

## How To make Capital Markets Union work

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Europe has a high rate of savings and using those savings to increase productive investment is the right approach.

However, Capital Markets Union (CMU) will not do this simply by removing barriers to competition in the European single market. The reason is that nearly all financial markets activity in the world today is carried out by professional intermediaries like asset managers and banks (agents), on behalf of actual end savers (principals).

Their interests are not identical. Competition between intermediaries can either be on the basis of expected cash flow (the stream of income from holding a financial asset), or on the basis of expected changes in the market price of assets. Intermediaries have incentives causing them to favour the latter approach, but the more widely it is adopted in the market the greater the instability of asset prices and the fewer the savings put to productive investment.

The solution is to make it a condition of cross-border access to the European capital market that a specified minimum proportion of assets of each portfolio under professional management is invested for savers solely on the basis of expected cash flow. This method of competition should be promoted by an audited publication of the results.

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## Introduction

Europe has a [high rate of savings](#). Developing capital markets in a way that ensures that savings are put to productive investment in companies across Europe is one of the main objectives of the European Commission's project to create a union of capital markets. And, by doing so, it will also reduce companies' traditional reliance on bank finance.

But, as with other areas in services, creating a single market for capital is not as simple as it sounds. The [2015 Action Plan](#), comprising a bundle of legislative measures – some adopted, some still in the pipeline – aims to create an integrated capital market in the European Union. It is thus an updating of the 1999 [Financial Services Action Plan \(FSAP\)](#), which intended to do something very similar.

The FSAP was itself an updating of the plan to complete the single market in financial services, an important element in the European single market, which was due to be in place by 1993. And this initiative in turn was an update of the original movement to create a European common market, taking advantage of the lifting of all European controls on capital movements in the 1980s.

From the outset, developing a single market for many types of services has often proved challenging. The problem frequently resides in differing national rules for regulating services, and sometimes in differing conceptions about what services *are*. The solution usually involves some minimum European-level agreement over the content of a service, as well as authorising firms which meet specified standards to provide such a service to customers anywhere in the single market. This was the philosophy behind the original Investment Services Directive (ISD), adopted in 1993, creating a single licence for non-bank securities firms, so they could offer their securities services anywhere.

But Europe's capital markets face an even deeper and conceptual problem.

This arises from the fact that nowhere in the European single market today – and not in the UK, before it left the single market – is there a working example of a capital market which actually does fully and properly what the European Commission's project is intended to do.

That is, transform savings into productive investment in companies. The problem, moreover, is a global one, by no means confined to Europe, all of which suggests that a deeper analysis is needed if Europe is to learn from experience and avoid replicating what is not functioning well anywhere else.

## Capital market dysfunctionality

Since 2007 the London School of Economics has hosted a [research centre](#) whose objective has been to build a theoretical framework to provide a better understanding of how financial markets work. It has done this by assuming that market participants act rationally and optimally, given the information available to them. There should be no need, in other words, to fall back on behavioural economics, biases or psychological quirks to explain what is observed in practice.

**The starting point is to recognise that nearly all financial markets activity in the world today is carried out by professional intermediaries** – such as asset managers and banks – who act as agents on behalf of the end savers and ultimate owners of assets, the principals.

Delegation creates an agency problem. **Agents have access to more and better information than the principals who appoint them, and the interests and objectives of the two frequently differ.** Nor can principals be certain of the agents' competence or diligence. They may, for example, be uncertain whether underperformance against any given market benchmark arises from an agent's prudent avoidance of over-priced stocks, or is instead a sign of incompetence.

If shortfalls grow, they may conclude the reason is incompetence, and react by transferring funds to be managed by other agents, which amplifies price swings. Or they may set limits on the margin of difference they are prepared to accept between the annual returns of a portfolio and the returns on a benchmark index, or the performance of a peer group.

This theoretical framework also provides an explanation on how competition actually works between intermediaries themselves. This is particularly relevant to the objectives of creating well-integrated capital markets.

## Two Types of Competition

**Financial intermediaries** – institutions such as insurance, pension, sovereign wealth, charitable and mutual funds, as well as banks – **can compete in capital markets in essentially two different ways.**

**One is on the basis of the expected cash flow, or stream of income,** from holding a financial asset. This means each asset is judged in terms of its fundamental value and intermediaries differentiate themselves from one another by the skills, knowledge and research they apply to understanding those financial assets and the companies which issue them.

It is this kind of competition which was assumed under the Efficient Market Hypothesis (EMH), which dates all the way back to the 1960s. The hypothesis says that securities are priced to reflect the discounted value of the stream of cash flows they are expected to generate over time. The price of any one asset will be determined by investors' consensus estimates of its future earnings and riskiness, and the profit motive will ensure that prices adjust promptly to new information.

If competition were indeed solely on this basis, CMU would be a relatively straightforward project. Removing barriers to competition would be the answer. Expanding financial intermediaries' frame of competition from national markets to a wider European market, and expanding the number of companies to invest in to all companies in Europe, would by itself lead to a more efficient allocation of savings to industry.

