I Securities markets and their agents: situation and outlook

Contents

1	Executive summary	13
2	Macro-financial setting	15
	2.1 International economic and financial developments	15
	2.2 National economic and financial developments	23
	2.3 Outlook	32
3	Spanish markets	33
	3.1 Equity markets	33
	3.2 Fixed-income markets	41
4	Market agents	48
	4.1 Investment vehicles	48
	4.2 Investment firms	57
	4.3 UCITS management companies	61
	4.4 Other intermediaries: venture capital	63

List of exhibits

Exhibit 1:	"Dark liquidity: the new IOSCO principles"	22
Exhibit 2:	"The stockmarket flotation of Spanish savings banks"	27
Exhibit 3:	"The temporary ban on short selling"	35
Exhibit 4:	"Green Paper on the EU Corporate Governance Framework"	40
Exhibit 5:	"Asset Securitisation Markets: Joint Forum Recommendations"	44
Exhibit 6:	"Circular 3/2011 of 9 June modifying UCITS investment policies"	51
Exhibit 7:	"ESMA technical advice to the European Commission on level 2 implementing measures for the Alternative Investment Fund Managers Directive"	54

1 Executive summary

- The pace of the world economy slowed appreciably in the year's middle months in contrast to the 4.5% growth of the opening quarter, with some advanced economies among the weaker performers. Emerging market economies kept up a comfortable growth lead although they too experienced some loss of steam. Against this backdrop, evidence of the U.S.'s struggle to get its public finances under control, coupled with persistent concerns about Greece's public debt, brought renewed turbulence to international financial markets which reached its height during the first half of August. The downside risks for world economic growth, which augur a renewed downturn in the coming quarters, have been increasing over the past two months.

- Financial market stress bore down heavily on equity prices, with European banks particularly affected, and was also responsible for an upswing in volatility. Third-quarter losses on main stock markets ranged from 6.6% in the case of the Nasdaq to 25% in some European indices. In parallel, the rush into "safe-haven" assets intensified, with U.S., UK and German debt among the beneficiaries, alongside assets denominated in Swiss francs and, also, non-financial assets such as gold. The sovereign credit spreads of a growing list of European countries were pushed to historic highs, and were only restored to stability by the ECB's decision to buy European government bonds on secondary markets, and the adoption of new, national measures. At the closing date for this report,[1] market volatility was still running high.

- The Spanish economy expanded 0.2% in the year's second quarter, for a year-on-year rate of 0.7% – in both cases two points below the result posted in the previous quarter. The slowdown in domestic activity was less marked than in other European countries, though year-on-year growth again trailed the average for the euro area (1.6%). Unemployment rates stayed stuck above 20%, while Spanish inflation abated to 2.7% in August from the 3.5% peak of April, narrowing its differential versus the euro area to 0.2 percentage points. Figures for central government budgetary execution to the month of July square with the 2011 deficit reduction target, though the latest round of financial market turmoil unquestionably poses an upside risk for the public deficit and a downside risk for economic activity.

- The business environment for Spanish financial institutions remains complex in the extreme, given the prevailing weakness of domestic activity and the disruption suffered by wholesale markets, which has caused funding conditions to deteriorate sharply.

1 20 September.

- Non-financial listed companies increased their aggregate profits by 8% in the first-half period to 13.15 billion euros, while their aggregate debt dropped back 5.1%.

- Spanish stock markets' first-quarter gains gave way to a price correction that gained in intensity from end-July onwards. The Ibex 35, up by 7.3% to March, shed 2% of its value in the second quarter and a further 19% approximately in the third, a performance more or less mirroring that of indices elsewhere in Europe. Market volatility peaked at times above 65%, recalling the levels reached in May 2010 during the first wave of the Greek debt crisis. Here, as in the rest of Europe, the banks were hardest hit, though the temporary ban on short selling of financial shares, ordered last August by the CNMV in concert with other European supervisors, went some way to smoothing out price volatility. In this context, stock market turnover has contracted by 2.7% year-to-date, putting liquidity conditions under a degree of strain.

- Domestic fixed-income markets also moved on the turbulences afflicting European sovereign debt. These reached a new peak in early August, sending Spanish government yields and spreads back to highs. Following this, the ECB's secondary-market purchases of European bonds and the approval of other measures at national level restored a degree of calm that was to prove short-lived. In September, evidence of the weakness of world economic activity set the markets on edge once more and prompted a fresh ascent in Spanish bond yields and spreads, which by the deadline for this report were testing 360 bp over the German bond. Meantime, the volume of fixed-income issues registered with the CNMV shrank by 1.3% to 162 billion euros between January and September.

- Assets under management in investment funds dropped 2.5% in the first six months to just over 140 billion euros, as the redemption rush continued. Outflows were strongest in fixed-income funds albeit on a rather smaller scale than in previous semesters. Investment fund returns held in positive territory though here too investment policies marked the difference. The aggregate profits of UCITS management companies fell by 3.8% between January and June in consonance with the downtrend in industry assets. Strong competition from bank deposits continues to dull the sector's short-term recovery prospects and, furthermore, will likely persist in the foreseeable future.

- Investment firm business continued to labor under financial market turmoil throughout the first half of 2011, putting paid to hopes of a recovery in income flows from core industry services. The small advance in aggregate pre-tax profits (1.4% year-on-year) owed basically to extraordinary income coupled with operating cost containment. The number of loss-making firms rose slightly in the first-half period, though the volume of their losses tended to decrease. The sector's solvency conditions remained in the comfort zone.

- The report includes seven monographic exhibits:

  - The first runs through some of the issues raised by the recent trading boom in non-transparent securities market segments (dark liquidity) and the proposals made by IOSCO to mitigate its adverse impacts.

- The second describes the stockmarket flotation in July 2011 of Bankia and Banca Cívica as part of the restructuring of the Spanish financial system, setting out the criteria used by the CNMV in verifying both transactions.

- Exhibit three brings analytical considerations and empirical evidence to bear on the joint decision of 11 August by the securities market regulators of Spain, France, Italy and Belgium, under the coordinating aegis of ESMA, to impose a temporary ban on the creation or increase of short positions in certain financial shares.

- Exhibit four looks at the initiatives contained in the Green Paper on Corporate Governance published by the European Commission in April 2011, in order to improve the corporate governance of Europe's companies, focusing on those traded in regulated markets.

- The fifth exhibit reproduces the recently published recommendations of the Joint Forum to establish a regulatory framework that supports the re-establishment of a sustainable securitisation market.

- The sixth describes the main changes made by Circular 3/2011 modifying UCITS categories based on investment policy, in order to adapt the definition of money-market fund to the harmonised definition issued by the Committee of European Securities Regulators (CESR), now ESMA, and introduce certain technical improvements.

- Finally, the seventh exhibit describes the main thrust of ESMA's advice to the European Commission on the level 2 implementing measures of the Alternative Fund Managers Directive.

2 Macro-financial setting

2.1 International economic and financial developments

The international macro--financial setting is gripped by renewed turbulence.

Since the latest edition of this report in the CNMV Quarterly Bulletin for the first quarter of 2011, the world macroeconomic and financial landscape has been perturbed by a new wave of European sovereign debt market tensions, extending this time to a larger number of euro-area nations, and anxieties about certain aspects of the U.S.'s federal debt management. All this in a context of faltering economic activity.

World economic activity slows sharply in the year's middle months...

So even though first-quarter figures showed world growth to be holding up well with rates close to 4.5%, the second quarter was characterised by a slowdown that was especially marked in the U.S. and some European economies, and will likely persist through the second half, according to the tenor of the latest indicators. The IMF is now projecting a 2011 advance of 4.0%, over one point less than in 2010, on account of the downturn in Japan (–0.5%), after the March earthquake, and the lesser growth momentum of emerging and certain advanced economies (see table 1).

Gross domestic product (annual % change) TABLE 1

	2007	2008	2009	2010	IMF(*) 2011F	IMF(*) 2012F	OECD(*) 2011F	OECD(*) 2012F
World	5.4	2.8	-0.7	5.1	4.0 (-0.3)	4.0 (-0.5)	–	–
United States	1.9	-0.3	-3.5	3.0	1.5 (-1.0)	1.8 (-0.9)	2.6 (+0.4)	3.1 (=)
Euro area	3.0	0.4	-4.3	1.8	1.6 (-0.4)	1.1 (-0.6)	2.0 (+0.3)	2.0 (=)
Germany	3.4	0.8	-5.1	3.6	2.7 (-0.5)	1.3 (-0.7)	3.4 (+0.9)	2.5 (+0.3)
France	2.2	-0.2	-2.6	1.4	1.7 (-0.4)	1.4 (-0.5)	2.2 (+0.6)	2.1 (+0.1)
Italy	1.5	-1.3	-5.2	1.3	0.6 (-0.4)	0.3 (-1.0)	1.1 (-0.2)	1.6 (=)
Spain	3.6	0.9	-3.7	-0.1	0.8 (=)	1.1 (-0.5)	0.9 (=)	1.6 (-0.2)
United Kingdom	2.7	-0.1	-4.9	1.4	1.1 (-0.4)	1.6 (-0.7)	1.4 (-0.3)	1.8 (-0.2)
Japan	2.4	-1.2	-6.3	4.0	-0.5 (+0.2)	2.3 (-0.6)	-0.9 (-2.6)	2.2 (+0.9)
Emerging	8.9	6.0	2.8	7.3	6.4 (-0.2)	6.1 (-0.3)	–	–

Source: IMF and OECD.

(*) Figures in brackets show the change over the previous published forecasts. IMF, forecasts published in September 2011 (versus June 2011). OECD, forecasts published May 2011 (versus November 2010).

...while inflation has tended to moderate, in Europe especially.

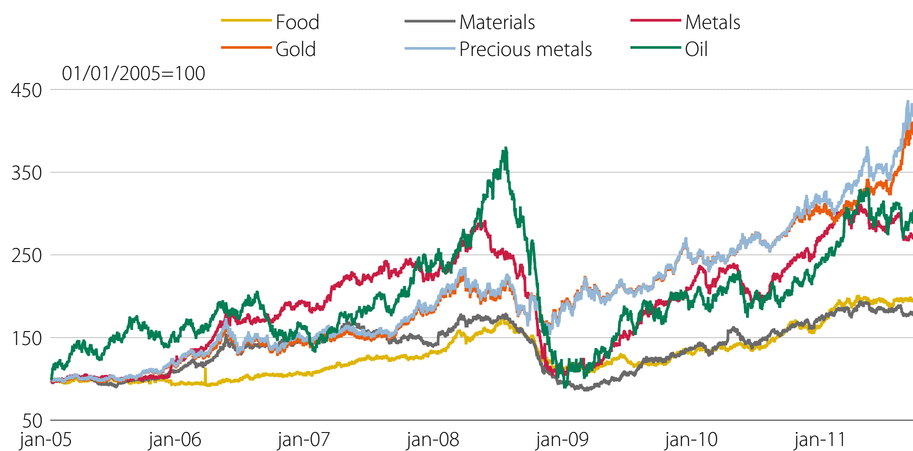
The world's main economies experienced a surge in inflation over the year's opening months, which tended to remit in the middle months, in some European countries at least. Commodity prices began to head gradually lower in the spring after two years of vigorous growth, the exception being precious metals (see figure 1). Inflationary pressures were strongest in the emerging economies on their greater output buoyancy, and were contested in many cases by hikes in official interest rates. Among the advanced economies, the big news was the ECB's decision to raise its benchmark rate by 25 bp on two occasions, to 1.25% in April and 1.5% in the month of July, after nearly two years without movement. Stateside, the Federal Reserve announced that it expected to keep rates at their current lows until 2013, in view of increasingly feeble domestic activity.

The upswing in uncertainty spells a new blow for world bond and equity markets...

Against this renewed backdrop of global macro-financial instability, stock markets began sinking rapidly, volatility surged to end-August highs in excess of 40% and a broad group of European countries saw their sovereign spreads escalate once more. Further, the rush into "safe-haven" assets, both financial as in the case of U.S., British and German bonds or instruments denominated in Swiss francs, or non-financial, as in the case of gold, continued to intensify. Approval of a new public spending ceiling in the United States, the adoption of additional consolidation measures in Europe's most vulnerable economies and the government bond purchases effected by the ECB from 8 August onwards, together with the joint decision by securities market regulators in Spain, France, Italy and Belgium to impose a temporary ban on the short selling of domestic financial sector shares, initially helped to drive down aggregate volatility. But come September, the confirmation of slowing world growth and fears of a restructuring of Greece's sovereign debt dealt a new blow to financial markets.

Commodity prices

FIGURE 1



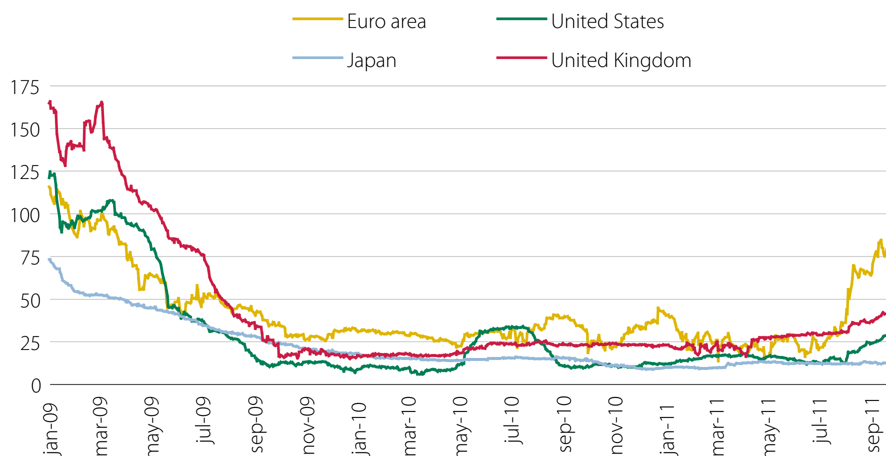
Source: Thomson Datastream. Data to 20 September.

The tensions gripping stock and bond market were also quick to drag in interbank trading. As we can see from figure 2, the three-month euro Libor-OIS spread widened significantly as of July from just under 25 basis points to mid-September highs testing 80 basis points, the highest level since spring 2009.

...and also European interbank markets.

Three-month Libor-OIS (basis points)

FIGURE 2



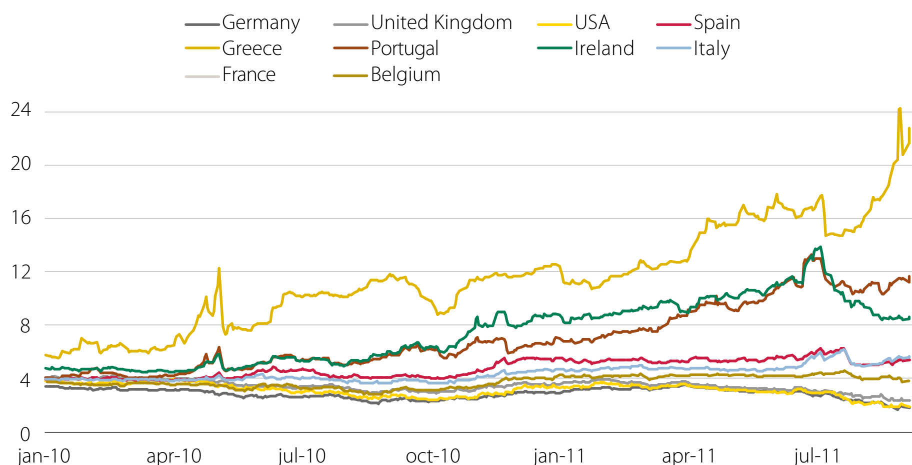
Source: Bloomberg. Data to 20 September.

Government bonds yields displayed similar behaviour to during the last bouts of volatility in certain euro-area sovereign debt markets; namely a significant rundown in the yields of U.S., German and UK treasuries on their reputation as safe-haven assets to historical lows of below 2% for the ten-year maturity. In contrast, the European economies in receipt of multilateral financial assistance saw their interest rates soar to peak levels of 24% for Greece and 14% in the cases of Ireland and Portugal. Meantime, interest rates on Spanish and Italian government paper pulled into line over the year's middle months with yields in both cases touching highs of over 6% (see figure 3). As figure 4 shows, these rising tensions progressively drew in other European economies like Belgium and France, which had not previously suffered major fluctuations in their sovereign risk indicators.

As in earlier rounds of market turmoil, investors have rushed in growing number into perceived safer assets...

Ten-year government bond yields (%)

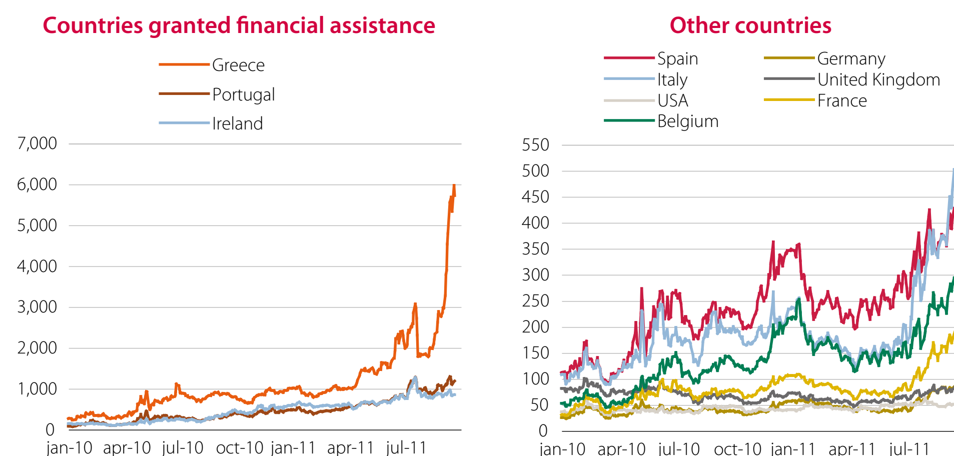
FIGURE 3



Source: Thomson Datastream. Data to 20 September.

Sovereign credit spreads, 5-year CDS (basis points)

FIGURE 4



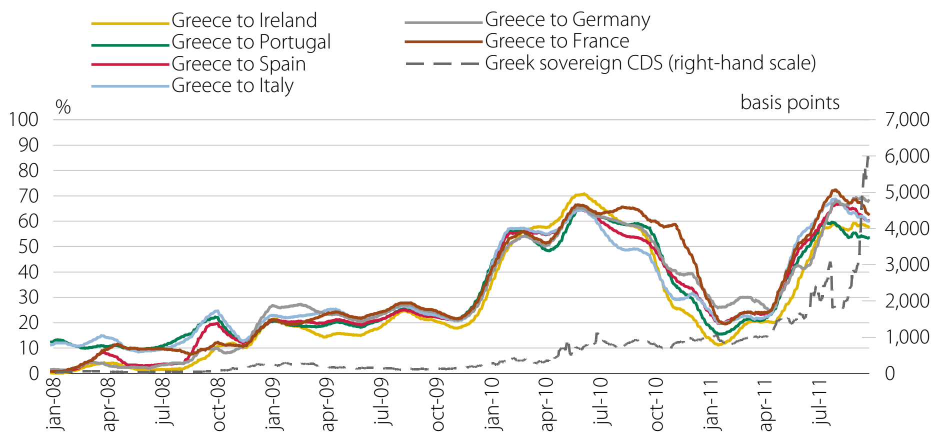
Source: Thomson Datastream. Data to 20 September.

