I Securities markets and their agents: Situation and outlook

Contents

List of exhibits

1 Executive summary

- Economic recovery proceeded throughout the second half of 2010, with the main emerging economies once more leading the way, while industrialised economies lagged behind to varying extents. Rising world inflation has not yet sparked interest rate hikes in the advanced economies, though some emerging markets have already gone down this path. Short-term risks centre on the wide group of economies striving to ensure the sustainability of their public finances and to round off the restructuring of their financial systems, fears that macro-financial imbalances may be piling up in certain emerging economies, and the increasingly complex landscape for monetary policy, which will have to carefully calibrate the potential impact on prices of a negative supply disturbance, associated to the escalating oil, commodity and food prices of these last few months, in combination with still weak economic recovery.

- The Japan earthquake caused stock markets to falter in mid-March,[1] after the price rally of the second half of 2010. Meantime, long government bond yields in main developed economies settled at more moderate levels after the run-up of 4Q 2010, coinciding with the Irish crisis. Sovereign risk indicators remained at highs over the closing quarter for Europe's peripheral economies, though recently a gap has opened up between Greece, Ireland and Portugal, where indicators have been straining higher since early February 2011, and Italy and Spain, where indicators have stabilised.

- The Spanish economy expanded 0.2% in the fourth-quarter period (-0.1% over full-year 2010), in a context again marked by heavy unemployment (20.3%). Rising commodity prices pushed inflation higher to a February rate of 3.6%, while stretching Spain's differential vs. the euro area to 0.9 percentage points. A restrictive fiscal policy stance sliced two points off the budget deficit, which closed last year at 9.2% of GDP. The short-term prospect is that Spain will continue to grow a little less than other advanced economies, in view of the financial system restructuring still underway and the uncertain outlook for some of its key macroeconomic variables.

- Spanish deposit-taking entities again had to negotiate a complex business landscape characterised by subdued domestic output growth, a mounting bad debt burden, margin erosion, and, in some cases, funding constraints, especially on wholesale markets. It was with this scenario in mind that the Government launched its Financial System Reinforcement Plan in January 2010, intended to restore the markets' confidence in the soundness of Spain's financial system.

1 The closing date for this report is 15 March.

- The aggregate earnings of non financial listed companies climbed by 40% in 2010 to 35.60 billion euros, while their leverage inched down from 1.6 to 1.5 times on moderately decreasing debt levels (-0.5%).

- Main national equity markets got off to a strong start after the losses of 2010. The Ibex 35 posted a quarterly advance of 8.9% after the mid-March losses that followed the Japan earthquake, but before that was registering increases of nearly 13%. Stock market volatility died down to levels bordering on 25% after the peaks reached in 2010 (70% and 40% in May and November respectively). Market turnover continued to expand and liquidity conditions remained comfortable. Of the Ibex 35 participants, financial entities were hardest hit by the turbulence on European public debt markets.

- Yields on Spanish public and private debt rose across all maturities in the fourth quarter of 2010 then eased back in the next three months, more intensely so in shorter segments. The sovereign risk premium receded from the highs reached in November 2010 before entering a stable phase as of end-February. Fixed-income issues registered with the CNMV dropped by 42% in 2010 to 226 billion euros.

- Assets under management in investment funds fell by 15.6% to a year-end total of 144 billion euros. The main force at work was again unitholder redemptions, with fixed-income funds losing out most due to competition from high-interest bank deposits. The proportion of less-liquid assets in fund portfolios hovered between 7.1% and 7.4% in the second-half period. Real estate schemes saw their assets shrink by 5.4% in the full-year period, and hedge funds too suffered something of a setback with a number of entities entering liquidation. But this recession climate did not stop foreign UCITS marketed in Spain from growing their investment 41%, lifting their combined assets to 20% those of Spanish schemes from just 12% in 2009.

- UCITS management companies grew their earnings by 24.5% despite a yearlong decline in managed assets, thanks to a small advance in net fee income and savings in operating costs. Although UCITS managers have been working hard to rationalise their investment fund offerings, we would not rule out some midterm sector restructuring, as counselled by the excess capacity in the system and in view of the gathering consolidation wave among Spanish banks and savings banks. Meantime, stiff competition from products like foreign UCITS and exchange-traded funds and the decline in household savings rates spell a still uncertain outlook for the investment fund industry.

- The crisis continued to take its toll on investment firm business, though with notable differences between types of entity and business lines. Aggregate pre-tax profits were down vs. 2009 at both broker-dealers (-20%) and broker firms (-6%). However fewer entities closed in losses, what losses there were smaller than in 2009, and the sector's capital ratios stayed in safe terrain, with not one firm showing an own funds deficit. The excess capacity in the sector and the mergers underway among the savings banks could herald more restructuring further ahead.