There is, however, a second way of competing. **This is on the basis of expected changes in the market price of those same financial assets.** Irrespective of any cash flow or stream of income arising from holding a financial asset, the essence here is to be able to correctly time the market movements affecting its price, and to buy or sell assets accordingly. This is sometimes known as momentum behaviour, and it is found across all types of assets. It is inexplicable within the logic of the EMH, but is very widespread in practice – and indeed can be the basis of a successful investment strategy.

A moment's reflection on these two methods shows how different they really are. One rests upon an analysis of an independent objective reality – the actual cash flow resulting from an asset, like a security issued by a company, which depends upon the success of that company in its own market, how it responds to competitive pressures, how it might innovate, and so on. None of this intrinsic value is affected by the behaviour of financial intermediaries.

The other method rests upon an analysis of what the market price of holding that asset is likely to be at any given time. Since that market price is set by the views of other financial intermediaries, it is the knowledge of those views which is the important factor (even, at times, more important than the intrinsic value of an asset). This is why sometimes intrinsically worthless assets can be swept up in waves of market enthusiasm.

**These two methods of competing correspond, broadly, to long-term and short-term investment.** The cash flow resulting from an asset is a long-term value, measurable over periods of years. But its market price is a short-term value, fluctuating over short periods of days, weeks, and months, and not generally foreseeable at all very far ahead.

Intermediaries which compete over expected cash flow bring the savings they manage to match the long-term prospects of the companies in which they invest. Therefore, those companies can in turn concentrate on the long-term success of their business.

Intermediaries which compete over expected price changes do so in the short term, and so the savings they manage skip from one price-changing asset to another. Companies whose assets are affected concentrate on maintaining their short-term share price, even if that is at the expense of long-term business success.

Much corporate behaviour in the modern world is explained by this second type of competition. The focus on the short term produces economically debilitating effects such as cutting back on capital expenditure and research and development, share buybacks, raising debt levels, and the pursuit of financial engineering. And if maximising the share price is the objective of companies, and company CEOs are remunerated in ways linked to their share price, inequalities between them and ordinary employees ensue.

## The theoretical framework

Theory can help us explain how these situations arise, why the real world of finance differs from the hypothetical world of efficient markets, and why in practice there is a bias towards short-term, price-based, behaviour.

**Momentum, or price trending, can become embedded in the pricing process due to principal/agent issues<sup>1</sup>.** At its simplest level, asset owners, as principals, hire asset managers as agents, and slowly learn about their abilities from the performance of the fund they manage, when compared with the relevant index or returns of a peer group.

After a period of poor performance, an asset owner may take the seemingly rational decision to fire an agent and replace them with another manager, one with a better record. The underperforming assets are sold and replaced by better performing assets – but this leads to an amplification of the recent price trends of securities in both directions. However, because share prices have a finite floor but not a ceiling, the outcomes are asymmetric and momentum is always stronger on the upside.

The **second contribution of this theoretical framework relates to the instructions contained in the contracts between principals and agents.** Principals rarely have unqualified confidence in the competence or diligence of a hired manager. Thus, they often set limits on the margin of difference they are prepared to accept between the annual returns of a managed portfolio and the return on a benchmark index (or the performance of a peer group). This leads to the benchmarking of agents against one another. But benchmarking against competitors in the market is of dubious merit in any corner of the economy. It is no different in finance.

Academic papers show the response required of managers who are underperforming the index and at risk of breaching their tracking constraint (see [here](#) and the references therein). They are obliged to buy

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<sup>1</sup> See Vayanos, D. and Woolley, P. (2013), 'An institutional theory of momentum and reversal', *Review of Financial Studies*, Vol. 26, pp. 1087-1145.

assets which are rising strongly but are under-represented in their portfolio. They have to be late-stage buyers of stocks on the rise and which they had previously deemed unattractive, and sellers of the shares that have underperformed to fund the purchases<sup>2</sup>. These responses have been confirmed in [empirical studies](#) of fund portfolios. The impact on pricing is the same as with momentum trading – amplifying price shocks in both directions, but mainly upwards.

In practice asset managers need little encouragement or formal guidance to hug benchmark returns. They mostly seek to avoid sharp shortfalls against index returns and so engage in what is termed ‘performance-chasing’, buying stocks that are exposing them to relative losses.

The scale of mispricing in capital markets is best illustrated by the inversion of the relationship between risk and return. Standard theory predicts that high risk assets should be priced to offer a commensurately high return as recompense. However, [accumulating evidence](#) based on equity valuations going back to the 1930s shows either no systematic link between the two, or that high-risk assets have offered a lower return than low risk assets over the long run.

A final important point to note from this body of academic work is that, although there are clear conceptual differences between the two types of competition (between that based on long-term expected cash flow and that based on short-term expected price changes), they are currently impossible to disentangle within the world’s largest funds.