...and rising sovereign spreads across a wide range of Europe's economies, victims of contagion.

Available indicators for the extent of sovereign risk contagion from more vulnerable economies to the rest of Europe, and the financial sector, show that the effect has been considerable. More specifically, indicators for sovereign credit risk contagion from Greece to other European economies have been running at highs since the start of August, peaking at just above the crisis levels of May 2010 (see figure 5). Further, dynamic estimates of credit risk transmission between Europe's financial and public sectors reveal that the public sector has been a contagion source of the first magnitude since early 2010, to increasingly damaging effect since the second quarter of this year (see figure 6).

Contagion of the Greek crisis to other European economies[1]

FIGURE 5

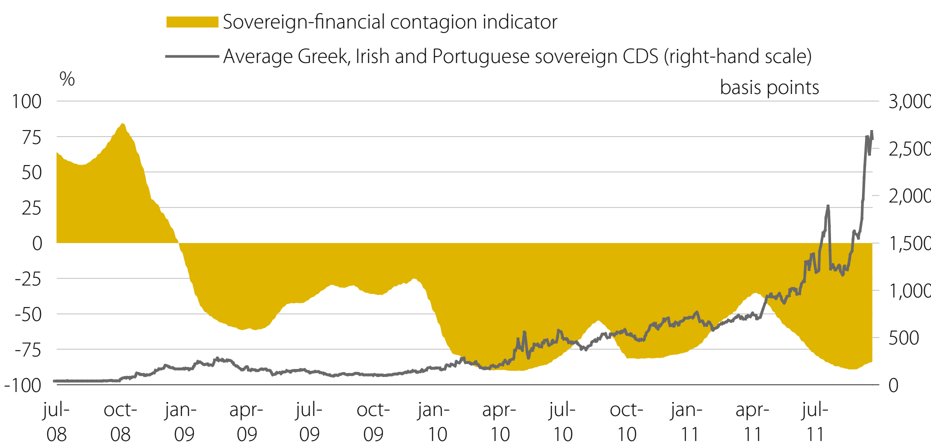


Source: CNMV.

1 The figure shows the percentage of variance in the CDS premiums of various European countries that is not ascribable to historical information but to contemporaneous shocks in Greece's credit risk. The resulting contagion indicator is increasing with the intensity of the effect produced by specific shocks in Greek sovereign spreads. The scale of contagion on a given day is calculated from available data for the 100 days preceding the current date, with the series also filtered by 30-day moving averages. Data to 20 September.

Sovereign-financial contagion in Europe[1]

FIGURE 6



1 The figure shows the percentage of variance in the average CDS of the European banks sector and Greek, Portuguese and Irish sovereign bond that is not ascribable to their historical information but to contemporaneous return shocks. The resulting contagion indicator is decreasing with the increase in relative intensity of the impact of specific sovereign risk shocks on financial sector CDS. Positive values denote a net contagion effect from the European banking sector to the three countries' sovereign sector, while with negative values the source of the contagion is the sovereign risk of the study nations. Contagion on a given day is calculated from available data for the 60 days preceding the current date, with the series also filtered by 30-day moving averages. Data to 20 September.

Tensions in private fixed-income markets drive up the premiums of worse-rated issuers...

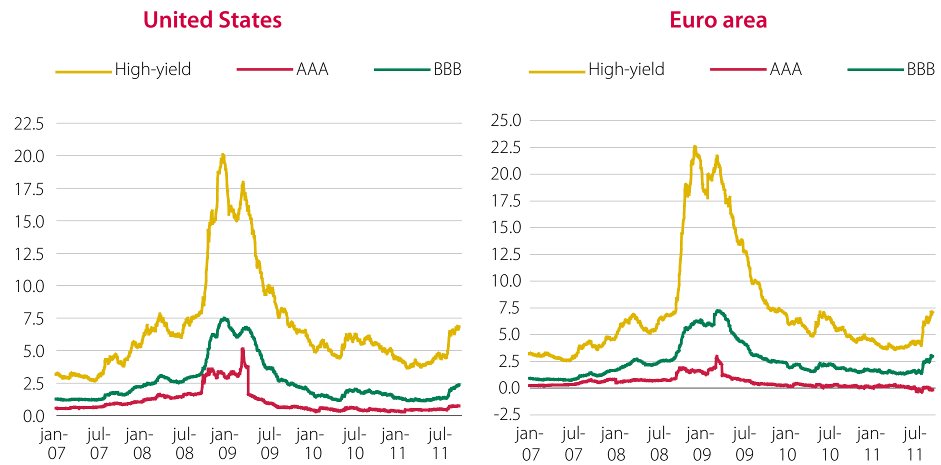
Public debt market tensions also took their toll on the risk premiums of U.S. and European corporate issuers and, by extension, on their volumes of issuance. As figure 7 shows, the spreads of medium-to-low rated corporate issuers widened significantly in both the U.S. and euro area to not far short of the levels recorded in May 2010. Specifically, high-yield borrowers saw their spreads rise by around 315 and

350 basis points in the United States and euro area respectively, from the lows of spring 2011 to the neighbourhood of 7%. Meantime, the spreads of medium-grade issuers (rated BBB or equivalent) climbed 125 bp in the U.S. and 165 bp in the euro area as far as 2.4% and 3.0% respectively.

...and cause an issuance slump that has proved especially intense in Europe.

But the single most visible effect of the tensions gnawing at the private corporate sector must be the relentlessly declining issue volumes on primary debt markets. As we can see from figure 8, net international debt issuance continued to shrink in the year's middle months due to lower government borrowing, the virtual drying-up of financial sector issuance, primarily in Europe, and the lull in borrowing by non-financial corporations. The tougher funding conditions faced by European financial institutions are not the only factor bearing down on issue volumes. Other regular funding sources, such as U.S. money-market funds, also thinned considerably in the summer period. In this respect, the recent coordinated decision by a number of banks, including the ECB, to provide liquidity in dollars to the commercial banking sector could help them steer clear of a funding crunch.

Corporate bond risk premiums[1] (percentage points) FIGURE 7



Source: Thomson Datastream (Merrill Lynch, IBOXX indices). Data to 20 September.
Expressed as the yield spread between bonds of the same maturity and credit quality belonging to a given index and 10-year government bonds (a synthetic bond in the case of the euro area).

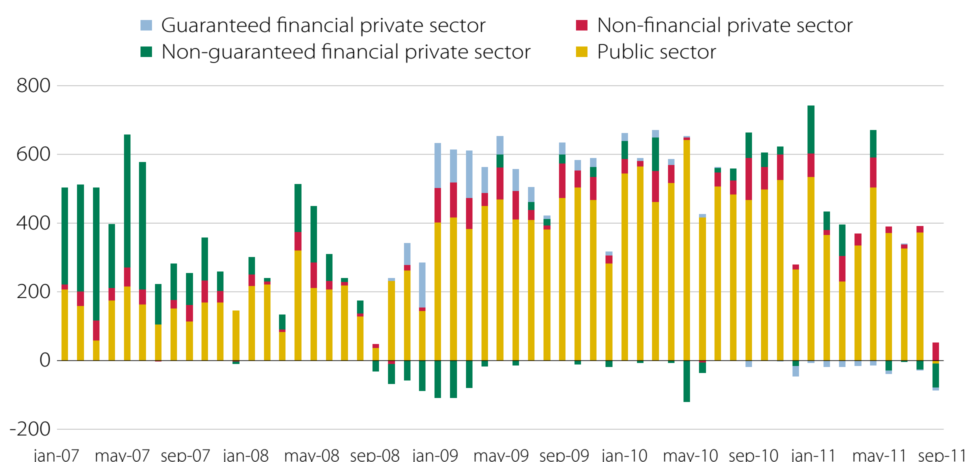
Key stock indices of advanced economies recede sharply in the third quarter, especially in Europe...

Meantime, the stock indices of leading advanced economies, which had generally held up well over the second quarter of 2011, plunged into losses in the third – by over 20% in the case of European indices and from 6.6% to 11% in the U.S. and Japan. Accompanying the fall was an upswing in volatility (as far as 40% in terms of historic volatility and, in some indices, to over 50% by the implied volatility measure). In most cases, however, the increase stopped short of the levels reached in May 2010, when the Greek crisis first erupted, or at end-2008 following the Lehman Brothers collapse. Falling share prices reduced the P/E (price-earnings) ratios of main world indices to around or below 10 times, compared to historical averages of 14 to 16 depending on the index.

Net international debt issuance, billion dollars

FIGURE 8

By type of issuer



Source: Dealogic. Monthly data. Data for September 2011 (to the 20th) are restated on a monthly basis.

Performance of main stock indices[1] (%)

TABLE 2

	2007	2008	2009	2010	3Q10	4Q10	1Q11	2Q11	3Q11 (to 20 September) % prior qt.	% Dec	% y/y[2]
World											
MSCI World	7.1	-42.1	27.0	9.6	13.2	8.6	4.3	-0.3	-12.7	-9.2	-0.8
Euro area											
Euro Stoxx 50	6.8	-44.4	21.1	-5.8	6.8	1.6	4.2	-2.1	-24.9	-23.4	-23.6
Euronext 100	3.4	-45.2	25.5	1.0	7.5	2.8	3.2	-1.2	-19.9	-18.3	-17.2
Dax 30	22.3	-40.4	23.8	16.1	4.4	11.0	1.8	4.8	-24.5	-19.4	-11.5
Cac 40	1.3	-42.7	22.3	-3.3	7.9	2.4	4.8	-0.2	-25.1	-21.6	-21.2
Mib 30	-8.0	-48.7	20.7	-8.7	6.2	1.1	6.4	-7.1	-25.5	-26.4	-25.7
Ibex 35	*7.3*	*-39.4*	*29.8*	*-17.4*	*13.5*	*-6.2*	*7.3*	*-2.0*	*-19.3*	*-15.2*	*-22.2*
United Kingdom											
FTSE 100	3.8	-31.3	22.1	9.0	12.8	6.3	0.1	0.6	-9.8	-9.1	-4.3
United States											
Dow Jones	6.4	-33.8	18.8	11.0	10.4	7.3	6.4	0.8	-8.1	-1.5	6.1
S&P 500	3.5	-38.5	23.5	12.8	10.7	10.2	5.4	-0.4	-9.0	-4.4	5.2
Nasdaq-Cpte	9.8	-40.5	43.9	16.9	12.3	12.0	4.8	-0.3	-6.6	-2.4	10.0
Japan											
Nikkei 225	-11.1	-42.1	19.0	-3.0	-0.1	9.2	-4.6	0.6	-11.2	-14.7	-9.4
Topix	-12.2	-41.8	5.6	-1.0	-1.4	8.4	-3.3	-2.3	-11.1	-16.0	-11.4

Source: Datastream.

1 In local currency.

2 Year-on-year change to the reference date.

...with the bear trend extending to the stock indices of emerging market economies.

European and Japanese stock indices have been the worst performers year-to-date (from -9.1% in the case of the FTSE 100 to -26.4% in the case of the Mib 30), while U.S. indices managed to contain their losses between the -1.5% of the Dow Jones and -4.4% of the S&P 500. Emerging market indices, with few exceptions, posted falls on a similar scale. By sector, financial shares took the biggest punishment, especially in Europe, where doubts persist about the strength of the banking sector and the extent of its exposure to European sovereign debt.

The euro loses ground against other leading currencies.

In currency markets, salient developments have been the euro's slide against the dollar, starting last May, which has taken exchange rates down from 1.49 to 1.37 dollars, and, above all, the appreciation of the yen and Swiss franc against the euro and the dollar, in tune with the safe-haven role they have exercised throughout the crisis.

Exhibit 1: "Dark liquidity: the new IOSCO principles"

For some years now, a growing part of securities market trading has taken place in dark venues or else has been instrumented through orders that are not subject to pre-trade transparency requirements. In both these cases, buy and sell orders are not disclosed to all market participants, while the liquidity they generate is not factored with remaining orders into the price formation process. This kind of trading is conducted on electronic platforms managed by multilateral trading facilities, broker-dealers and even regulated markets in specific trading segments. According to data from the European Securities and Markets Authority (ESMA), as many as 10% of the transactions closed on European regulated markets and multilateral facilities in 2010 did not meet conditions of pre-trade transparency.

In May 2011, IOSCO's Technical Committee approved a report[1] expressing regulators' concerns about the rapid development of these so-called dark pools. Specifically, IOSCO identifies three ways or areas in which trades not subject to pre-transparency requirements may impair market operation:

– Price formation, since dark liquidity does not contribute to price discovery.

– Potential fragmentation of liquidity and information, so buyers have to search for liquidity across a greater number of venues, pushing up their transaction costs.

– Fair access and market integrity, such that certain participants may be denied access to the market or order information selectively channelled towards some users at the expense of others.

IOSCO has accordingly developed a series of principles to mitigate the adverse effects of dark pool trading in these three domains. And its Technical Committee urges members to bear them in mind when preparing regulatory initiatives that address dark pools and dark orders:

– The first principle refers to the need to ensure timely access to information on the price and size of securities orders (pre-transparency) to mitigate the

potentially adverse effects of liquidity being fragmented across a multiplicity of trading venues, and to facilitate best execution and efficient price formation. The Technical Committee acknowledges the heterogeneous nature of trading platforms and orders themselves and that it may be appropriate to apply different levels of pre-trade transparency. Indeed it recognises that full disclosure requirements may need to be waived in the case of large orders with a potential impact on price formation.

- The second principle, turning on the dissemination of price and volume information on already executed trades (post-transparency), insists that all transactions should be disclosed on the same basis to all participants, including those executed in dark pools. Regarding the content of disclosure, the Technical Committee leaves it to regulators' discretion whether to specifically identify dark venues or the fact that a trade has resulted from a dark order.

- The third principle proposes that transparent orders should take priority over dark orders in the execution queue.

- The fourth principle stresses that regulators must be able to access information on orders and transactions effected in dark pools.

- The fifth principle insists that dark pools should provide market participants with sufficient information about the way orders are handled and executed.

- Finally, the sixth principle calls on regulators to periodically monitor developments in dark pools and dark orders to ensure that they are not impairing the efficiency of the price formation process, and, where necessary, to take appropriate preventive action.

1 *Principles for Dark Liquidity. Final Report*. May 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD353.pdf

2.2 National economic and financial developments

Spanish GDP advances at a modest rate...

Quarterly National Accounts data for the second quarter of 2011 show that Spain's GDP grew 0.2% in quarterly and 0.7% in year-on-year terms, in both cases two decimal points below previous quarter's rate. Note that deceleration was rather less than in other European countries, though the economy's year-on-year advance still trailed behind the average for the euro area (1.6%).

...thanks to the strength of exports...

Year-on-year growth of Spain's GPD drew heavily on external demand, which doubled its contribution to aggregate growth as far as 2.6 points. Conversely, domestic demand detracted 1.9 points against the 1.5 points of one year before, with private consumption (-0.2% year-on-year), government consumption (-1%) and, particularly, gross fixed capital formation (-6%) also contributing on the downside. Meantime, imports dropped by 1.7% year-on-year after a steady advance spanning five consecutive quarters, while exports rose by 8.4% (12.1% in the first quarter).

...and positive input from industry and, to a lesser extent, services.

On the supply side, deceleration extended to all branches of production except construction which, despite clawing back some ground, still registered the steepest decline (-4.1%) in year-on-year terms. The energy sector, meantime, slowed to 0.9% (3.4% in the first quarter) and industry to 3.2% (4.1% in the first quarter), while the services sector dropped one decimal point of growth as far as a year-on-year rate of 1.2%.

Spain: main macroeconomic variables (annual % change) TABLE 3

					European Commission*	
	2007	2008	2009	2010	2011F	2012F
GDP	**3.6**	**0.9**	**-3.7**	**-0.1**	**0.8 (+0.1)**	**1.5 (-0.2)**
Private consumption	3.7	-0.6	-4.2	1.2	0.8 (-0.1)	1.1 (-0.5)
Government consumption	5.5	5.8	3.2	-0.7	-1.4 (-0.1)	-0.3 (=)
Gross fixed capital formation, of which:	4.5	-4.8	-16.0	-7.6	-3.4 (-0.3)	1.8 (-0.9)
Equipment	10.4	-2.5	-24.8	1.8	3.1 (-0.6)	4.4 (-1.6)
Exports	6.7	-1.1	-11.6	10.3	7.0 (+1.5)	5.8 (+0.2)
Imports	8.0	-5.3	-17.8	5.4	1.7 (+0.3)	3.8 (-0.7)
Net exports (growth contribution, pp)	-0.8	1.5	2.7	1.0	1.4 (+0.3)	0.5 (+0.2)
Employment	2.8	-0.5	-6.6	-2.4	-0.6 (-0.3)	0.9 (-0.2)
Unemployment rate[1]	8.3	11.3	18.0	20.1	20.6 (+0.4)	20.2 (+1.0)
HICP	2.8	4.1	-0.2	2.0	3.0 (+1.5)	1.4 (=)
Current account (% GDP)	-10.0	-9.6	-5.5	-4.5	-4.1 (-0.3)	-4.1 (-0.5)
General government (% GDP)	1.9	-4.2	-11.1	-9.2	-6.3 (+0.1)	-5.3 (+0.2)

Source: Ministry of Economy and Finance, National Statistics Office (INE) and European Commission.

1 Eurostat definition.

* Forecasts published in spring 2011 (with respect to autumn 2010). In September 2011, the European Commission released interim European economic forecasts ahead of the autumn edition, which maintained its growth projection for the Spanish economy at 0.8% for 2011, and downward revised its inflation forecast by one decimal point to 2.9%.

Spanish inflation has abated since April, narrowing the gap versus the euro area...

Inflation in the EU, measured by the harmonised index of consumer prices, eased to 2.7% in August after the peak levels of April 2011 (3.5%), with the fall extending to most components. Spain's headline inflation moderated rather more steeply, narrowing the differential with the euro area to 0.2 points. Core inflation, meantime, dropped to 1.6% from the 2.1% high of April-May to stand four decimal points above the euro-area average.

...in a framework of labour market weakness...

