and the consequence is relatively low liquidity of them.

Braeley and Myers differentiate in their book "Company's Finance Theory and Use"⁴ "directly placed commercial paper" and "trade commercial paper". Both they have according to the authors the same maturity term – maximally 270 days, both they are negotiable – no secondary market, the purchase agreement can be made with the trader, and interest rate basis – both they can be discounted or they bear interest. On the other hand there are differences at lenders – in the first case about 70 sale and financial firms and bank holding companies and in the other industrial firms and smaller financial companies. The above mentioned maximal maturity term is probably a reflection of the fact that firms do not have to ask US SEC for registration when observing this presumption, at the same time the authors point at many companies offering regularly medium-term drafts under completely the same conditions as commercial papers. Most of them are sold via traders

³ Musílek P.: *Trhy cenných papírů (Securities Markets)*, 2002, pp. 38-39

⁴ Braeley R.A., Myers S.C.: *Teorie a praxe firemních financí (Company's Finance Theory and Use)*, 1992, p. 836

but some companies issue them directly with a usual date of maturity from 1 to 10 years.

Following and publishing of commercial papers reliability are done by even the most important rating agencies as e.g. Moody's Standard and Poor's. Investors use these assessments for their decisions together with other information. Two new markets with commercial papers have developed recently. It is especially the market with securities exempt from taxes and secondly it is a fast growing market with eurocommercial papers.

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The attempt to bring commercial papers into Czech financial market and also to prepare conditions for the possibilities of their trading within the framework made for the purpose of alternative commercial system would be, in my opinion, very thankworthy. If I leave out the most important thing without which it is not possible to achieve anything in this market segment and which must be ensured always and everywhere, i.e. the mutual trust of all participants, then it would leave, in my opinion, the following three specific steps.

- First, as I mentioned in the first part of this contribution, there would have to be made necessary changes in the three already existing laws, i.e. the Capital Market Trading Act and consequently, or more precisely simultaneously, in the Securities Commission Act and the Bonds Act. In the second case, it would mean explicit determination of duties for the regulator by acceptance and rejection for established subjective, objective and relational innovations. This determination of duties would have to be connected with a clearance to issue relevant subnorms, again with certain 'globalization' of up to then used definitions in legal norms.
- Second, the maximal use of regulations which are included in effective or proposed legal norms such as the possibility of bonds issue by natural persons, particularization and widening of the content of bond issue conditions, cancellation of general precondition of minimal bond issue circulation for those bonds which should be accepted for trading on regulated market, public tender and organization of securities tender offer.
- Third, creation of material, organizational and personal prerequisites enabling rational and effective realization of both the above mentioned steps. First it would probably be necessary to convince the MF and the Securities Commission representatives of the rationality of the proposed intention and its positives for the Czech capital market and its participants, then to choose and persuade a suitable subject for this purpose, which could be, for example, Chamber of Commerce CR or Association of Industry and Transport CR, that the formation of specialized and

specific alternative trade system (in this case we may talk about the subsystem of money market), the basic objective of which would be commercial papers issue, subscription, guarantee, trading and repayment, as an alternative source of their members financing, could be a significant contribution to their existence and development insurance. Moreover it would also be important to carry out many other necessary steps such as the acquisition of one of the existing or founding one's own securities trader who could, in the framework of investment services stated in a granted licence, well ensure complex of required activities, creation of necessary internal regulations for these activities, cooperation establishment with potential and above all institutional investors and at last to persuade the membership of already won organization about the rationality and positives of the created system. An inseparable part of the preparation and implementation of the above mentioned intention would obviously be the study of similar systems already existing in the EU countries and the use of their up to now experience.

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