- This report includes seven exhibits focusing on the following issues:

  – The first looks at recent trends in international capital flows, particularly the copious portfolio investment inflows reaching emerging economies in recent quarters. A discussion follows as to whether some of these economies may be storing up macro-financial imbalances

  – The second discusses amendments made to the EU Regulation on credit rating agencies, which transfer registration and supervisory powers in their respect to the new European Securities and Markets Authority (ESMA) as of 1 July 2011.

  – The third exhibit reviews the mechanisms in place to ensure adequate price formation and investor protection in stock market listings, in view of the interest shown by some financial entities in issuing listed shares.

  – The fourth sets out the good practice criteria for liquidity provision to retail bond investors published by the CNMV in October 2010, with the focus on new recommendations on trading practices and disclosure requirements.

  – The fifth describes the latest amendments to UCITS regulations, including the authorisation to create special-purpose schemes or "side pockets", and a series of measures to give the industry more operational flexibility.

  – The sixth explores the key features of U.S. money market funds and the regulatory changes they have undergone since the onset of the crisis. It also summarises the main arguments in the current debate around their future regulation.

  – Finally, the seventh exhibit offers a run-through of the questions and comments arising during the consultation round for CNMV Circular 6/2009 on internal controls in UCITS management companies, particularly those touching on the delegation of key functions.

2 Macro-financial setting

2.1 International economic and financial developments

Economic recovery remains on course ...

Since the last issue of this report, in the CNMV Quarterly Bulletin for the third quarter of 2010, the international macroeconomic climate has been shaken by a new wave of turbulence, coinciding with the Irish debt crisis in early November, and, more recently, by the earthquake in Japan, whose impact on the world financial system is still incalculable.

...despite the European sovereign debt crisis and the uncertainty generated by events in Japan.

The Irish debt episode added a new layer of uncertainty, especially in Europe, but did not palpably alter the economic recovery course the region has been tracing since mid- 2009. Nor did it disrupt the performance of international financial markets in general, and stock markets in particular, though they were later caught up in the aftermath of the disaster in Japan.

Emerging economies conserve their growth lead in 2010, contrasting with the uneven performance of the developed economies.

The IMF estimates that the world economy grew around 5% in 2010, after the 0.6% dip of the previous year. The two-speed pattern was maintained, with the emerging economies (7.1%) continuing to expand ahead of the industrialised contingent (3.0%). Quickening output growth was also reflected in the resurgence of world trade in the last year and a half. However the strength of recovery was notably uneven among the developed economies. This is nowhere clearer than in Europe (see table 1), where 2010 growth was led by the German economy (3.6%), while remaining countries either grew more weakly (around 1.5%) or not at all. Beyond Europe, both Japan (3.9%) and the United States (2.9%) expanded at a healthy rate.

Gross domestic product (annual % change) TABLE 1

					IMF(*)		OECD(*)	
	2007	2008	2009	2010	2011F	2012F	2011F	2012F
World	5.2	3.0	-0.6	5.0	4.4 (+0.2)	4.5 (=)	–	–
United States	1.9	0.0	-2.6	2.9	3.0 (+0.7)	2.7 (-0.3)	2.2 (-1.0)	3.1
Euro area	2.8	0.4	-4.1	1.7	1.5 (=)	1.7 (-0.1)	1.7 (-0.1)	2.0
Germany	2.7	1.0	-4.7	3.6	2.2 (+0.2)	2.0 (=)	2.5 (+0.4)	2.2
France	2.4	0.2	-2.6	1.6	1.6 (=)	1.8 (=)	1.6 (-0.5)	2.0
Italy	1.5	-1.3	-5.0	1.1	1.0 (=)	1.3 (-0.1)	1.3 (-0.2)	1.6
Spain	3.6	0.9	-3.7	-0.1	0.6 (-0.1)	1.5 (-0.3)	0.9 (=)	1.8
United Kingdom	2.7	-0.1	-4.9	1.4	2.0 (=)	2.3 (=)	1.7 (-0.8)	2.0
Japan	2.4	-1.2	-6.3	3.9	1.6 (+0.1)	1.8 (-0.2)	1.7 (-0.3)	1.3
Emerging	8.3	6.1	2.6	7.1	6.5 (+0.1)	6.5 (=)	–	–

Source: Eurostat, IMF and OECD.