Spanish labour market statistics offered little to celebrate, with around 1% fewer employed workers at the close of the second quarter (18.3 million) and unemployment rates stuck above 20%. Unit labour costs have receded by an average 2% since 2010 in contrast to the pre-crisis years, when they were advancing ahead of 4% annually driven by rising wage compensation per worker. The subsequent decline was the combined work of flat wage growth and higher labour productivity.

...and intense budgetary adjustment spearheaded by central government.

The latest data for central government budgetary execution reveal a 22.75 billion deficit on a national accounts basis over the first seven months of 2011 (2.1% of GDP), an 11.8% decrease with respect to the year-ago period. Non-financial revenues

grew by 1% while non-financial payments fell by 22.7% in year-on-year terms in tune with budgetary austerity. Meantime, the budgetary outcomes of the autonomous communities throw up a first-half deficit equivalent to 1.2% of national GDP (1% of GDP in the same period of 2010) on the back of a decline in non-financial revenues (-3.6%) and slightly higher spending (0.5%). The general government debt ratio moved up 4.8 points in the opening quarter to 65.2% of GDP. Of this volume, 49.4 points corresponded to central government, 12.4 to the autonomous communities and 3.5 to local authorities.

The newly approved public deficit ceiling may help to dispel market uncertainty.

One move that may help alleviate the uncertainty surrounding the sustainability of Spain's public finances is Parliament's approval of a bill to limit the structural budget deficit by amending Article 135 of the Constitution. Under the recast provision, the structural deficit (discounting public revenues and expenditures derived from the normal fluctuations of the business cycle) may not exceed 0.40% of GDP across all sub-sectors of general government.[2]

Credit institutions have to negotiate a complex landscape, characterised by...

As well as conducting their business in the face of persistently weak domestic activity, Spanish credit institutions had to cope with both the challenges of sector restructuring and a resurgence in market tensions that has placed added pressure on their share prices and funding conditions.

...weak domestic activity...

The income sheets of national deposit-taking entities held in positive territory over the first six months of 2011, with aggregate net profits topping 4.70 billion euros, 23% less than in the first half of 2010. Behind these lower numbers was a fall in net interest income (down 21%), originating in higher interest costs (up 30%), which could not be sufficiently offset by substantial improvement in the sector's impairment losses in financial assets.

...an ongoing contraction in lending to the non-financial private sector...

Outstanding loans to the non-financial private sector (corporations and households) registered a year-on-year decline of 3% to the month of July, prolonging the downward trend that commenced in 2009. All lending modalities shared in the decrease led by household consumer credit (-5%) and business loans (-4.2%). Home purchase lending has contracted by around 1% since June after the small advance of full-year 2010, the likeliest cause being the increased tax pressure on home ownership.[3] The contrast is provided by lending to public authorities, which expanded 15% in year-on-year terms. In the euro area, aggregate lending to the non-financial private sector rose at a year-on-year rate ahead of 2%. The advance extended to all modalities with home purchase loans strongly to the fore (5%). Finally, growth of household consumer credit cooled to 0.6%, while business lending kept up a steady but discreet recovery (1.4%).

...an NPL ratio fast approaching 7% on the deterioration of loans to construction and real estate...

By July, the non-performing loans ratio of Spanish credit institutions was up to 6.9%, two decimal points higher than in June and almost one and a half points

2 This ceiling will be regulated by a future law to be approved before 30 June 2012 and implemented as of 2020. The limit will be set at 0.4% of GDP on a general government basis, 0.26% for central government and 0.14% for the autonomous communities, but may be subject to review in 2015 and 2018. Local authorities will be required to present a balanced budget.

3 Tax deductions for first home purchases will be discontinued in 2011. Also, the VAT on new housing purchases was raised from 7% to 8% in July 2010.

above its year-ago levels. The biggest culprits were again construction and real estate development, with a combined second-quarter ratio of 17% (13.5% in December 2010 and 10.9% in June 2010), while delinquent loans to households held at 3.2%, two decimal points less than at mid-year 2010.

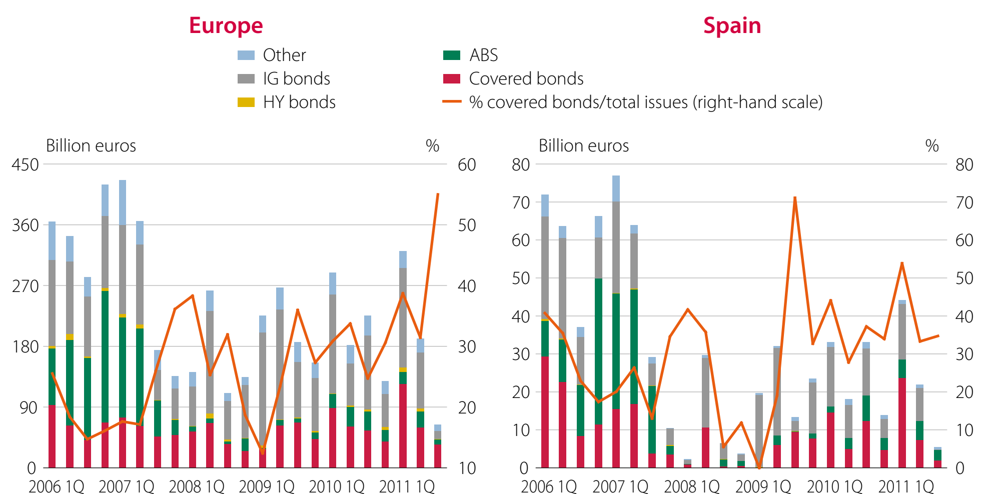
...and tougher funding conditions amid renewed market stress.

Spanish banks have faced increasing funding difficulties, with the summer months proving especially tough as market tensions flared once more. Since the start of the crisis, institutions have had to find alternative sources to the international wholesale markets they could comfortably draw on around the middle of the last decade. Hence their recourse to non-conventional means like government-backed bonds, whose issuance has nonetheless tapered off this year,[4] or borrowing from the Eurosystem. Funds raised through this last channel peaked at over 130 billion euros in the middle months of 2010, then dropped back to around 40 billion in the first quarter of 2011 until renewed debt market tensions sent them heading back upwards to 70 billion euros in August last.

Entities respond by competing for deposits and centring their debt issuance in high-quality instruments.

The trends emerging over recent months in Spanish credit institution financing strategies combine: (i) a major drive to broaden their customer base and build their deposit volumes (deposits from the non-financial private sector have climbed by over 16 billion euros since the lows of April 2010); (ii) a gathering shift in the debt financing mix towards mortgage covered bonds; and (iii) a step-up in equity issuance. The above change in the debt mix mirrors developments elsewhere in Europe (see figure 9), where the across-the-board surge in investor risk aversion has persuaded banks to opt increasingly for products of perceived higher quality, like mortgage covered bonds (46% of Spanish entities' issue volume in the year and 38% that of their European peers). Finally, the recent upswing in the equity issuance of Spanish credit institutions traced mainly to the stockmarket listings of two entities arising from savings bank mergers (see exhibit 2 of this report).

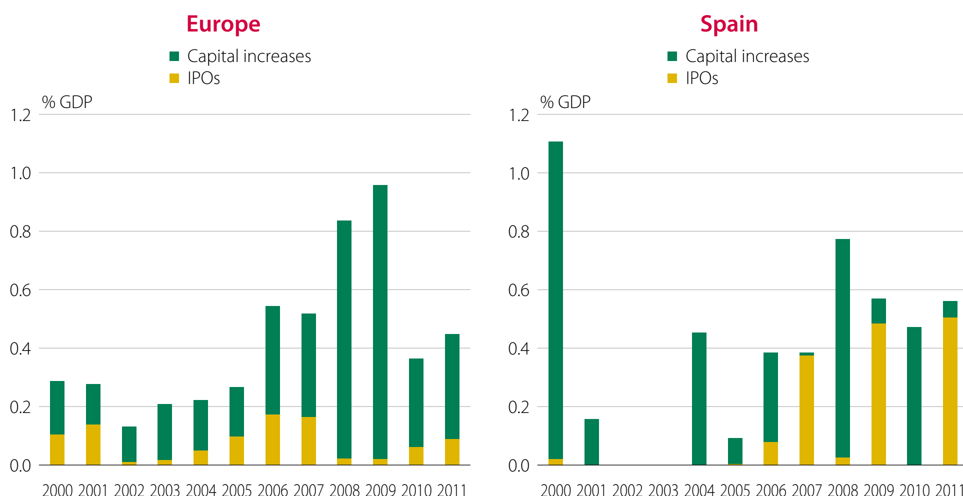
Gross medium- and long-term debt issuance by financial entities FIGURE 9



Source: Dealogic. Data to 20 September 2011.

4 Issuance of government-backed bonds has faded to just four billion euros year-to-date compared to the 13 and 48 billion euros of 2009 and 2010 respectively.

Equity issuance by financial entities FIGURE 10



Source: Dealogic. Data to 20 September 2011. Data for this last year restated on an annual basis.

Exhibit 2: "The stockmarket flotation of Spanish savings banks"

Royal Decree-Law 2/2011 of 18 February on the strengthening of the Spanish financial system, toughened the capital requirements of Spanish credit institutions by establishing a minimum core capital ratio of 8% of risk-weighted assets, rising to 10% for those institutions with less than 20% of their equity in the hands of private investors and, additionally, reliant on wholesale funding for over 20% of their net loans. In order to meet the condition of having a minimum percentage of equity under private investor ownership, some savings banks have opted to transfer their financial activities to a newly created commercial bank and apply for its shares to be admitted to stockmarket trading. By the deadline for this report, the first entities arising from this strategy, Bankia and Banca Cívica, had had their listing applications approved by the CNMV, on 20 and 21 July respectively.

The criteria utilised by the supervisor in verifying these operations are summarised below:

1. Ownership dispersion

Among the listing conditions stated in Royal Decree 1310/2005 is that shares admitted to trading should have a wide enough distribution to ensure them sufficient secondary market liquidity. This requirement is normally met through a public offer for sale or subscription before the entity begins trading. The RD establishes that ownership dispersion will be sufficiently wide if 25% of the shares for which admission is sought are distributed among the public. However this threshold can be lowered if the market can operate effectively due to the large number of the issuer's shares outstanding and the extent of their distribution. At times, the CNMV has accepted an ownership dispersion below 25% (though never as low as 20%) for large-scale transactions involving a large number of shareholders, but always providing the issuer makes certain undertakings in return. In the case of

the stockmarket listings of Bankia and Banca Cívica, the regulator's view was that share distribution was sufficient, considering that Bankia and Banca Cívica had a free-float[1] on their admission dates of 43.3% and 44.7% respectively.

2. The listing price

As on any occasion when the public are asked to invest their savings in particularly complex market conditions, the CNMV was doubly vigilant with regard to the pricing procedures followed by issuers and their advisors. Normally, the most effective guarantee of fair, independent price formation is the existence of a large tranche of qualified investors participating in the bookbuilding[2] process. In this case, it was stipulated that the qualified investor tranche should equate to 40% of the offer volume before the exercise of the purchase or greenshoe option traditionally reserved for placing agents.

In savings bank placements, the CNMV has established that at least half of the qualified investors' tranche should be formed by the sub-category of institutional investors, that is, the investors envisaged in letters a), b), c) and d) of Article 78(2) of the Securities Markets Law, defining the different types of qualified investor.

Finally, the supervisor considered that to guarantee a diverse enough base of investor institutions contributing to efficient price formation, at least one hundred qualified investors should acquire a significant stake through the bidding process.

The following two tables show the breakdown of placements across subscriber categories.[3]

Results of BANKIA IPO

Types of subscribers	No. of shares	% offering	No. of subscribers
Financial institutions	105,055,568	12,74	532
- *Spanish market*	80,208,378	9,73	511
- *Foreign market*	24,847,190	3,01	21
Insurance corporations	86,433,137	10,48	145
Public authorities	2,597	0,00	2
SUB TOTAL	191,491,302	23,22	679
Others (*)	633,080,951	76,78	270,484
TOTAL OFFERING	**824,572,253**	**100**	**271,163**
Pro memoria:			
Price per share (euros)	3,75		
Capital raised (million euros)	3,092		

(*) Non-financial corporations, households and private not-for-profit organisations.

Results of BANCA CÍVICA IPO			
Types of subscribers	**No. of shares**	**% offering**	**No. of subscribers**
Financial institutions	46,371,203	20,87	89
- Spanish market	18,324,440	8,25	83
- Foreign market	28,046,763	12,63	6
Insurance corporations	12,304,399	5,54	30
Public authorities	13,330	0,01	5
SUB TOTAL	58,688,932	26,42	124
Others (*)	163,453,868	73,58	66,530
TOTAL OFFER	**222,142,800**	**100**	**66,654**
Pro memoria:			
Price per share (euros)	2,7		
Capital raised (million euros)	600		

(*) Non-financial corporations, households and private not-for-profit organisations.

1 Percentage of the issuer's share capital that is available for purchase on the market.
2 Bookbuilding is a price formation mechanism based on a demand prospection among potential investors assessing the quantities and price at which they would be willing to transact. Depending on the results, the placing agent and issuers arrive at a fixed price or discount rate for the placement.
3 For a correct reading of these data, please bear in mind that a portion of institutional investment (corresponding to non-financial large corporations) appears under "Others".

Non-financial listed companies grow their profits 8% in first half 2011...

Non-financial listed companies reported aggregate net profits of 13.15 billion euros in the first half of 2011, 8% more than in the same period last year (see table 4). Profits growth extended to all sectors with the exception of energy, whose combined earnings dropped 10% approximately to 6.13 billion euros. The top performers were retail and services and industrial sector companies, with profits growth of over 10% to 5.24 billion and 818 million euros respectively. But perhaps the most newsworthy development was the return to profit of construction and real estate firms, who posted first-half earnings of 954 million euros after several years of heavy losses.

Earnings by sector:[1] non-financial listed companies TABLE 4

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	**1H10**	**1H11**	**1H10**	**1H11**	**1H10**	**1H11**
Energy	16,044	15,545	10,767	10,265	6,796	6,129
Industry	2,161	2,217	1,328	1,394	741	818
Retail and services	14,583	15,777	8,333	8,917	4,660	5,240
Construction and real estate	3,616	4,340	2,004	2,722	-3	954
Adjustments	-102	-85	-28	-18	1	14
AGGREGATE TOTAL	**36,302**	**37,794**	**22,404**	**23,280**	**12,195**	**13,155**

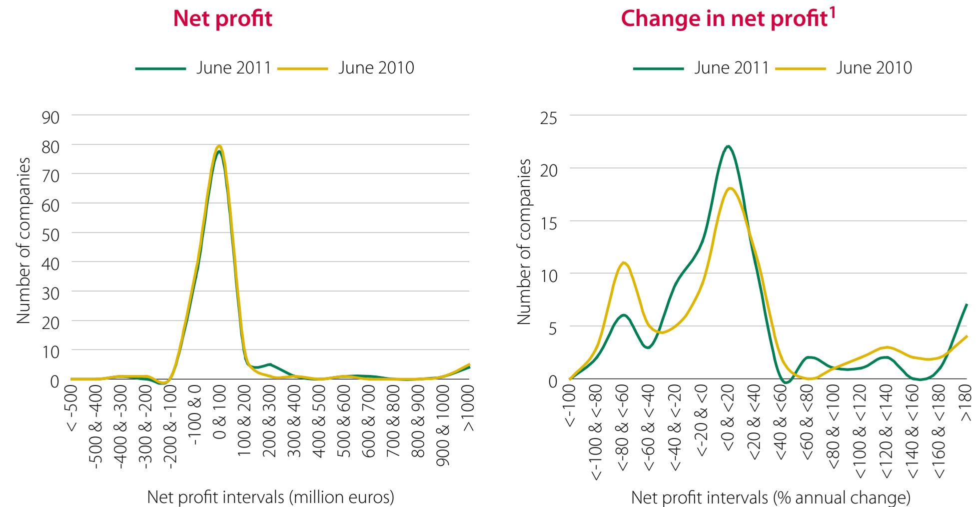
Source: CNMV.
1 Year-to-date.
2 Earnings before interest, taxes, depreciation and amortisation.
3 Earnings before interest and taxes.

...with little variation in the results of individual firms.

Breaking down listed companies in terms of their net profit for the year (see figure 11, left panel), we find a broadly similar pattern to the two preceding first-half periods. A majority of firms posted earnings of less than 100 million euros, though the number with profits between 200 and 300 million was higher than in the year-ago

period. As occurred last year, no single firm suffered losses deeper than 400 million euros. Finally, among the listed companies in profit over first-half 2010 and 2011 (see figure 11, right panel), a larger number had reported moderate improvement or deterioration (an increase or decrease of less than 40%), while those with more pronounced swings in either direction were fewer overall.

Non-financial listed companies by: FIGURE 11



Source: CNMV.

1 Number of entities distributed according to the change in their net profit, including only those with a positive net outcome in both years.

Non-financial listed companies pay down debt by 5.1% in the first half of 2011...

The combined debt of non-financial listed companies dropped by 5.1% to 310 billion euros between December 2010 and June 2011, in a break with the rising trend of previous years (see table 5). The contraction, however, was far from universal, with debt actually increasing in two (the industrial sector and construction and real estate) and falling in two others (energy and retail and services). More specifically, industrial firms grew their debt balance 19.2% to almost 18 billion euros, the cause being one firm's financing of its acquisition of a foreign competitor, while the total debt of construction and real estate operators rose by a more subdued 1.7% to 101 billion euros. Meantime, firms in the energy sector and retail and services cut their debt levels by 7.6% and 12.0% respectively. Note that the sectors reporting higher debt in the first half of 2011 were also those that had increased debt less or even decreased it in the course of the preceding years.

...though not all sectors share in the decrease.

Despite this aggregate reduction in indebtedness, financial leverage (the ratio between debt and net equity) ticked up from 1.4 at end-2010 to 1.5 in June 2011 due to a reduction on the equity side (see table 5). Meantime, the debt coverage ratio, measuring the years needed to repay existing debt assuming constant EBITDA, rose from 3.8 in December 2010 to 4.0 in June 2011. The biggest jump here (from 2.1 to 4) corresponded to industry, the source being the same large corporation remarked on above. Retail and services was the only sector that reduced its debt coverage ratio thanks to a strong earnings performance coupled with a decrease in aggregate indebtedness. Companies' interest coverage ratios deteriorated slightly, with EBIT/interest expenses down from 3.1 at end-2010 to 2.6 in June 2011, though not all sectors participated in the decline.