While some specialist intermediaries, like hedge funds, do expressly focus on short-term shifts in price, the managers of the largest funds usually pursue both strategies at the same time. That is, the same fund runs two separate, distinct and conflicting strategies: one targeting the short-term market value of the portfolio; and the other targeting its long run cash flows.

The first has a destabilising impact on market prices; the second is stabilising. Consequently, financial markets are in a state of constant flux – there is a battle between short-term price-based strategies, tending towards instability, and long-term cash flow strategies, tending towards stability.

## Implications for Capital Markets Union – and a solution

This analysis shows why making CMU work in Europe is not at all straightforward. Simply joining or connecting up national capital markets – or parts of the infrastructures of national capital markets – is not sufficient to create a European capital market which actually serves the economy in the manner desired.

On the contrary, the prevailing bias in finance to short-term price instability means this could amplify the transmission mechanism. This would make asset price instability worse in Europe, at the expense of productive long-term investment. While it is understandable to want to rely less on banks as a source of finance for companies, the price for doing so should not be increased corporate short-termism plus a greater propensity to asset price bubbles and crashes, with all their dire macroeconomic consequences.

There is, however, **a practical solution which would benefit the users of capital in each of the national markets**. The solution builds on the tough competition policy framework which is at the heart of the European single market. **This is a commitment by financial intermediaries, such as asset managers, to**

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<sup>2</sup> The need to act is less strong if managers are over-weight assets that fall in price. If a portfolio is half-weight an asset that doubles in price, any mismatch also doubles, but if the price halves, the mismatch also halves.

**invest a specified minimum proportion of funds solely on a cash flow basis, taking into account only the fundamental value and without any reference to or alignment with competitors, or any benchmarking.**

By focusing expressly on only one objective, this proportion of funds would be kept safe from the dysfunctionalities due to the same portfolio having dual and conflicting objectives. Moreover, **it would be possible to measure, check and audit the results of this strategy over time, and by doing this promote competition between all the asset managers using the same cash flow method of investing.** In return, this would provide a stable basis upon which the EU's capital markets can be developed and eventually unified.

How in practice might this solution be achieved? **By making it a condition of funds, perhaps over a certain size, that having cross-border access to the European capital market requires a minimum proportion of assets in each portfolio under professional management to be invested in such a way.**

The results should then be audited and published by a competent independent body, and made available to all savers, investors and companies in Europe. While it would take some time for meaningful results to become available, and therefore for competition properly to develop, there would be a stable core of investment funds created from the outset, available for the long-term investment purposes of European companies.

Regarding the proportion of assets that each fund would need to dedicate, **a good starting point might for example be 10 % of assets under management (which can be reassessed after a suitable trial period).** This may seem only a modest proportion, but the scale of assets under professional management in the world today comes to some [USD 100 trillion](#), which is greater than global GDP. Even a small proportion of this total would constitute a significant contribution towards long-term investment. European companies will need such investment if they are to transition to a low carbon economy.

In the medium and long run, funds would enjoy a private benefit and, at the same time, contribute to the social utility of more stable financial markets, plus the higher returns from companies which would also be investing for the long run.

As for the risk of asset price instability from the remaining funds not actually committed to fundamental value investment in Europe, there are two important considerations. First, **the existence of a stable core should in itself provide a source of stability to the rest of the market.** This follows Keynes' dictum that it makes a vast difference to an investment market if there are sufficient long-term investors to influence short-term game-players. Assets which constitute the stable core are less likely to be susceptible to price instability.

Secondly, **the source of such asset price instability should become easier to identify.** Since it would not come from fundamental value investment it could only arise from short-term price-based strategies in the market, between intermediaries. If it is the consequence of benchmarking agreements or practices causing intermediaries to be aligned with one another, then that is a structural matter which European competition policy should be able to address.

The bedrock of competition in the single market is decision-taking independence by every firm in relation to its competitors. Serious asset price instability, sufficient to create asset price bubbles, regardless of intrinsic value, which distort the very fabric of the economy, might also raise questions over whether it could result from any other kind of anti-competitive concerting of expectations between market participants.

Central banks need to be concerned with price stability in financial assets, as well as price stability in product markets. This solution should make their task easier too.

## Conclusion

There has always been ambivalence about capital movements across Europe. When the common market was originally launched in the 1950s, the free movement of capital was considered a factor of production – like the free movement of workers (see the 1956 [Spaak report](#) which formed the basis for the creation of the common market).

But, even then, there were fears that speculative capital movements, resulting from divergent monetary policies or currency instability, might mean that capital would not flow to the parts of the economy where it was most needed.

All capital controls in Europe were formally lifted in the 1980s, as part of the initiative to complete the single market. But to this day it has not proved practically possible to ensure that the movement of capital constitutes a true factor of production, and is not instead a force for instability.

CMU, by creating a stable core of fundamental value investment, could be the mechanism to finally solve this problem.

## European Capital Markets Institute

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