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

Rising inflation has not yet triggered interest rate moves in the main industrialised economies…

Against this backdrop of gathering recovery, the developed economies experienced a year-long rise in inflation, with its main origin in the price of energy and non-energy commodities (see figure 1). However, core inflation held reasonably stable due to the persistence of excess productive capacity, and with unemployment rates remaining stubbornly high despite the better news on growth. So, with the exception of deflationary Japan, inflation expectations remained relatively well anchored in the main advanced economies, implying that official interest rates could be safely kept at lows. In the United States and Japan, concretely, rates had stood at 0%-0.25% and 0.1% respectively since December 2008, while the UK rate had held at 0.5% since March 2009 and the euro area rate at 1% since May 2009.

...though it seems likely that hikes will begin in Europe over the next three months.

In recent weeks, however, this placid scenario has been overturned, with inflation forecasts revised upwards across the board. The cause, basically, has been the build-up of political tensions in a series of oil-exporting Arab countries, which are fuelling expectations of interest rate hikes in the main industrialised countries. This, certainly, is the message being conveyed by three-month forward rates, and some analysts are confidently predicting that UK and euro-area interest rates will be revised upwards in the coming quarter, with the U.S. following some time later, towards the end of this year or in early 2012.

Commodity prices[1] FIGURE 1

Source: Thomson Datastream.

1 Thomson Reuters Equal Weight Continuous Commodity Index (formerly CRB index).

Some emerging economies raised their official rates in 2010.

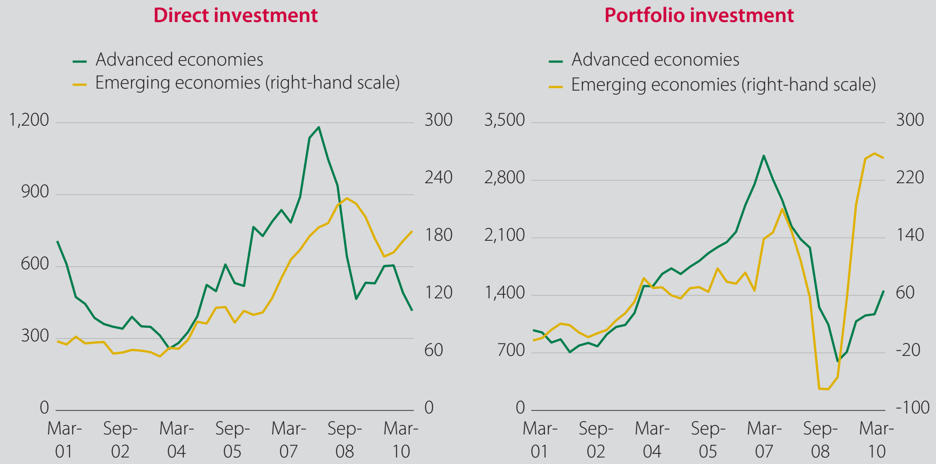
Meantime, a number of the emerging economies tightened their monetary policy stance in the second half of 2010 in the face of growing inflationary pressure stoked by strong external and domestic demand. This was the case of India, China and South Korea, and Chile and Brazil in Latin America.

Exhibit 1: "Recent trends in international financial flows and global imbalances"

For the world's principal emerging economies, the decade preceding the current crisis was one of extraordinary dynamism. Rapidly rising income was in most cases accompanied by high domestic savings rates which could go to feed the growing financing requirements of a series of industrialised economies - the most visible symptom of today's global imbalances. It was in this soil of abundant finance, low interest rates, pockets of high priced assets and fast expanding private credit that the present crisis took root.

The global surge in uncertainty that followed the Lehman Brothers collapse in September 2008 triggered an immediate reaction in international capital flows. But this time something had changed. Unlike in previous crisis episodes, the flow of capital was from the periphery (emerging economies) to the epicentre (the industrialised economies and, above all, the United States). This outpouring of funds from emerging countries was basically instrumented as portfolio divestments, as we can see from figure E1.1.

Capital inflows in billion dollars FIGURE E1.1



Source: Datastream. Cumulative four-quarter data to the third quarter of 2010. Advanced economies are the United States, euro area, United Kingdom and Japan (48% of world GDP in 2001-2010 in terms of purchasing power parity). The emerging economies group comprises Brazil, Mexico, Chile, China, India, Indonesia, Malaysia, Russia and South Korea (27% of world GDP in 2001-2010 in terms of purchasing power parity).