Gross debt by sector: listed companies

TABLE 5

Million euros		2007	2008	2009	2010	1H11
Energy	Debt	69,172	82,608	100,572	98,283	90,815
	Debt/ Equity	0.8	0.9	1.1	0.9	0.9
	Debt/ EBITDA[1]	2.5	2.8	3.5	2.8	2.9
	EBIT2/ Interest expenses	4.1	3.7	3.4	4.2	3.8
Industry	Debt	13,312	15,645	15,953	14,948	17,824
	Debt/ Equity	0.6	0.7	0.7	0.6	0.9
	Debt/ EBITDA	1.8	2.7	3.0	2.1	4.0
	EBIT/ Interest expenses	5.9	3.4	3.1	5.0	2.8
Construction and real estate	Debt	138,933	119,788	104,762	99,917	101,605
	Debt/ Equity	3.1	3.8	4.1	3.4	3.1
	Debt/ EBITDA	10.8	31.9	22.5	11.2	11.7
	EBIT/ Interest expenses	1.2	0.0	0.3	1.0	1.0
Retail and services	Debt	96,941	112,322	108,579	115,413	101,605
	Debt/ Equity	1.7	2.1	1.8	1.6	1.9
	Debt/ EBITDA	3.0	3.6	3.7	3.4	3.2
	EBIT/ Interest expenses	3.2	2.9	3.3	3.9	3.1
Adjustments[3]	Debt	-17,391.0	-20,802.0	-1,908	-1,792	-1,670
AGGREGATE TOTAL[4]	**Debt**	**300,967**	**309,561**	**327,958**	**326,769**	**310,179**
	Debt/ Equity	1.5	1.6	1.6	1.4	1.5
	Debt/ EBITDA	4.0	4.6	4.8	3.8	4.0
	EBIT/ Interest expenses	3.0	2.0	2.4	3.1	2.6

Source: CNMV.

1 Earnings before interest, taxes, depreciation and amortisation.

2 Earnings before interest and taxes.

3 In drawing up this table, we eliminated the debt of issuers consolidating accounts with some other Spanish listed group. The figures in the adjustments row correspond to eliminations from subsidiary companies with their parent in another sector.

4 This table did not previously include any financial entities, comprising credit institutions, insurance companies and portfolio companies. However, as IPP (Periodic Public Information) forms are the same for portfolio companies as for non-financial companies starting in 2008, it has been decided to include them in the aggregate figure. Data for the 2007 close have been restated to factor the impact of Criteria Caixacorp.

Household savings shrink, along with indebtedness.

Household asset indicators for the first quarter of 2011 reveal a further decline in savings rates to just over 12% of disposable income, remote from the highs recorded at the start of 2010 (18.1%). In the same period, household debt dropped below 125% of gross disposable income on a combination of stable income and lower liabilities, while net wealth contracted slightly as depreciating real estate cancelled out the small advance in financial asset prices.

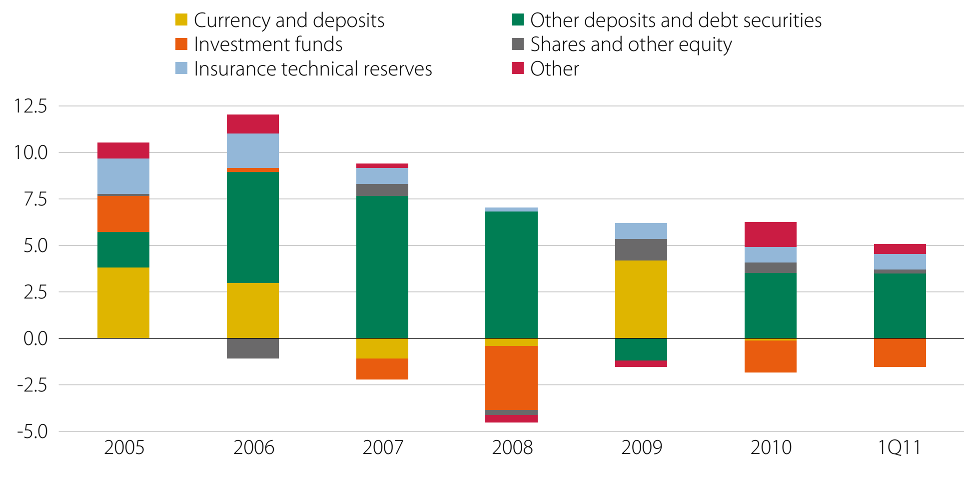
Homes continue gearing their investment to lower-risk instruments.

As to investment decisions, households' net financial asset purchases in the year's opening quarter came to 3.5% of GDP[5] (4.4% in 2010). The acquisitions mix evidenced Spaniards' continuing preference for lower-risk instruments, with invest-

5 Cumulative four-quarter data.

ment in term deposits and insurance and pension plan products at 3.1% and 0.8% respectively of first-quarter GDP. The contrast was provided by the slump in equity investment (0.1% of GDP) versus the two previous years, and net outflows from investment funds approaching 1.5% of GDP (1.7% in 2010). Finally, the share of household liabilities receded five decimal points to 0.8% of GDP.

Households: financial asset acquisitions (% GDP) FIGURE 12



Source: Banco de España, *Cuentas Financieras*. Cumulative four-quarter data.

2.3 Outlook

Forecasts by leading organisations auguring a global slowdown in the next few quarters...

The IMF's latest forecasts, published in September after the high point of the summer crisis, project a world growth slowdown from 2010 rates just topping 5% to nearer 4.0% in 2011 and 2012. These figures represent a cut of three and five decimal points respectively over the same organisation's June forecasts. Emerging market economies are expected to again spearhead the advance in world activity with growth rates of 6.4% in 2011 and 6.1% in 2012, compared to the considerably thinner 1.6% and 1.9% augured for the advanced economies, where the big talking-point was the substantial revise-down in the growth forecasts for the United States (by 0.9 points to 1.8%) and Germany (by 0.7 points to 1.3%).

...are surrounded by uncertainty since turbulence returned to world markets...

These forecasts are inevitably subject to considerable uncertainty after the latest flare-up in the European debt crisis and the weakening activity of the year's middle months. Indeed the heightened instability of financial markets observable since spring, and attributed primarily to European debt markets is being increasingly linked to mounting fears of a new worldwide recession.

...and estimate risk remains tilted to the downside.

As such, the main and, without doubt, growing downside risks for these baseline scenarios have to do with: (i) prolongation of the distrust affecting certain euro-area sovereign borrowers, pushing up the costs of funding and thereby depressing activity; (ii) a slowdown in growth and employment affecting leading advanced economies; (iii) the need to secure public finance sustainability across a wide range of economies and, finally; (iv) the resurgent liquidity and funding problems besetting the financial sector, especially in Europe, where doubts persist over the scale and effectiveness of the restructuring process.

The forecasters' consensus for the Spanish economy, after near zero growth in domestic activity in 2010, is just under 1% in 2011, then improving to 1.1-1.5% in 2012. The IMF's revision of its growth projections for Spain (unchanged in 2011 and a half-a-point revise-down in 2012) is less severe than the correction applied to other advanced economies. The main uncertainties hanging over this gradual recovery scenario stem from the aggregate risk induced by sovereign debt problems and, in particular, their possible contagion to other sectors of the economy, and the possible drag effect on domestic activity of a slowdown in the dynamic economies that constitute its main export markets.

Spain is expected to see moderate growth, with risks lurking mainly in debt market tensions and the projected deceleration of external demand.

3 Spanish markets

3.1 Stock markets

The deepening impact of the European sovereign debt crisis and the worsening outlook for world economic activity unleashed a new wave of volatility in the year's middle months, and sent prices tumbling in international markets for equity instruments. The shares of European financial institutions were among the hardest hit, reflecting their heightened exposure to the sovereign debt of the region's more vulnerable economies. Spanish stock markets too were caught up in the prevailing uncertainty in the form of increased volatility and a price slide mirroring that of other European bourses. It was in response to the unsettled state of some of these markets, due in part to manipulative rumour-mongering, that the securities regulators of Belgium, Spain,[6] France and Italy, under the coordination of ESMA (European Securities and Markets Authority), decided on 11 August to impose a temporary ban on the creation or increase of short positions in financial sector shares in their respective jurisdictions (see exhibit 3 of this article).

The latest round of the European sovereign debt crisis and worsening prospects for world economic growth sent stock markets tumbling in a climate of growing instability...

Against this backdrop, the country's main stock market indices posted third-quarter losses approaching 20%,[7] in line with other European benchmarks, in contrast to the mild falls of the second quarter and, more strikingly, the price rally of the opening months (in all but Latin American securities platforms, see table 6). The Ibex 35 shed 19.3% of its value in the third-quarter period on the heels of 2% losses in the second quarter and a 7.3% price gain in the first, resulting in a year-to-date fall of 15.2%. Smaller cap indices experienced similar fortunes with declines of over 18% in the third quarter, for year-to-date losses summing 19.4% in the case of the Ibex Medium Cap and 15.8% for the Ibex Small Cap. Finally, Latin American indices contained their third-quarter losses at 9% and 11%, to close the first nine months down by 19% and 23%.

....which led to a temporary ban on the creation or increase of short positions in financial shares, applied in various European countries including Spain.

6 On 11 August last, the CNMV approved a temporary ban on transactions involving the creation or increase of short positions in Spanish financial sector shares, pursuant to Article 85.2 j of Securities Markets Law 24/1988 of 28 July and with the sole exception of market maker trades. A short position is understood as one arising from a positive economic exposure to a fall in the share price. On 25 August 2011, the CNMV extended its prohibition to 30 September 2011, with the possibility of lifting it earlier if market conditions settle and otherwise prolonging it as an exceptional measure.

7 To 20 September.

Performance of Spanish stock market indices and sectors (%) TABLE 6

Index	2007	2008	2009	2010	1Q11[1]	2Q11[1]	3Q11 (to 20 September) % prior qt.	% Dec	% y/y
Ibex 35	7.3	-39.4	29.8	-17.4	7.3	-2.0	-19.3	-15.2	-22.2
Madrid	5.6	-40.6	27.2	-19.2	7.5	-2.7	-19.7	-16.0	-23.9
Ibex Medium Cap	-10.4	-46.5	13.8	-5.6	6.3	-6.9	-18.6	-19.4	-19.3
Ibex Small Cap	-5.4	-57.3	17.6	-18.3	17.4	-8.2	-21.9	-15.8	-18.5
FTSE Latibex All-Share	57.8	-51.8	97.2	9.0	-3.2	-9.9	-11.2	-22.6	-15.5
FTSE Latibex Top	33.7	-44.7	79.3	9.7	-3.9	-8.1	-8.6	-19.2	-16.5
Sector[2]									
Oil and gas	1.8	-30.8	-20.1	0.3	22.5	-2.2	-12.5	4.9	15.0
Chemicals	-58.4	-67.8	3.4	-60.0	30.4	5.8	-19.6	10.8	0.0
Basic materials	-17.2	-45.4	23.1	-5.6	9.0	-6.6	-26.3	-25.0	-25.0
Construction mat. and construction	-12.0	-51.0	25.5	-14.4	13.8	-5.7	-17.5	-11.4	-11.7
Industrial goods and services	6.9	-41.9	29.3	-1.9	4.6	-1.4	-14.1	-11.3	-11.8
Health	19.2	-45.0	17.7	-22.2	14.1	0.3	-10.8	2.0	-8.8
Utilities	18.5	-31.0	-7.8	-14.3	10.8	3.3	-22.4	-11.2	-9.7
Banks	-4.5	-47.9	46.3	-32.3	7.3	-4.4	-25.5	-23.6	-38.5
Insurance	-13.3	-25.0	19.8	-26.8	26.6	-1.3	-12.2	9.7	-0.7
Real estate	-42.6	-58.6	-43.8	-53.2	24.2	-20.8	-32.9	-34.0	-51.6
Financial services	-35.6	-44.3	20.8	12.8	22.6	-3.6	-13.0	2.8	4.4
Telecommunications and media	26.3	-31.4	23.5	-13.4	4.3	-5.4	-17.7	-18.8	-24.1
Discretionary consumption	-7.7	-39.2	37.0	20.6	2.9	5.9	-5.6	2.8	0.4
Basic consumption	6.9	-22.5	-8.4	15.8	0.8	-5.4	-17.5	-21.3	-14.6

Source: Thomson Datastream.

1 Change versus previous quarter.

2 Classification according to Thomson Datastream.

The third-quarter price slide extends to all sectors, with the banks among the worst affected.

All sectors shared in the third-quarter price slump in national equity markets, with losses ranging from the 7% of consumer goods (discretionary and basic) to the 33% of the real estate sector. Among the big cap players the steepest slide corresponded to the banks (-25%), telecommunications and media (-18%) and utilities (-22%), while those in the middle capitalisation bracket, like construction and materials, oil and gas and industrial goods and services, posted falls in the interval of 12% to 17%. Year-to-date, the worst performers have been real estate (-34%), basic materials (-25%), banking (-24%), basic consumption (-21%) and telecommunications and media (-19%), while the firms that have best withstood the financial market stress are those in chemicals (cumulative 2011 gain of 11%), insurance (10%) and, to a lesser degree, oil and gas (5%), non-bank providers of financial services (3%), discretionary consumption (3%) and health and related services (2%).

Exhibit 3: "The temporary ban on short selling"

On 11 August last, the securities regulators of Belgium, France, Italy and Spain, under the coordination of ESMA, jointly decided a temporary ban on the creation or increase of short positions in financial sector shares. On 28 September, the CNMV agreed to extend this measure for the second time (the first was on 25 August) until market conditions accompany.

The precautionary ban on short selling owes to the risks posed for the stability and orderly functioning of markets by the extreme volatility which for the past few months has gripped European stock markets and, particularly, financial sector shares. This situation, it is feared, could lead to disorderly markets and provoke downward price spirals in determined shares driven by investor panics or, even, manipulative rumours or information.[1] Financial institutions have been singled out for their importance in the preservation of financial stability and the containment of systemic risk. In particular, their need to raise funds continuously makes them vulnerable to the destructive dynamics of the "self-fulfilling prophecy" whereby a falling share price pushes up their cost of funding.

But despite these pretendedly preventive or stabilising effects, there is no denying that this kind of ban can impede the action of certain indicators of the quality of market functioning. Indeed numerous studies conducted in the past few years have found that restrictions on short sales curtail market efficiency and liquidity.[2] And certainly in their absence, market participants have a narrower transactional range to choose from (lower liquidity) and can extract less reliable information from market prices (lower efficiency).

The experience of the Spanish market since the short selling ban was imposed last August is illuminating with regard to these effects. As we can see from the upper panel in the figure below, the average bid-ask spread of banks has widened in comparison with that of Ibex 35 shares unaffected by the ban, evidencing some deterioration in the formers' liquidity.[3] But the mid panel shows that the prohibition has allowed bank shares as a whole to outperform the rest of the market, though this boost effect appears to fade with time.[4] The lower panel, finally, confirms that the ban has done much to reduce the high volatility that had plagued bank shares, particularly in the days before its application.

The empirical evidence therefore suggests that disallowing short sales has helped reduce the volatility of target shares, although its apparently lasting consequences for their liquidity endorse the wisdom of lifting the ban as soon as market conditions so allow. In this respect, the CNMV stated in its 28 September communication that the ban would be maintained for as short a time as possible, and that it would continue to coordinate its work, though ESMA, with that of other European regulators operating similar restrictions, in order to make regular assessments of the market situation.

The ban's effects on the liquidity, price and volatility of target shares FIGURE E3.1

The upper panel tracks the bid-ask spread of a wide range of companies subject or otherwise to the prohibition. The affected companies are in this case the banks (our analysis excludes two financial services providers and two insurance firms for the sake of a homogeneous sample). The companies unaffected are all those listed on the Ibex 35 when the ban was imposed. Liquidity is defined by reference to relative bid-ask spread. The central panel shows the cumulative outperformance of target shares since the prohibition date, defined as the difference in each share's return relative to the return of the Ibex 35. The lower panel charts the volatility gap between target and non-target companies, based on data for the 22 trading days prior to the prohibition date. In all three panels, the value 0 on the Y-axis corresponds to 11 August 2011, while negative and positive values indicate the number of trading days before and after the ban respectively.

1 See I. Goldstein and A. Guembel (2008), "Manipulation and the allocational role of prices", in *Review of Economic Studies*, vol. 75, pp. 133-164, discussing how certain manipulation strategies involving short sales can have a lasting adverse impact on a company's earnings (damage to client, supplier and investor perceptions, costlier access to external finance, etc.).

2 See for instance D. Diamond and R. Verrecchia (1987), "Constraints on short-selling and asset price adjustment to private information", in *Journal of Financial Economics*, vol. 18, pp. 277-311; D. Abreu and M. Brunnermeier (2003), "Bubbles and crashes", in *Econometrica*, vol. 71, pp. 173-204; and H. Hong and J. Stein (2003), "Differences of opinion, short-sales constraints, and market crashes", in *Review of Financial Studies*, vol. 16, pp. 487-525.

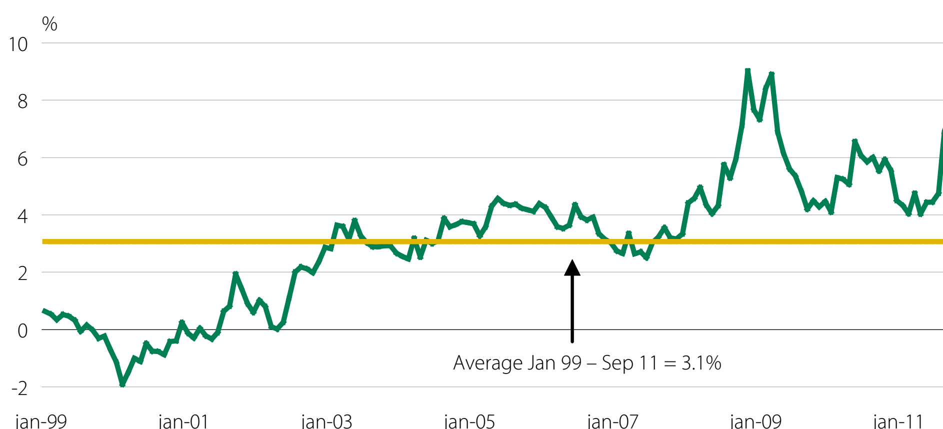
3 This analysis confines itself to the shares of the banking institutions targeted by the ban, and therefore excludes four non-banking financial companies. The full list of issuers whose shares comes under the prohibition can be consulted on http://www.cnmv.es/

4 The first two results concur with the international evidence gathered by A. Beber and M. Pagano (2011), "Short-selling bans around the world: evidence from the 2007-09 crisis", to be published shortly in the *Journal of Finance*. The authors, however, make no assessment of bans' impact on share price volatility.

The P/E of the Ibex 35 contracts sharply in the third quarter...

The P/E of the Ibex 35 prolonged its descent as far as 8 times approximately in the third quarter, below the level of year-end 2010 (around 10) and in line with other European indices. The earnings yield gap, which reflects the return premium required to be invested in equity versus long-term government bonds, turned up sharply in August, after charting an even course for most of the year, and by mid-September was running at 7.7% (4.3% in early August), at a distance from both its start-out level (4.9%) and its average since 1999 (3.1%).

Earnings yield gap[1] of the Ibex 35 FIGURE 13



Source: Thomson Datastream and CNMV.

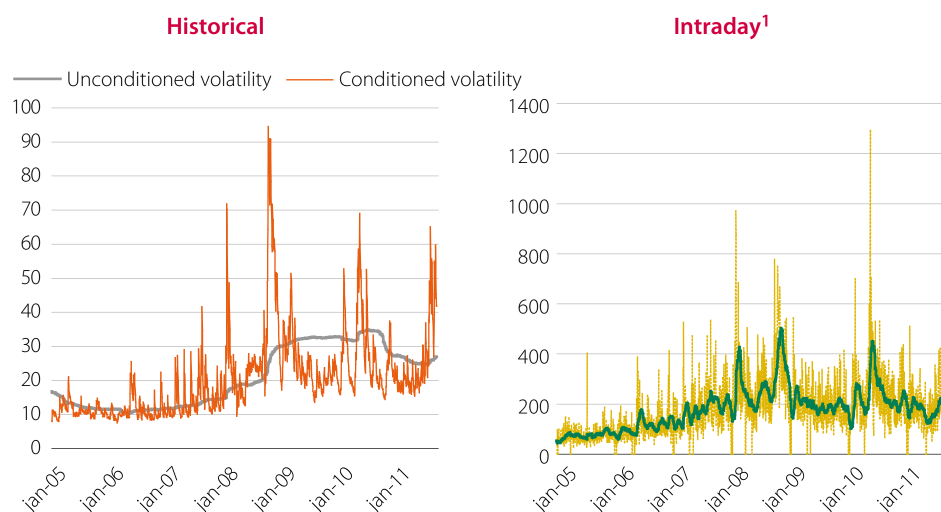
1 Difference between stock market yield, taken as earnings/price and ten-year Spanish government yields. Monthly data to 20 September 2011.

...against a backdrop of fast-rising volatility,...

As figure 14 shows, both historical and intraday volatility moved up a gear in the third quarter. Ibex 35 historical volatility peaked at 65% in August, close to the heights reached during the first outbreak of the European debt crisis in May 2010 but still far short of the levels observed in the fourth quarter of 2008. By mid-September, readings had eased back to 40%. Meantime, intraday volatility, taken as the difference between the index's high and low prices in each trading session, peaked at 700 points in the thick of market disruption and has since cooled considerably.

Ibex 35 volatility

FIGURE 14



Source: Thomson Datastream and CNMV. Data to 20 September.

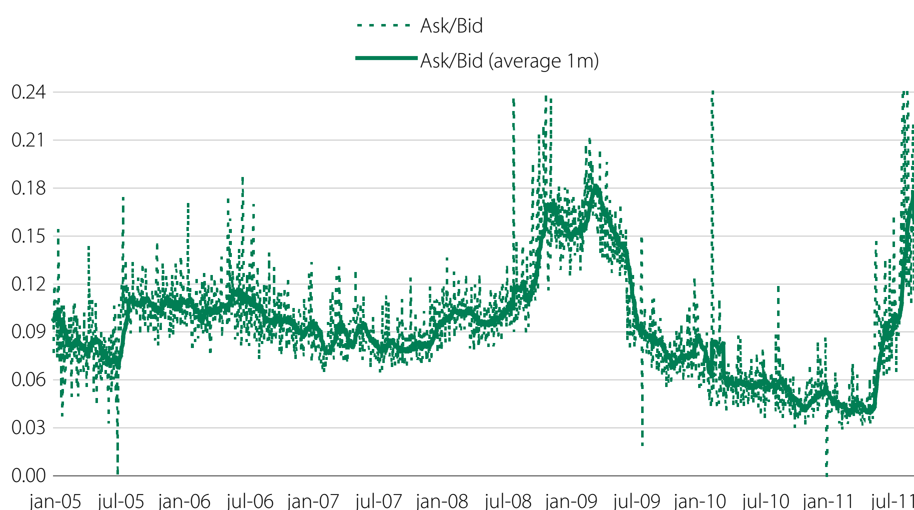
1 Depicting the difference between the daily price highs and lows of the Ibex 35 and the average of the last month.

...deteriorating liquidity conditions,...

This heightened volatility put the liquidity conditions of domestic equity markets under a growing strain in the second quarter which only intensified as the months progressed, with third-quarter readings resembling those of the first quarter of 2009. Specifically, the average bid-ask spread of the Ibex 35 was up to 0.14%, well above the 0.05% of the first-half period and the 0.09% average of the past six years.

Ibex 35 liquidity. Bid-ask spread (%)

FIGURE 15



Source: Thomson Datastream and CNMV. Data to 20 September.

...and a conjunctural upswing in market turnover.

Turnover on the Spanish stock market exceeded 699 billion euros in the first three quarters of 2011 (to 20 September), 2.7% less than in the same period last year. Average daily volume in the third quarter was 3.69 billion, after a year-on-year increase of 13%, just slightly below the average levels of full-year 2010 (4.05 billion euros).

The strong comeback in equity issuance over the second and the third quarter was all about the stockmarket listing of various savings banks (see table 2), as part of the restructuring of the Spanish financial system, and capital increases at already listed banks ahead of the new capital requirements to be introduced by Basel III. Issue volumes in these two quarters exceeded 11 billion euros, of which 67% corresponded to the above transactions. Between January and September, funds raised on domestic equity markets came to nearly 14.40 billion euros, rivalling the 16 billion raised in full-year 2010.

Savings banks IPOs explain the recent surge in equity issuance.

Turnover on the Spanish stock market

TABLE 7

Million euros

	2007	2008	2009	2010	1Q11	2Q11	3Q11[1]
Electronic market	1,658,019	1,235,330	880,544	1,032,447	245,990	236,897	212,868
Open outcry	1,154	207	73	165	20	11	4
of which SICAVs[2]	362	25	20	8	2	3	1
MAB[3]	6,985	7,060	5,080	4,145	880	1,134	1,000
Second Market	193	31,50255	3	3	1	0	0
Latibex	868	757,88857	435	521	102	89	82
All exchanges	**1,667,219**	**1,243,387**	**886,135**	**1,037,282**	**246,992**	**238,131**	**213,953**
Pro-memoria: non resident trading (% all exchanges)							
	61.6	66.0	64.6	75.3	77.6	n.d.	n.d.

Source: CNMV and Dirección General de Comercio e Inversiones.

1 Cumulate data from 1 July to 20 September.

2 Open-end investment companies.

3 Alternative equity market. Data since the start of trading on 29 May 2006.

n.a.: data not available at the closing date for this report.

Equity issues and public offerings[1]

TABLE 8

	2007	2008	2009	2010	1Q11	2Q11	3Q11[2]
CASH AMOUNTS[3] (million euros)	**69,955**	**16,349**	**11,391**	**16,013**	**3,237**	**4,797.6**	**6,323.4**
Capital increases	67,887	16,340	11,389	15,407	3,237	4,797.6	6,323.4
Of which, through POS	8,503	292	17	959	0	3,696.4	8,4
National tranche	4,821	292	15	62	0	3,696.3	8,4
International tranche	3,681	0	2	897	0	0.1	0.0
Public offerings	2,068	10	2	606	0	0.0	0.0
National tranche	1,517	10	2	79	0	0.0	0.0
International tranche	551	0	0	527	0	0.0	0.0
NUMBER OF FILINGS[4]	**100**	**54**	**53**	**69**	**17**	**23**	**24**
Capital increases	91	53	53	67	17	22	24
Of which, through POS	8	2	2	12	0	3	3
Of which, bonus issues	19	18	11	15	2	5	6
Public offerings	12	2	1	3	0	1	0

Source: CNMV.

1 Incorporating issues admitted to trading without a prospectus being filed.

2 Data to 20 September 2011.

3 Excluding amounts recorded in respect of cancelled transactions.

4 Including all transactions registered, whether or not they eventually went ahead.

Exhibit 4: "Green Paper on the EU Corporate Governance Framework"

The Green Paper on Corporate Governance published by the European Commission in April 2011 puts forward a series of initiatives to improve the corporate governance of European companies, particularly those listed on regulated markets. These initiatives are spread over the four chapters into which the paper is organised:

1. General: the report raises the ideas of creating a specific corporate governance regime tailored to small and medium-sized companies and encouraging good governance codes for unlisted firms.

2. Boards of directors: it may be necessary, the Commission says, to strengthen the diversity of non-executive members, to ensure selection is based on professional qualifications, skills, and technical expertise and to require a higher level of dedication. Attention should also go to promoting greater gender diversity and a clear separation between the board chairperson and chief executive officer. Finally, it proposes introducing mandatory disclosure requirements for directors' remuneration and remuneration policy, which should also be put to the vote of the shareholders' meeting.

3. Shareholders: the Commission acknowledges that the current corporate governance framework rests on the assumption that shareholders feel engaged with companies and actively concerned about the quality of their management performance. Yet it has been widely observed that most shareholders take a passive, short-termist approach. For this reason, the Commission proposes a debate on ways to overcome this disinterest, increase institutional investors' involvement in corporate governance and convince shareholders to adopt a longer-term outlook and investment strategy. It also looks at ways to strengthen minority shareholder protection vis à vis controlling shareholders in cases like related-party transactions.

4. Application of the "comply or explain" framework: the Commission expresses its concern about the shortcomings detected in the application of "comply or explain". This occurs basically because companies' explanations for departures from their respective codes are of poor informative quality, and because mechanisms are lacking for effective compliance monitoring. To this end, the Green Paper proposes more stringent requirements and tighter quality monitoring and analysis of the information companies supply in their corporate governance statements, over and above that performed by shareholders. The Commission refrains from comment regarding the proper functions or legal status of the authority charged with such monitoring, but solicits stakeholders' views on what these functions should be.

The consultation round concluded on 22 July, and the European Commission will now review its proposals in the light of stakeholder responses and decide on future action at the Community level.

3.2 Fixed-income markets

The climate on domestic fixed-income markets was again dominated by the ongoing crisis in European sovereign debt markets, which gained new intensity in early August, sending Spanish government bond yields and spreads to record highs. The decision by the European Central Bank to purchase euro-area bonds on the secondary market plus other measures taken nationally helped contain the upward spiral in sovereign spreads that over the course of August had sucked in a fair proportion of Europe's economies. But nor did spreads abate to any meaningful extent. In September, both debt markets and sovereign risk premiums tensed once more amid gathering fears of a slowdown in the world economy.

In domestic fixed-income markets, government bond yields and spreads scale new heights in early August.

In this context, treasury bill rates, which had headed significantly lower in the opening quarter, began rising again to early August before falling once more in the weeks that followed. Between March and September, rates on three-, six- and twelve-month bills gained an average of 43, 92 and 100 basis points to 1.4%, 2.3% and 3.1% respectively (see table 9) – still well below the rates of late 2010 in the thick of the Irish debt crisis.

Short-term interest rates also rise on both government...

Short-term interest rates[1] (%) TABLE 9

	Dec 08	Dec 09	Dec 10	Mar 11	Jun 11	Sep 11
Treasury bills						
3 month		0.44	1.63	0.96	1.46	1.39
6 month		0.61	2.76	1.40	1.84	2.32
12 month		0.88	3.26	2.10	2.63	3.10
Commercial paper [2]						
3 month	3.09	0.76	1.37	1.29	1.57	1.67
6 month	3.63	1.25	2.52	2.03	2.12	2.50
12 month	3.74	1.63	3.04	2.66	2.73	2.94

Source: Banco de España and CNMV.

1 Average daily data. September data to 20/09.

2. Interest rates at issue.

In private fixed-income markets, short-term rates dropped rather less than their public debt equivalents in the first quarter of 2011,[8] and also rose more gently in the second and the third quarters. Hence the interest rate on three-, six- and twelve-month commercial paper climbed by 38, 47 and 28 basis points on average to 1.7%, 2.5% and 2.9% respectively.

...and corporate paper.

After an opening stretch in which rates were flat, or even falling in the case of three- and five-year maturities, long government bond yields initiated an upward trajectory in April that intensified throughout July. By the first days of August, the 10-year bond was trading at highs ahead of 6%, a reading not seen since November 1997. Thanks to the ECB's government bond purchases on the secondary market, Spanish

Long-term government yields are stabilised by ECB bond buying after reaching their highest levels since 1997.

8 In fact, average interest rates on three-month commercial paper rose slightly between December 2010 and March 2011.

government yields and those of other European economies like Italy, Portugal, Ireland and Belgium came down sharply in just a few days (by over 130 bp in Spain's case). But by early September, they were rising again as far as 3.8%, 4.5% and 5.2% at three, five and ten years respectively on the closing date for this report.

Corporate bond yields keep on rising into September.

Long-term corporate bonds performed broadly similarly over the first six months of the year, with initially falling yields giving way to a renewed increase in the second quarter. Unlike with public debt, however, the run-up in yield persisted through the third quarter. Between March and September, corporate bond yields climbed 111 bp, 83 bp and 98 bp in three-, five- and ten-year maturities respectively as far as 4.9%, 5.6% and 7.0%.

Medium and long government and corporate bond yields[1] TABLE 10

%	Dec 08	Dec 09	Dec 10	Mar 11	Jun 10	Sep 11
Government bonds						
3 year	3.05	1.95	3.87	3.41	4.07	3.82
5 year	3.41	2.67	4.65	4.30	4.70	4.45
10 year	3.86	3.75	5.38	5.25	5.48	5.22
Corporate bonds						
3 year	5.45	3.14	4.31	3.79	4.51	4.90
5 year	5.99	4.30	5.44	4.75	5.40	5.58
10 year	6.08	4.88	6.42	5.98	6.90	6.96

Source: Reuters and CNMV.

1 Monthly average of daily data. September data to 20/9.

The rise in sovereign risk affecting Spain and other European economies...

After opening with a downward run that bottomed at 174 bp,[9] Spanish long-term bond spreads over the German benchmark were driven higher once more as doubts grew about the sustainability of Greece's public finances and investors turned distrustful eyes on other European economies. After an early August peak of 390 bp,[10] Spanish sovereign spreads tightened to below 300 bp, until renewed uncertainty at the start of September sent them back above the 360 bp mark (see figure 16).

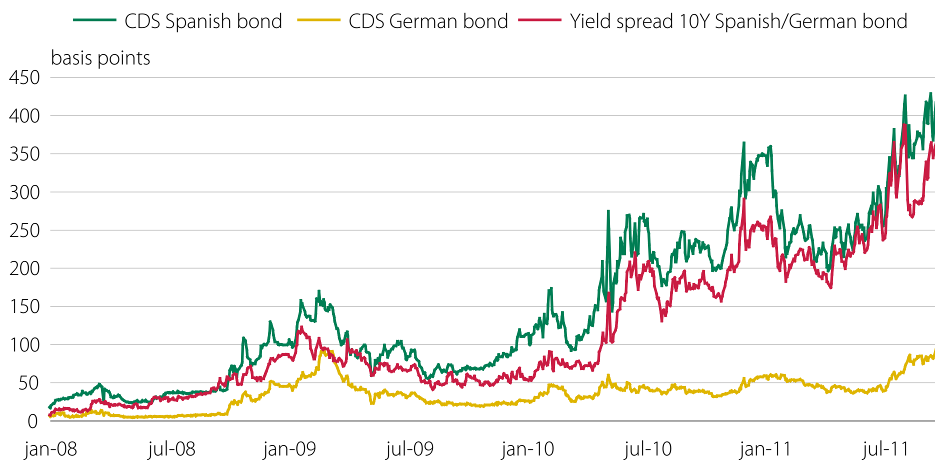
...was largely due to doubts surrounding the sustainability of Greece's public finances...

As in previous episodes of European debt market turmoil, sovereign risk contagion from more troubled economies to the rest was readily apparent. According to the estimates shown in figure 5 below, in Spain's case, over 65% of the variability in sovereign spread attributable to recent newsflow may have derived from contemporaneous shocks in Greek credit risk. This degree of contagion is consistent with the levels observed during the first Greek crisis, in May 2010, and also with estimates made for other European economies like Italy, France and Belgium.

9 12 April.

10 In intraday terms, spreads at times exceeded 400 basis points.

Risk premium of Spanish government debt[1] FIGURE 16



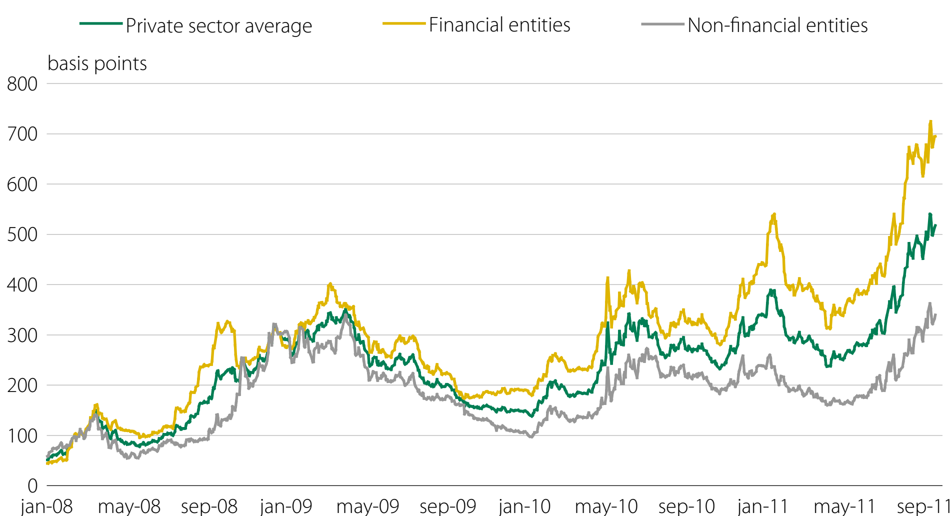
Source: Thomson Datastream.

1 Data to 20 September.

...which also dragged in the area's banks.

This contagion phenomenon not only shaped the risk premium movements of sovereign states but also those of a banking sector which, in Spain's case, was already immersed in an intense restructuring process. As we can see from figure 17, the average five-year CDS premiums of Spanish financial institutions climbed to highs approaching 700 bp against the average 340 bp approximately of non-financial issuers. According to the synthetic contagion indicator in figure 18, at times of maximum turbulence, a sizeable portion (around 65%) of the variability in Spanish banks' average CDS ascribable to recent newsflow may derive from contemporaneous shocks in the sovereign risk of Spanish government bonds.

Aggregate risk premium[1] **based on the five-year CDS of Spanish issuers** FIGURE 17

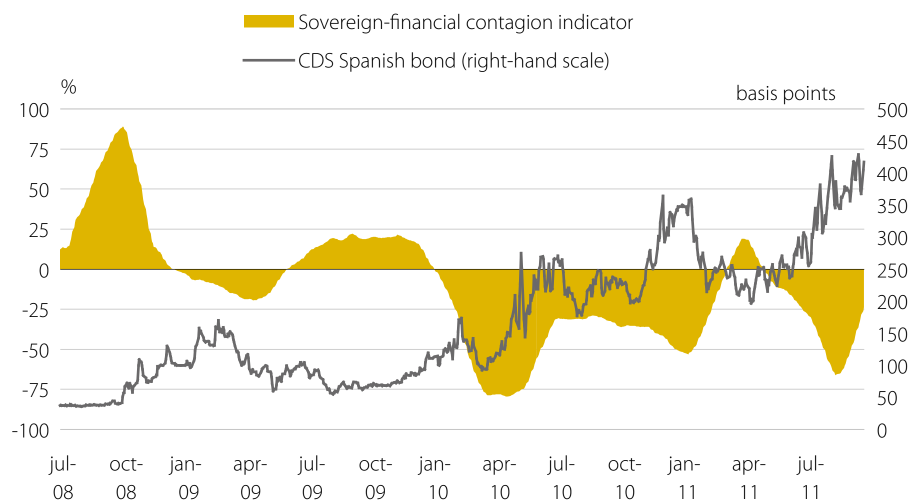


Source: Thomson Datastream and CNMV.

1 Simple average. Data to 20 September.

Sovereign-financial contagion in Spain[1]

FIGURE 18



1 This figure shows the percentage of variance in the average CDS indices of the Spanish banking sector and the CDS of the Spanish sovereign bond that is not attributable to their historical information but to contemporaneous return shocks. The resulting contagion indicator is decreasing with the increase in relative intensity of the impact of specific sovereign risk shocks on financial sector CDS. Positive values indicate a net contagion effect from the banking to the sovereign sector, while with negative values the source of the contagion is the sovereign risk carried by Spain. Contagion on a given day is calculated from available data for the 60 days preceding the current date, with the series also filtered by 30-day moving averages. Data to 20 September.

Exhibit 5: "Asset securitisation markets: Joint Forum recommendations"

In mid-2010, the Joint Forum received a mandate to advise its parent committees[1] and the Financial Stability Board (FSB) on developing a coordinated suite of policy responses to facilitate the regulation of sustainable securitisation markets.

In July 2011, the Joint Forum published a paper setting out the main conclusions of the work done under this mandate.[2] It describes the incentives which drove participation in the securitisation markets by originators, issuers, arrangers and investors before the financial crisis and analyses how those incentives have changed since then. It also reviews the academic literature on the subject and catalogues the main regulatory responses undertaken to date, considering both how they have been received by leading members of the international finance industry and how they might influence the future direction of securitisation markets.

While expressly acknowledging the potential benefits of securitisation, the Joint Forum paper also advocates reforms to correct the distortions and excesses brought to light by the financial crisis. And it is with this dual goal, of helping to stimulate securitisation markets while correcting their deficiencies, that the Joint Forum puts forward a series of recommendations directed at the competent authorities. One overarching need, it emphasises, is to develop rules that are mutually consistent, globally applicable, while allowing for local market circumstances, and implemented in a timely manner, so uncertainty about future regulation does not pose an impediment to market recovery.

The resulting recommendations are as summarised below:

1. Authorities should employ a broad tool kit to address misaligned incentives

The Joint Forum provides a checklist for action in this respect:

– Require originators or securitisers to retain an appropriate amount of risk in the securitisation transaction.

– Improve the quality of origination and underwriting practices or standards for assets eligible to be securitised.

– Provide guidance to investors on the analyses they should run to arrive at a fair valuation of securitisation products.

– Strengthen the warranties required of originators and issuers regarding the processes they have undertaken in relation to asset pools.

– Craft measures to discourage investors from relying automatically on credit ratings in reaching their decisions.

– Improve accompanying documentation to clarify the duties of advisors and service providers, including setting out obligations to manage conflicts of interest.

– Provide guidance on (or mandate) remuneration schemes which are linked to the long-term performance and quality of the assets.

2. Authorities should encourage the markets to improve transparency

The Joint Forum sees improving the quality and readability of the information available to investors and regulators as an important element of developing a sustainable securitisation market. The paper considers that this is not just a matter for the private sector, but that regulators should come actively on board by tightening up mandatory informative requirements.

3. Authorities should encourage a greater degree of document standardisation and a reduction of product complexity

The Joint Forum contends, furthermore, that the drive towards reduced product complexity and greater document standardisation should be co-led by financial institutions (in sponsoring and structuring securitisations), legal firms and investors, with the authorities providing support to their efforts. The hope is that advances on this front will reduce information asymmetries and create the foundation for a more liquid secondary market for structured products.

1 The Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

2 *Report on asset securitisation incentives*, available at http://www.bis.org/publ/joint26.pdf.

Sovereign debt market tensions also cut deeply into private debt issuance...

The stressed state of European sovereign debt markets also took its toll on primary bond market issuance. The volume of fixed-income issues registered with the CNMV plunged to just over 25 billion euros in the third quarter, 54% down versus the year-ago period, after a 26% advance in the first six months to 137 billion euros. This left year-to-date issuance at 162 billion, 1.3% less than in 2010 (see table 11). Financial institutions again had the fixed-income market virtually to themselves, and accounted for no less than 99% of funds captured in the period. Commercial paper remained the most popular financing instrument, with the 10.37 billion euros sold amounting to 41% of issue volumes. Next in importance were asset-backed securities (29% of the total) and covered bonds in their mortgage (17%) and territorial (10%) variants.

...with the contraction extending to all debt instruments (except covered bonds).

Covered bonds were the only instruments to escape the third-quarter stall in issuance. The biggest slide corresponded to non-convertible bonds and debentures, whose third-quarter issuance dropped to 733 million euros (-43%) for a year-to-date total of 6.63 billion (-61%).

Issuance of non-convertible bonds and debentures is down 61% year-to-date against the -3.3% of asset-backed securities...

After running ahead of last year's figures for the first six months of 2011, issuance of asset-backed securities tailed off in the third quarter to 7.45 billion euros (28.19 billion in third quarter 2010), giving a year-to-date decline of 3.3%. Note that the assets issued in securitisation deals were retained in their totality by the originators of the securitised loans, primarily for use as collateral in Eurosystem credit operations.

...while covered bonds are increasingly the debt instrument of choice.

Financial institutions retained their preference for mortgage bonds. Though third-quarter issuance of these instruments was on a rather more modest scale, the year-to-date figure is already ahead of 42 billion euros, eight thousand more than the full-year total for 2010. Also coming up fast are territorial covered bonds, with a positive change in issuance over the third quarter and year-to-date.

Foreign issuance was again a much-used resource for Spanish firms.

Foreign debt financing, again a much-used resource, conserved its relative weight in Spanish issuance at just over a third of the year-to-date total, albeit with some slippage in straight-number terms (see table 11). To 31 July, Spanish firms raised 88.39 billion euros on international markets, breaking down 50.59 billion via commercial paper and the rest via bonds and debentures.

Gross fixed-income issuance

TABLE 11

filed[1] with the CNMV	2007	2008	2009	2010	2011		
					1Q11	2Q11	3Q11[2]
NUMBER OF ISSUES	**335**	**337**	**512**	**349**	**88**	**82**	**44**
Mortgage bonds	32	47	75	88	32	29	8
Territorial bonds	8	8	1	9	4	4	10
Non-convertible bonds and debentures	79	76	244	154	19	27	12
Convertible/exchangeable bonds and debentures	0	1	6	3	6	1	0
Asset-backed securities	101	108	76	36	10	9	7
Commercial paper facilities	107	88	73	59	15	12	7
Securitised	3	2	2	2	0	1	0
Other commercial paper	104	86	71	57	15	11	7
Other fixed-income issues	3	0	0	0	0	0	0
Preference shares	5	9	37	0	2	0	0
FACE VALUE (million euros)	**648,757**	**476,276**	**387,476**	**226,449**	**77,161**	**59,900**	**25,471**
Mortgage bonds	24,696	14,300	35,574	34,378	19,254	18,980	4,250
Territorial bonds	5,060	1,820	500	5,900	2,935	1,800	2,664
Non-convertible bonds and debentures	27,416	10,490	62,249	24,356	2,578	3,320	733
Convertible/exchangeable bonds and debentures	0	1,429	3,200	968	682	1,500	0
Asset-backed securities	141,627	135,253	81,651	63,261	26,585	11,168	7,449
Domestic tranche	94,049	132,730	77,289	62,743	23,706	10,130	7,449
International tranche	47,578	2,522	4,362	518	2,879	1,038	0
Commercial paper[2]	442,433	311,738	191,342	97,586	24,928	23,131	10,375
Securitised	465	2,843	4,758	5,057	546	913	259
Other commercial paper	441,969	308,895	186,583	92,529	24,382	22,218	10,116
Other fixed-income issues	7,300	0	0	0	0	0	0
Preference shares	225	1,246	12,960	0	200	0	0
Pro memoria:							
Subordinated issues	47,158	12,950	20,989	9,154	5,408	4,207	1,640
Covered issues	86,161	9,170	4,794	299	10	0	0

abroad by Spanish issuers	2007	2008	2009	2010	2011		
					1Q11	2Q11	3Q11[4]
FACE VALUE (million euros)	**103,631**	**112,366**	**149,686**	**127,731**	**48,148**	**34,121**	**6,117**
Long-term	65,629	39,894	47,230	51,107	21,511	13,920	2,364
Preference shares	2,581	0	3,765	0	0	0	0
Subordinated debt	8,984	70	2,061	0	0	0	0
Bonds and debentures	53,327	39,360	41,404	50,807	21,511	13,920	2,364
Asset-backed securities	736	464	0	300	0	0	0
Short-term	38,003	72,472	102,456	76,624	26,637	20,201	3,753
Commercial paper	38,003	72,472	102,456	76,624	26,637	20,201	3,753
Securitised	12,119	425	108	248	97	75	0

Source: CNMV and Banco de España.

1 Incorporating issues admitted to trading without a prospectus being filed.

2 Data to 20 September.

3 Figures for commercial paper issuance correspond to the amount placed.

4 Data for the month of July.

4 Market agents

4.1 Investment vehicles

Financial UCITS[11]

Redemptions take a further 2.5% slice from investment fund assets...

Assets under management in investment funds fell by 2.5% to just over 140 billion euros in the first six months of 2011 (see table 13), prolonging the trend initiated in 2008. The cause, once more, was net redemptions, which summed almost five billion euros in the period – nonetheless a small improvement on previous semesters. The instruments carried in investment fund portfolios appreciated slightly in the first two quarters, albeit with considerable cross-category heterogeneity. Thus, while fixed-income funds kept up positive returns throughout the first-half period, equity funds saw their first-quarter gains turn to second-quarter losses, in line with the overall performance of stock markets.

Investment fund subscriptions and redemptions (million euros)[1] TABLE 12

	Subscriptions				Redemptions			
Category	**3Q10**	**4Q10**	**1Q11**	**2Q11**	**3Q10**	**4Q10**	**1Q11**	**2Q11**
Fixed income[2]	6,207	6,603	7,890	6,478	12,006	13,908	13,298	8,737
Balanced fixed income[3]	572	641	358	517	812	1,384	1,138	892
Balanced equity[4]	119	255	270	346	168	317	267	446
Euro equity[5]	291	335	575	524	452	534	595	454
Intern. equity[6]	779	1,227	2,489	721	626	982	2,521	801
Fixed-income guaranteed	3,404	2,506	7,424	2,595	1,414	1,719	2,008	2,224
Equity guaranteed[7]	727	1,247	829	622	1,400	2,550	1,625	1,717
Global funds	265	1,767	1,534	836	383	1,581	507	598
Passively managed[8]	74	96	221	149	142	254	237	108
Absolute return[8]	959	1,334	1,166	382	1,039	1,350	1,332	1,290
Hedge funds	21	31	30	–	72	41	24	–
Funds of hedge funds	14	10	2	–	24	57	-30	–
Total	**13,432**	**16,052**	**22,788**	**13,170**	**18,538**	**24,677**	**23,522**	**17,267**

Source: CNMV.

1 Estimate only.
2 Includes: Euro and international fixed income and money market funds.
3 Includes: Balanced euro fixed income and balanced international fixed income.
4 Includes: Balanced euro equity and balanced international equity.
5 Includes: Euro equity.
6 Includes: International equity.
7 Includes: Guaranteed and partially guaranteed equity.
8 New categories as of 2Q09. All absolute return funds were previously classed as global funds.

11 Although this classification includes hedge funds and funds of hedge funds, we make no separate reference to them here, since they are the subject of their own sub-section further ahead.

As we can see from table 12, fixed-income funds suffered the largest outflows – more than 7.60 billion euros – especially during the first quarter. Equity guaranteed funds were the other big losers (net redemption of almost 1.90 billion euros), while fixed-income guaranteed funds bucked the trend with net inflows of nearly 5.80 billion euros. Global funds also did well with net subscriptions exceeding 1.25 billion in the first six months of 2011. The result was a decline in the relative weight of the standard fixed-income segment in favour of fixed-income guaranteed funds. The former group saw their share drop from over 50% of total fund assets to 35% in the month of June, while fixed-income guaranteed funds rose from relative obscurity to take an industry share of 23%.

...especially in fixed-income categories.

Fund numbers dropped in the six-month period after a brief revival in the opening quarter, although the scale of decline was less than in preceding years. Finally nineteen funds ceased operation for a new total of 2,389. The main contributing factor was again fund mergers, which were nonetheless fewer than in previous quarters. Unitholder numbers too shrank by 2.3% to just over five million between end-2010 and June 2011. All categories shared in the decline except global and fixed-income guaranteed funds, where the number of participating investors rose by 17.4% and 25.4% respectively.

Both fund and unitholder totals fall once more between December 2010 and June 2011.

The latest analyses of the liquidity conditions of funds' private fixed-income holdings reveal a significant fall in the volume of less-liquid assets during the first and second quarters of 2011, from 10.64 billion at the year's outset to 9.19 billion at the end of June (see table 14). Their weight in industry assets likewise declined from the 7.4% of December 2010 to 6.6% in June, prolonging the trend initiated in 2009. This lower exposure to less-liquid instruments held true for all asset categories except high-grade financial fixed income (rated AAA/AA), which registered a slight increase. Moreover 70% of the reduction in exposure assets traced to lower holdings of less-liquid asset-backed securities; down from 3.26 billion euros at end-2010 to 2.25 billion in June 2011.

The sum of less-liquid assets drops from 7.4% of total fund assets in December 2010 to 6.6% in June 2011.

Main investment fund variables*

TABLE 13

	2008	2009	2010	2010		2011	
Number				**3Q**	**4Q**	**1Q**	**2Q**
Total investment funds inversión	**2,912**	**2,536**	**2,408**	**2,421**	**2,408**	**2,417**	**2,389**
Fixed income[1]	629	582	537	540	537	543	530
Balanced fixed income[2]	195	169	160	162	160	158	152
Balanced equity[3]	202	165	138	140	138	136	132
Euro equity[4]	237	182	172	174	172	171	157
International equity[5]	330	242	232	233	232	222	222
Fixed income guaranteed	260	233	276	261	276	303	324
Equity guaranteed[6]	590	561	499	518	499	485	470
Global funds	469	187	192	189	192	197	203
Passively managed[7]		69	61	61	61	61	57
Absolute return[7]		146	141	143	141	141	142
Assets (million euros)							
Total investment funds	**175,865.3**	**170,547.7**	**143,918.2**	**152,646.5**	**143,918.2**	**144,428.0**	**140,351.3**
Fixed income[1]	92,813.1	84,657.2	56,614.6	64,102.1	56,614.6	51,565.6	49,449.9
Balanced fixed income[2]	5,803.0	8,695.5	7,319.0	8,109.9	7,319.0	6,570.0	6,251.9
Balanced equity[3]	3,958.8	3,879.6	3,470.5	3,520.2	3,470.5	3,484.5	3,345.6
Euro equity[4]	5,938.9	6,321.6	5,356.8	5,504.4	5,356.8	5,656.3	5,687.2
International equity[5]	4,254.7	5,902.4	8,037.3	7,203.6	8,037.3	7,896.1	7,751.6
Fixed income guaranteed	21,150.3	21,033.4	26,180.2	25,795.6	26,180.2	32,084.4	32,742.1
Equity guaranteed[6]	30,873.7	25,665.8	22,046.5	23,600.0	22,046.5	21,181.6	19,827.6
Global funds	11,072.8	3,872.5	4,440.3	4,093.9	4,440.3	5,481.7	5,718.1
Passively managed[7]		3,216.6	2,104.8	2,323.6	2,104.8	2,193.0	2,172.2
Absolute return[7]		7,303.0	8,348.1	8,393.2	8,348.1	8,314.8	7,405.1
Unitholders							
Total investment funds	**5,923,346**	**5,475,403**	**5,160,888**	**5,348,482**	**5,160,888**	**5,160,482**	**5,044,106**
Fixed income[1]	2,204,652	2,041,487	1,622,664	1,745,366	1,622,664	1,525,292	1,466,938
Balanced fixed income[2]	277,629	290,151	270,341	280,230	270,341	251,992	238,275
Balanced equity[3]	209,782	182,542	171,336	182,860	171,336	162,861	156,631
Euro equity[4]	377,545	299,353	266,395	280,566	266,395	253,365	248,355
International equity[5]	467,691	458,097	501,138	502,463	501,138	493,052	493,057
Fixed income guaranteed	538,799	570,963	790,081	762,369	790,081	967,561	990,997
Equity guaranteed[6]	1,402,948	1,188,304	1,065,426	1,115,180	1,065,426	1,027,392	981,572
Global funds	444,300	88,337	105,719	110,538	105,719	114,244	124,088
Passively managed[7]		85,403	90,343	93,049	90,343	85,254	82,371
Absolute return[7]		270,766	277,445	275,861	277,445	279,469	261,822
Return[8] (%)							
Total investment funds	**-4.21**	**5.73**	**0.35**	**1.64**	**-0.04**	**0.95**	**0.03**
Fixed income[1]	2.06	1.91	0.11	0.63	-0.35	0.63	0.33
Balanced fixed income[2]	-7.14	6.85	-0.54	1.82	-0.56	0.9	0.09
Balanced equity[3]	-22.21	16.47	-0.98	4.67	0.78	2.23	-0.31
Euro equity[4]	-39.78	32.41	-2.94	10.11	1.27	6.11	-0.45
International equity[5]	-41.71	37.28	14.22	5.35	8.01	-0.49	-1.15
Fixed income guaranteed	3.29	3.81	-0.67	0.89	-1.28	0.89	0.36
Equity guaranteed[6]	-2.61	3.56	-1.79	1.20	-1.45	0.71	-0.48
Global funds	-8.64	10.90	3.22	2.80	1.87	0.98	-0.14
Passively managed[7]		-	-2.36	6.32	0.31	3.74	-0.30
Absolute return[7]		-	1.53	1.17	0.58	0.28	-0.35

Source: CNMV. As a result of the reclassifying of investment fund objectives, in force from 1 April 2009, some changes have taken place in the variables of this table.

* Data for funds that have filed financial statements (i.e., not including those in the process of winding-up or liquidation).

1 Includes: Euro and international fixed income and money market funds.

2 Includes: Balanced euro fixed income and balanced international fixed income.

3 Includes: Balanced euro equity and balanced international equity.

4 Includes: Euro equity.

5 Includes: International equity

6 Includes: Guaranteed and partially guaranteed equity.

7 New categories as of 2Q09. All absolute return funds were previously classed as global funds.

8 Annual return for 2008, 2009 and 2010. Quarterly data comprise non-annualised quarterly returns.

Estimated liquidity of investment fund assets TABLE 14

	Less-liquid investments					
	Million euros			% total portfolio		
Type of asset	**Dec 10**	**Mar 11**	**Jun 11**	**Dec 10**	**Mar 11**	**Jun 11**
Financial fixed income rated AAA/AA	4,374	4,335	4,391	22.4	22.5	22.8
Financial fixed income rated below AAA/AA	2,798	2,702	2,384	23.7	23.3	20.6
Non-financial fixed income	218	190	171	3.8	4.7	4.2
Securitisations	3,260	2,567	2,246	61.0	56.8	49.7
AAA-rated securitisations	1,429	919	609	62.8	74.3	49.3
Other securitisations	1,831	1,648	1,636	59.7	50.2	49.8
Total	**10,651**	**9,794**	**9,192**	**29.2**	**28.1**	**26.0**
% of investment fund assets	**7.4**	**6.8**	**6.6**			

Source: CNMV.

Exhibit 6: "Circular 3/2011 of 9 June modifying UCITS investment policies"

Circular 3/2011 of 9 June (BOE 27 June) partially amends CNMV Circular 1/2009 of 4 February on UCITS categories based on investment policy. The new text, which came into force two months after its publication in the *Boletín Oficial del Estado* (BOE), aims to align the definition of money market funds with the common definition issued by the Committee of European Securities Regulators (CESR), replaced in early 2011 by the European Securities and Markets Authority (ESMA), while introducing a series of technical improvements.

One of the big novelties of the amended Circular refers to the common definition of money market funds developed by the CESR (see document CESR/10-049). As a result of this new definition, the money market policy described in Circular 1/2009 is replaced by two new policies titled "short-term money market" and "money market". This change is in order to avoid conflicting definitions circulating around Europe and thereby to ensure investors standard protection as well as clearer information about the product they are investing in.

Although short-term money market funds must meet stricter duration and maturity requirements than their money market counterparts, both products share certain core features: namely, zero exposure to equity instruments, exchange rate risk or commodities; the goal of preserving capital while providing returns in line with money market rates; subscription and redemptions on a daily basis; and investment in money market instruments and deposits complying with the terms of Article 36.1 a), e) and h) of the Regulation on Collective Investment Undertakings and Article 16 of Order EHA/888/2008 on derivative products. All instruments should be of high quality in the judgement of the management company, which should consider, at least, their credit rating (as the case may be), the asset class they represent, counterparty and operational risk in the case of structured financial products, and, finally, their liquidity profile. Regarding credit quality, the minimum requirement is to hold a short-term credit rating of at least A2 (according to the scale used by Standard & Poor's) or equivalent from all the

agencies that have rated the instrument. If the asset has no specific rating, it should nonetheless be of an equivalent quality as determined by the management company.

The specific features of each fund category are as follows:

– Short-term money market funds: authorised to invest in other UCITS fitting the definition of short-term money market funds, average portfolio duration of less than or equal to 60 days, average portfolio maturity of less than or equal to 120 days and residual maturity to the legal redemption date of less than or equal to 397 days.

– Money market funds: authorised to invest in other UCITS fitting the definition of either short-term money market funds or money market funds, average portfolio duration of less than or equal to six months, average portfolio maturity of less than or equal to two years and residual maturity to the legal redemption date of less than or equal to 397 days. Money market funds may hold sovereign debt with a minimum rating of BBB- (on the Standard & Poor's scale) or equivalent, awarded by one or more recognised credit rating agencies.

The Circular also introduces a series of technical improvements for calculating the percentage of fixed-income and equity investment of each type of fund. For instance, it is now funds' total exposure that counts in defining its investment policy, i.e. the sum of its investments in spot and derivative instruments. Also computing for this purpose will be currency risk and investment in equity securities issued by entities from outside the euro area.

Finally, no additional exposure will be considered to arise if a fund's investments in spot or derivative financial instruments are materialised, among others, in public debt instruments issued by a state meeting the requirements set out in Article 38.2 b) of the UCITS Regulation or repos on the same, subject in both cases to maturity being of under three months and the issuer being of high credit quality.

Real estate investment schemes

The real estate investment sector loses mass in the face of manifold difficulties...

Real estate schemes continue to operate in a troubled environment, characterised by the prolonged downturn in Spanish real estate and a gathering outflow of investors since the year 2008. Latest data (for July 2011) put the number of real estate funds at seven, the same figure as in December 2010.[12] But only five of these funds were actually in operation, one of which had resumed business in March after lifting its suspension of redemptions. In four out of the five active funds, a large proportion of assets (ranging from 45% to 98%) were held by investors from the manager's financial group. All five also had at least one liquidity window in the year's first half which went ahead without incident.

12 Although eight funds figured on the register at end-2010, one had been effectively liquidated in December. This fund finally left the register in July 2011.

As we can see from table 15, assets under management in real estate funds contracted in the first six months, though less so than in the three preceding years, especially 2008. By July 2011, funds had 5.98 billion euros assets in their charge, 2.2% less than at end-2010, while unitholder numbers had tumbled 58% to 31,591. Note, however, that most of the slump owed to one particular fund, where the manager's financial group invited investors so wishing to exit the scheme after its redemptions embargo came to end, subscribing for a sufficient amount to fill the resulting redemption orders. Meantime, fund returns continued to sink, though not quite as deeply as in the preceding quarters.

...leaving just five funds in active operation.

Real estate investment companies fared similarly to funds in the January to July period, though with a rather gentler decline that skimmed over three million euros off their total assets to 317 million. Shareholder numbers were unchanged at 943 while a total of eight companies remained on the register.

Real estate investment companies have a slightly smoother ride.

Main real estate scheme variables TABLE 15

					2010	2011		
	2007	2008	2009	2010	4Q	1Q	2Q	3Q[2]
FUNDS								
Number[1]	9	9	8	7	7	7	7	7
Unitholders	145,510	97,390	83,583	75,280	75,280	33,747	31,963	31,591
Assets (million euros)	8,609	7,407	6,465	6,116	6,116	6,083	5,995	5,983
Return (%)	1.3	0.7	-8.3	-4.7	-0.9	-0.67	-0.65	-0.23
COMPANIES								
Number	9	9	8	8	8	8	8	8
Shareholders	843	937	928	943	943	943	943	943
Assets (million euros)	513	372	309	322	322	320	318	317

Source: CNMV.

1 Funds filing financial statements.

2 Data for July 2011. In this case, the stated return corresponds to the month of July.

Hedge funds

Hedge funds have performed unevenly throughout the crisis, with funds of hedge funds coming out worse. This sub-sector's key variables have been deteriorating steadily since the peak levels of 2008. The number of schemes has fallen away from 40 in 2008 to just 27 in mid-2011,[13] assets under management are down from 1.02 billion to 650 million euros and unitholder numbers have just about halved (from 8,151 in 2008 to 4,181 in May 2011). And their aggregate returns have fared no better, declining from 7.8% in 2009 to 3.1% in 2010 and close to zero in 2011.

Funds of hedge funds continue to underperform pure hedge funds...

13 A total of seven funds of hedge funds were in liquidation at the closing date for this report (with five more having advised the CNMV of their intention to liquidate).

Main hedge fund and fund of hedge fund variables

TABLE 16

					2010		2011	
	2007	2008	2009	2010	3Q	4Q	1Q	2Q[2]
FUNDS OF HEDGE FUNDS								
Number[1]	31	40	38	28	33	28	28	27
Unitholders	3,950	8,151	5,321	4,404	4,901	4,404	4,240	4,181
Assets (million euros)	1,000.6	1,021.3	810.2	694.9	726.8	694.9	667.2	650.3
Return (%)	-0.43	-17.8	7.85	3.15	-0.1	2.13	-0.01	-0.03
HEDGE FUNDS	21	24	29	33	33	33	33	35
Number[1]	1,127	1,589	1,917	1,852	1,925	1,852	1,958	1,984
Unitholders	445.8	539.4	652.0	646.2	639.3	646.2	693.5	719.0
Assets (million euros)	0.84	-4.82	14.94	5.37	2.97	3.11	1.79	1.18
Return (%)								

Source: CNMV.

1 Schemes that have filed financial statements.

2 Data to May. The return stated corresponds to April and May.

...which have even entered a tentative expansion phase.

Hedge funds, meantime, have seemingly pulled out of the crisis downturn and entered a new expansion phase, to judge by the year-to-date resurgence in funds in operation, unitholder numbers and managed assets. Fund returns have consistently outperformed those of the fund of hedge funds sub-sector. As table 16 shows, the number of schemes has grown each year since they were first authorised. By mid-2011, a total of 35 hedge funds were registered with the CNMV, two more than at end-2010 and six more than in 2009. Assets under management resumed solid growth in the first two quarters of 2011 after dipping slightly in 2010, while unitholder numbers traced a similar pattern. The upshot was that by mid-year 2011, hedge funds had 719 million euros under management (646 million at end-2010) and a total of 1,984 investors on the books (1,852 at end-2010).

Exhibit 7: "ESMA technical advice to the European Commission on level 2 implementing measures for the Alternative Investment Fund Managers Directive"

At end-2010, the European Commission called on ESMA to assist in preparing the level 2 measures envisaged in the Alternative Investment Fund Managers Directive or AIFMD. After due examination, ESMA published a consultation paper last summer setting out its draft advisory document and inviting feedback from external stakeholders. The definitive advice will be submitted to the European Commission on 15 November 2011. The Commission will then use its contents to draw up proposed AIFMD level 2 measures in the course of 2012 and the full legislative package will foreseeably come into force around mid-year 2013.

ESMA's draft technical advice develops the Directive's provisions on its scope of application, the organisational requirements of alternative fund managers,

depositary appointment and duties, and transparency and leverage, as well as filling out its varied precepts on relations with third countries and supervisory cooperation. Set out below are the main contents of the draft advisory document.

Scope of application of the Directive

In fulfilment of the Commission's mandate, the document makes proposals on calculating the value of assets under management to determine where managers stand in relation to the threshold for full compliance with the Directive (100 million euros or 500 million in the case of non-leveraged closed-ended funds). On this score, the draft proposes that assets under management be calculated annually at least on the basis of the latest net asset value, including any assets acquired through leverage. It also advises a course of action for cases where managers with fewer assets and therefore subject only to registration and reporting requirements move above the full compliance threshold (the situation should not be seen as of a temporary nature if it persists for more than three months). Finally, it specifies the registration requirements binding on managers below the threshold and the procedure they should follow if they choose to seek authorisation under the AIFMD (opt-in procedure).

Organisational requirements

Regarding the organisation of alternative investment fund managers, the draft advice draws on the rules laid down in UCITS and MiFID directives, adjusted as necessary to the specifics of the alternative management sector (and the diversity of alternative investment funds in operation). It accordingly puts forward ideas for general organisational arrangements, and for the management of risk, liquidity and conflicts of interest.

Further to the level 1 obligation for alternative fund managers to maintain additional funds to cover the potential risks arising from professional negligence, the two options posed acknowledge the particularities of the alternative investment sector rather than directly applying the Capital Requirements Directive regime, which allow for no such distinctions. These options are: 0.01% of the value of assets under management, or else 0.0015% of the value assets under management plus 2% of income from management activities.

Finally, the text makes proposals on valuation (general guidelines and the recommendation that non-financial assets should be valued at least once a year), on alternative fund investments in securitisations (for compliance by both originator and manager whenever managed funds take securitisation positions – a requisite also to be applied to UCITS) and on delegation (two cases are envisaged that serve as justification for delegating tasks: when the manager can demonstrate that delegation will improve the fund's management or administration, or when certain set preconditions are met).

Depositaries

The text specifies the oversight and monitoring functions to be discharged by depositaries as well as their depositary duties per se (asset custody or record-keeping in the case of assets not covered by custody, and the monitoring of cash

positions held at third-party entities). Regarding cash monitoring, two options are identified: one which requires the depositary to have a full overview of all movements in these cash accounts, and their reconciliations, and another which only requires it to verify reconciliation procedures. A similar two options are put forward for assets not covered by custody.

The depositary liability regime established in the Directive is filled out in some detail (depositaries to be obliged to replace assets under custody except when they are "lost" as a consequence of an external event beyond the reasonable control of the depositary, the consequences of which were unavoidable despite all reasonable efforts to the contrary), with attention to demarcating internal and external events for the purposes of determining such liability.

Transparency and leverage

Three methods are put forward for calculating leverage: one that measures gross leverage, another based on the commitment method employed by UCITS and a third, advanced method chosen by the manager subject to proof of its greater suitability. The text also sets out managers' periodic reporting requirements with the authorities and investors. Specifically, a quarterly report should be provided to the authorities so ESMA can fulfil its own disclosure obligations on alternative investment funds with the European Systemic Risk Board (ESRB).

Foreign UCITS marketed in Spain

Investment by foreign UCITS marketed in Spain recedes by 3% in the first-half period...

The investment of foreign UCITS marketed in Spain advanced 2.6% in the first quarter then fell back by 5.5% for a first-half decline of 3% (as far as 35.58 billion euros). In straight-number terms, the outflow of assets (1.10 billion euros) equated to a third of the total first-half decline of assets under management in Spanish UCITS. Meantime, the number of schemes being marketed rose from 660 at end-2010 to 695 in June 2011.

...suggesting some attenuation of their substitute role versus Spanish UCITS.

We can perhaps deduce from this setback in the asset share of foreign UCITS that the trend among investors to shift out of riskier Spanish into less risky foreign schemes has attenuated in 2011.

Outlook

Competition from bank deposits will continue to set the industry pace.

The prospects for the domestic collective investment industry remain clouded by uncertainties as investors continue to withdraw on the back of heightened risk aversion. Symptomatically, the cash redeemed from fixed-income funds is being diverted, in part at least, to perceived safer instruments such as fixed-income guaranteed funds and bank deposits, which have gone on competing strongly for investor funds. Banks' liquidity needs have led them to offer increasingly attractive deposit rates, and this situation seems likely to persist in the short-term at least. In the sector's favour are the competitiveness gains harnessed from the numerous fund mergers of recent years and the increased efficiency brought by operating cost containment at fund management companies.

4.2 Investment firms

Financial market stress continues to weigh on investment firm business.

Financial market instability continued to bear down heavily on investment firm business over the first half of 2011, barring the way to a recovery based on core service revenues. The small advance in the sector's aggregate profits (1.4%) was basically a product of positive extraordinaries and operating cost containment. The sector's solvency conditions remained sound.

Broker-dealers grow their aggregate profits 1.7% in first half 2011, thanks mainly to extraordinaries...

Broker-dealers' aggregate pre-tax profits amounted to 151 million euros in the first half of 2011, 1.7% more than in the year-ago period. The profits advance had its main origin in extraordinary items, while more recurrent income streams (fees and commissions) continued to thin out against a backdrop of rising costs, particularly depreciation and other charges (see table 17). A sharp jump (over 82%) in corporate income tax liabilities was the other factor that sent net income falling by 8.2% to 121 million euros.

...while fee income slips back further.

Net fee income dropped by 1% in the first six months to 419 million euros. Fees from order processing and execution fell by 7% to 285 million euros reflecting lower turnover in equity markets. This item, nonetheless retained its primacy among broker-dealer revenue streams, accounting for almost 70% of fee income in the period. Fees from investment advisory services managed a creditable advance of 51% to 37 million euros, while portfolio management fees rose by 24% to 7.9 million. Finally, fees from UCITS marketing were down 2.8% year-on-year at 31.3 million euros.

Broker-dealer gross margin holds at 2010 levels.

The aggregate gross income of broker-dealers held more or less flat versus end-2010, with a small fall of 0.5% to 362 million euros. This stability resulted from the offsetting effect of movements under its component captions, with falling fee income and results from financial investments countered by higher net interest income and a substantial fall in exchange losses. Further down the income sheet, net operating income dropped 4.4% to 142.7 million, due to rising operating costs (1.5%) and, above all, heftier charges for depreciation and other provisions.

Broker pre-tax profits advance 7% from January to June on operating cost containment.

Brokers managed to grow their pre-tax profits by 7% over the year-ago period to 5.8 million euros. Improvement, as in previous years, was sourced from sharply falling operating costs, which moved down 15% in year-on-year terms to 43 million euros. These cost savings did enough to offset deterioration at the gross income line (a fall of 12% to 50.2 million euros) and permitted a 14% advance in net operating income to 5.6 million euros. The fee income contributing most of gross margin sank by over 11% in the reference period, with most investment services sharing in the fall.

The fall in aggregate earnings of portfolio management companies is due to more firms leaving the market.

Finally, the aggregate profits of **portfolio management companies** plunged over 50% in the first six months to 677,000 euros, due mainly to the disappearance of one of the sector's bigger players. This means only six firms remain in the market, two fewer than twelve months back. The approximately 28% fall in aggregate gross margin to 4.3 million euros (six million in 2010) was almost entirely a consequence of falling fee revenues, which are currently confined to portfolio management and financial advisory fees. Both net interest income and the results of financial investments moved up strongly, by 78% and 258% respectively, though their weight in earnings is minor only. Operating expenses fell by 20.4% to 3.6 million euros.

Aggregate income statement

TABLE 17

Thousand euros	Broker-dealers			Brokers			Portfolio managers		
	Jun 10	Jun 11	% var.	Jun 10	Jun 11	% var.	Jun 10	Jun 11	% var.
1. Net interest income	43,915	52,973	20.6	732	1,144	56.2	165	293	77.7
2. Net fee income	279,871	275,520	-1.6	56,876	50,423	-11.4	5,967	3,840	-35.6
2.1. Fee income	423,657	419,375	-1.0	65,412	57,899	-11.5	11,440	9,123	-20.3
2.1.1. Order processing and execution	306,583	285,047	-7.0	21,791	19,345	-11.2	–	–	–
2.1.2. Distribution and underwriting	2,906	2,830	-2.6	610	1,181	93.5	–	–	–
2.1.3. Securities custody and administration	11,218	10,887	-3.0	186	191	2.5	–	–	–
2.1.4. Portfolio management	6,366	7,911	24.3	8,808	6,760	-23.3	9,218	8,323	-9.7
2.1.5. Design and advising	24,477	37,047	51.4	1,291	2,634	104.1	719	800	11.2
2.1.6. Search and placement	7	184	2,722.1	115	538	367.8	–	–	–
2.1.7. Margin trading	5	4	-15.2	10	13	30.5	–	–	–
2.1.8. UCITS marketing	32,261	31,359	-2.8	12,004	11,097	-7.6	26	0	-100.0
2.1.9. Others	39,834	44,104	10.7	20,596	16,141	-21.6	1,477	0	-100.0
2.2. Fee expense	143,785	143,855	0.1	8,536	7,476	-12.4	5,473	5,283	-3.5
3. Result of financial investments	76,990	38,782	-49.6	-104	-54	48.1	65	233	257.6
4. Net exchange income	-38,210	-5,344	86.0	278	-225	–	16	-14	-189.1
5. Other operating income and expense	1,437	171	-88.1	-654	-1,081	-65.3	-173	-5	97.1
GROSS INCOME	**364,004**	**362,102**	**-0.5**	**57,128**	**50,207**	**-12.1**	**6,040**	**4,347**	**-28.0**
6. Operating expenses	209,760	212,791	1.5	50,836	43,433	-14.6	4,543	3,616	-20.4
7. Depreciation and other charges	1,776	6,538	268.2	1,430	1,209	-15.4	86	54	-37.2
8. Impairment losses	3,159	-1	–	-32	-3	90.7	0	0	–
NET OPERATING INCOME	**149,310**	**142,774**	**-4.4**	**4,894**	**5,568**	**13.8**	**1,411**	**677**	**-52.0**
9. Other profit and loss	-929	8,100	-	551	275	-50.1	-6	0	100.0
PROFITS BEFORE TAXES	**148,381**	**150,874**	**1.7**	**5,445**	**5,843**	**7.3**	**1,405**	**677**	**-51.8**
10. Corporate income tax	16,200	29,472	81.9	1,003	554	-44.8	234	187	-20.2
PROFITS FROM ONGOING ACTIVITIES	**132,181**	**121,402**	**-8.2**	**4,443**	**5,289**	**19.1**	**1,170**	**490**	**-58.1**
11. Profits from discontinued activities	0	0	–	0	0	–	0	0	–
NET PROFIT FOR THE YEAR	**132,181**	**121,402**	**-8.2**	**4,443**	**5,289**	**19.1**	**1,170**	**490**	**-58.1**

Source: CNMV.

Sectoral ROE holds at 15%...

In keeping with the year-to-date figures to June 2011, the sector's pre-tax return on equity[14] (ROE) stayed flat versus the year-ago period at 15%. Disaggregating, we find that the 15.4% ROE of broker-dealers was on a par with the year-ago outcome,

14 ROE is calculated as:

$$ROE = \frac{\textit{Profit before taxes (annualised)}}{\textit{Equity}}$$

In which:

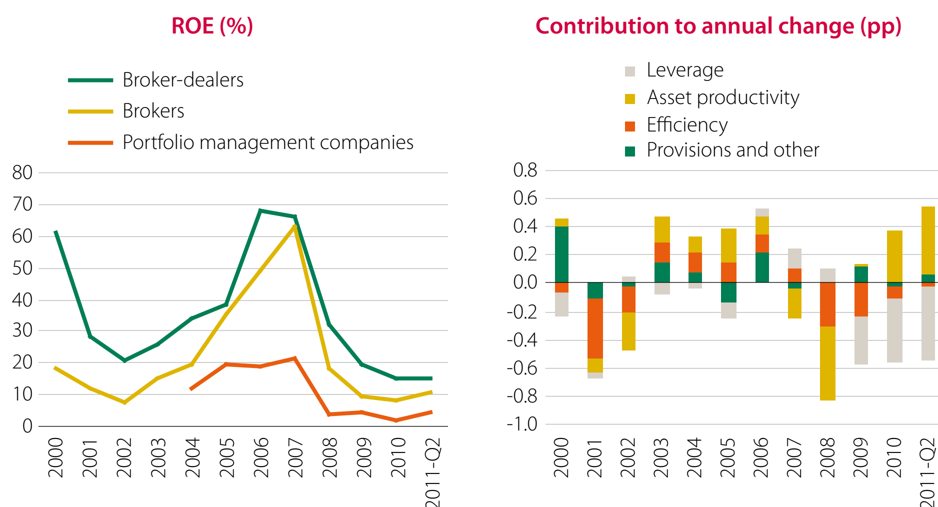
Equity = Capital + Share premium + Reserves – Treasury shares + Retained earnings and prior-year profit/loss – dividends and other entitlements.

while brokers grew their ratio from last year's 9% to 10.7% in 2011. Portfolio management companies traced the opposite course with ROE down from 7.2% to 4.2%.

...with gains from asset productivity wiped out by lower leverage.

A look at the change factors[15] for ROE in broker-dealers and broker contingents compared to 2009 and 2010 shows that the same forces were operating but with a rather different intensity. As we can see from figure 19 (right-hand panel), ROE held stable over first-half 2011 because the positive contribution of asset productivity balanced out the negative impact of lower leverage, while remaining components performed broadly as before.

Pre-tax ROE of investment firms FIGURE 19



Source: CNMV.

Smaller losses at a larger number of firms...

As figure 20 shows, the number of firms reporting losses rose from 23 at end-2010 to 30 in mid-June 2011 (13 broker-dealers, 16 brokers and 1 portfolio management company). Comparing with June 2010, we find that of the 34 entities then in losses (15 broker-dealers, 16 brokers and 3 portfolio managers), 21 were in the same situation one year later (9 broker-dealers, 11 brokers and 1 portfolio management company). Despite the higher number of loss-making entities, the amount of their losses was 26% lower at 9 million euros.

...while the sector remains comfortably in line with capital requirements.

Sector firms remained comfortably compliant with capital standards in the first half of 2011, hinting at a pain-free adaptation to the stricter requirements imposed under the 2009 solvency rules. As we can see from figure 21, the own funds of broker-dealers were 3.9 times above the minimum requirement at mid-year 2011

15 The following equation allows us to isolate the effects of changes in each factor contributing to investment firm ROE:

$$ROE = \frac{PBT}{Equity} = \frac{PBT}{Net\ operating\ inc.}(1) \times \frac{Net\ operating\ inc.}{Gross\ income}(2) \times \frac{Gross\ income}{Assets}(3) \times \frac{Assets}{Equity}(4)$$

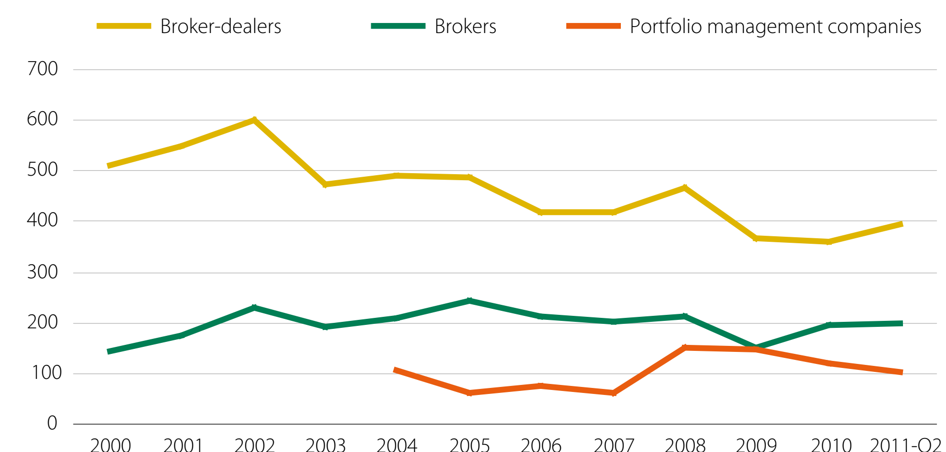
in which the numbered elements serve as indicators of: (1) extraordinary items in the income statement, (2) efficiency, (3) asset productivity and (4) leverage. For a fuller description of how to interpret the elements in this equation, see the exhibit "ROE breakdown" in *Securities markets and their agents: situation and outlook* in the CNMV Bulletin for first quarter 2008.

(3.7 times in June 2010), similar to the levels reported before the new regime came into force. Brokers too increased their surplus to two times the minimum (1.8 times in June 2010), albeit without matching the levels of broker-dealers. The contrast was marked by the portfolio management companies, whose own funds edged down slightly in first-half 2011 to just above the minimum standard. At the first half close, as in mid-2010, no single entity had an own funds deficit.

Number of investment firms in losses FIGURE 20

Source: CNMV.

Investment firm capital adequacy (surplus of qualifying equity to the minimum requirement, %) FIGURE 21



Source: CNMV.

Investment advisory firms continue their push.

Investment advisory firms (IAFs), whose activity is legally confined to dispensing investment advice and guidance, have been operating in Spain since 2009 and the transposition of the Directive on Markets in Financial Instruments (MiFID). By mid--2011 a total of 64 such firms were registered with the CNMV (see table 18), twelve more than at end-2010 and double the number of twelve months before. Sector expansion is apparent in both the growing number of contracts signed (3,278 in June 2011 against 2,430 in December) and the volume of assets under advice, which advanced 5.2% in the first-half period to 17 billion euros. Professional clients account-

ed for 3.3% of contracts signed but 87% of assets advised (an average 136 million euros compared to the 700,000 per contract of retail customers). Finally, the fees earned by IAFs stood at over 14 million euros against the 7.7 million of first-half 2010.

Although sector earnings have risen slightly, recovery drivers remain weak.

The small improvement in investment firms' earnings has already been remarked upon in previous reports. Unfortunately recovery is for the moment no more than tentative and insufficiently supported on core business growth. Given the renewed downturn in financial market turnover, the prolonged drought in primary market issuance and the fragile state of the collective investment industry, providers have increasingly turned their attention to other business lines, like investment advice or portfolio management, which nonetheless bring in only a small part of their total income. So although the sector is adequately capitalised and firms are doing what they can to strengthen income statements through operating cost containment, at brokers especially, or the reduction of financial leverage, the fact is that unless financial markets conditions normalise and more headway is made in sector restructuring, the outlook is none too favourable. That said, we are unlikely to see a repeat of the profits slump experienced in the first throes of the crisis.

Main investment advisory firm variables TABLE 18

			2009	2010		2011
Million euros	2009	2010	2Q	1Q	2Q	1Q
NO. OF ENTITIES	**16**	**52**	**16**	**36**	**52**	**64**
ASSETS UNDER ADVICE[1]	1,411	16,122	1,411	11,930	16,122	16,968
1. Retail customers	364	1,709	364	1,164	1,709	2,091
2. Professional customers	1,047	14,321	1,047	10,746	14,321	14,787
3. Others	0	92	0	19	92	91
NO. OF CONTRACTS	**317**	**2,430**	**317**	**1,789**	**2,430**	**3,278**
1. Retail customers	293	2,343	293	1,732	2,343	3,161
2. Professional customers	24	80	24	53	80	109
3. Others	0	7	0	4	7	8

1 Data at period end. Periodicity of six months.

4.3 UCITS management companies

Assets under management in UCITS management companies drop by 1.2% in the year's first half...

The managed assets of UCITS management companies fell by 1.2% to 175.5 billion euros in the first half of 2011. The was much less severe a decline than in previous years[16] – just two billion euros in absolute terms – but still meant industry volumes stayed stuck at the level of the late 1990s (see figure 22 and table 19).

...translating as a 3.8% fall in the sector's aggregate earnings.

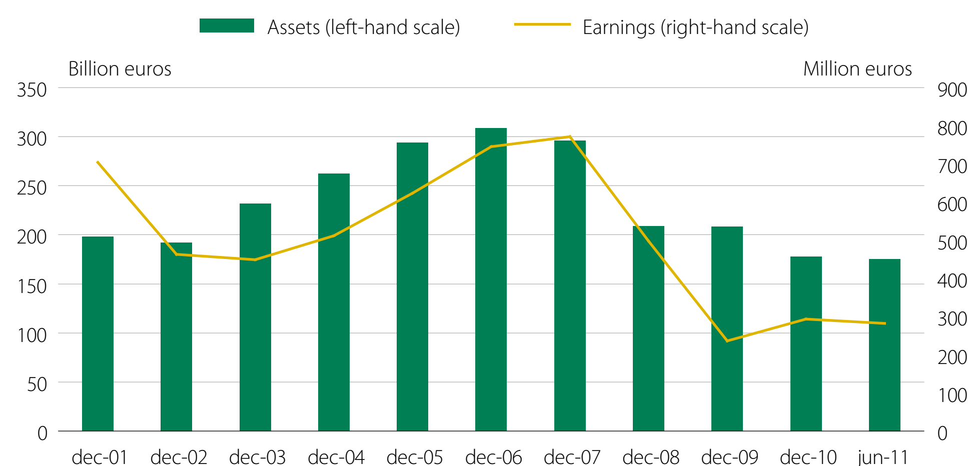
This decline in managed assets was reflected in a 3.8% slide in UCITS managers' first-half profits as far as 282 million euros.[17] Management fees too receded slightly to 0.87% of assets in June 2011 (see table 19), while aggregate return on equity held more

16 The steepest fall since the onset of crisis was in 2008, when the industry lost over 87 billion euros with respect to 2007.

17 Annualised profits.

or less flat at around 20%. Finally, although the number of loss-making companies was up to 35, one more than in December 2010, their combined losses fell to around half (ten million euros in annual terms), repeating the pattern of the previous year.

UCITS management companies: assets under management and pre-tax profits FIGURE 22



Source: CNMV. The profits figure to June 2011 has been restated on an annual basis.

The impact of financial sector restructuring is making itself felt.

In the first half of 2011, UCITS management companies pressed on with the task of streamlining their investment fund offerings by means of multiple inter-product mergers. At the same time, financial sector restructuring has meant the reorganisation of certain companies. Indeed of the five managers that ceased operation in the first half of 2011, three did so as the result of the wider restructuring process.

UCITS management companies: assets under management, management fees and fee ratio TABLE 19

Million euros

	Assets under management	UCITS management fee income[2]	Average UCITS management fee (%)	Fee ratio (%)[1]
2002	192,099	2,259	1.18	72.7
2003	231,458	2,304	1.00	73.8
2004	262,132	2,670	1.02	73.6
2005	293,973	2,976	1.01	72.2
2006	308,476	3,281	1.06	71.5
2007	295,922	3,194	1.08	70.5
2008	209,014	2,302	1.10	70.8
2009	203,379	1,702	0.84	68.6
2010	177,676	1,622	0.91	68.1
2011 (June[2])	175,458	1,532	0.87	67.0

Source: CNMV.

1 Ratio of fee expenses for fund marketing to fee income from UCITS management.

2 Data for fee income and average management fees are restated on an annual basis.

4.4 Other intermediaries: venture capital

The register of venture capital entities (VCEs) has recorded 13 new entrants and 10 retirals since year-end 2010. The number of venture capital funds and venture capital management companies in operation rose by three and four in net terms in the first three quarters of 2011, taking their respective totals to 111 and 79. Conversely, the number of venture capital companies dropped from 150 at end-2010 to 146 in September 2011 after a run of retirals (nine).

Movements in the VCE register in 2011 TABLE 20

	Situation at 31/12/2010	Entries	Retirals	Situation at 20/09/2011
Entities	**333**	**13**	**10**	**336**
Venture capital funds	108	4	1	111
Venture capital companies	150	5	9	146
Venture capital management companies	75	4	0	79

Source: CNMV.

Venture capital funds expand their assets 18% in 2010...

The annual statistics kept at the CNMV put the end-2010 assets of venture capital funds at a total of 3.75 billion euros, an 18.2% increase with respect to 2009 (see table 21). A breakdown of assets by holder shows that institutional investors were again the majority force. In all, legal entities commanded a 95% share of total fund assets in 2010, practically the same proportion as in 2009 (95.6%), while the share corresponding to individuals fell to 5%. Savings banks and non-financial corporations maintained significant positions, with around 15% each of the fund assets held by legal persons, ahead of public authorities (13%), pension funds (11%) and foreign entities. Proportionally, investor holdings varied little between 2009 and 2010.

...while the share capital of venture capital firms shrinks by 4.2%.

The share capital of venture capital companies came to 3.95 billion euros at the 2010 close, 4.2% less than at end-2009. Ownership was more tightly concentrated than in the venture capital fund segment. Specifically, non-financial corporations were the largest holders with 38.4% of capital at the 2010 close compared to 34.8% in 2009, ahead of the savings banks with 23.5% (19.9% in 2009), other financial companies with 16.6% (17.4% in 2009) and, finally, the banks, with 10.2%. Note that this last group withdrew significantly from capital in 2010 in both absolute and relative terms.

According to data furnished by the Asociación Española de Entidades de Capital Riesgo (ASCRI) for the first half of 2011, the sector is experiencing something of an upturn. Venture capital firms invested 1.93 billion euros over the first six months of the year, comparable to the pre-crisis levels of first-half 2007 and 66% more than in first-half 2010. International funds were again prime movers in the period, with pan-European investment accounting for 65% of the total. Sixty per cent of all transactions, whose numbers (387) varied little with respect to 2010, corresponded to expansion capital, 34% to venture capital and 4% to leveraged operations. The sectors receiving most of this investment were medicine and health (24%), other services (23%), industrial products and services (17%) and consumer goods (14%).

Venture capital entities: assets by type of investor TABLE 21

	Venture capital funds		Venture capital companies	
Million euros	**2009**	**2010**	**2009**	**2010**
Natural persons				
Residents	139.34	183.89	79.07	81.81
Non-residents	1.80	2.54	0.39	0.59
Legal persons				
Banks	207.38	226.40	551.92	402.42
Savings banks	490.57	547.46	819.37	929.81
Pension funds	357.41	413.29	25.23	10.35
Insurance undertakings	77.39	95.02	15.83	16.20
Broker-dealers and brokers	0.00	0.00	0.89	0.00
Collective investment schemes	22.39	26.02	8.20	8.28
Domestic venture capital entities	49.46	68.46	64.39	25.42
Foreign venture capital entities	247.67	296.70	50.53	44.87
Public authorities	372.65	494.53	132.44	133.80
Sovereign funds	26.02	33.17	0.00	0.00
Other financial companies	263.84	292.51	717.45	657.82
Non-financial companies	460.91	538.34	1,436.89	1,520.16
Foreign entities	347.26	395.53	36.34	44.45
Others	108.15	137.22	187.13	78.46
TOTAL	**3,172.24**	**3,751.08**	**4,126.07**	**3,954.44**

Source: CNMV.

...but bank lending constraints continue to hamper recovery.

The latest news on the sector hints at a return to a more dynamic market. But despite a sturdy advance in sector investment over these past months and the tentative resumption of large-scale transactions, persistent difficulties of access to bank finance are hampering what could and should be a stronger recovery.