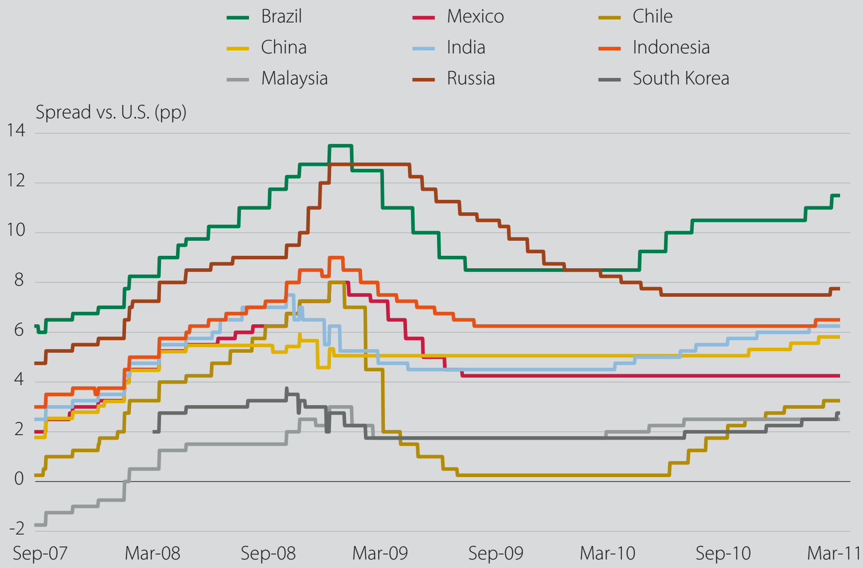
It was soon plain that emerging economies' less developed financial systems had only negligible exposure to the products and practices that had caused the crisis in the first place, and this, allied with the gathering recovery of world trade flows, earned them a renewed growth boost to rates exceeding even those of the immediate pre-crisis years.

In recent quarters, however, signs have emerged that some of these economies may be accumulating macro-financial risks. Among the causes of concern are the rapid run-up in prices in some asset markets, the unchecked expansion of borrowing and, in some cases, mounting inflation and strong currency appreciation. It is reasonable to suspect that some of these trends have been magnified in part by the extraordinarily accommodative monetary policies pursued by the industrialised countries, which may be playing in favour of carry trade strategies. With this kind of operation, investors borrow in a low-yielding currency to fund the acquisition of higher-yielding assets, normally denominated in their own national currency. And we can see from figure E1.2 below how the spreads in official interest rates between emerging economies and the United States have indeed been widening of late.

This partial reversal in the direction of world capital flows with respect to the pre-crisis pattern has raised the spectre of imbalances building up in some emerging economies, with concern that movements of a potentially unstable and/or speculative nature could distort the prices of certain assets. The consequences in this case would be particularly grave for countries that rely most on external financing.

Official interest rate spreads vs. the United States

FIGURE E1.2



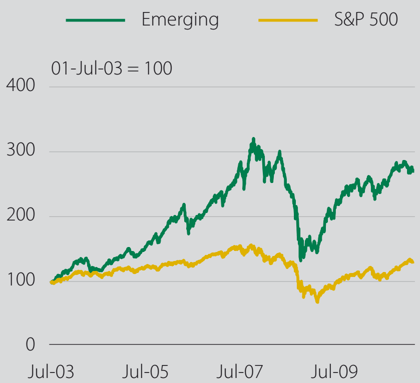
Source: Bloomberg. Data to 15 March.

Similarly, the aggregate equity and bond indices of emerging markets, which are now back to the levels of just before the crisis, may be partly factoring their improved growth prospects but could also betray some undervaluation of the risks they present (see figure E1.3).

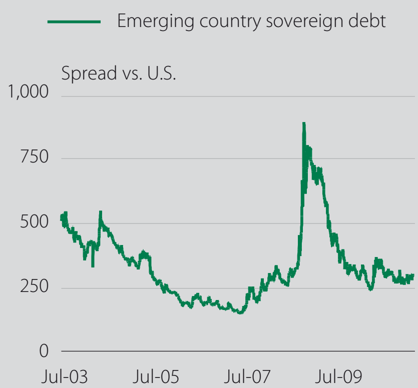
Valuation of the risk of emerging economies

FIGURE E1.3

Emerging market equity index (MSCI)



Risk premium of emerging market debt (EMBI)



Source: Bloomberg and Datastream. Data to 15 March.

Stock indices weathered the turbulence from the Irish crisis but were driven lower by the earthquake in Japan.

Leading industrialised economy stock indices weathered the turbulence caused by the end-2010 Irish crisis and were marking up steady gains until the Japanese earthquake on March 11, 2011 (see table 2). Since then, all reference indices have suffered significant falls, at times wiping out the gains accumulated year to date. By mid-March, Japan's market indices had shed more than 15% of their initial value, while U.S. indices were trading slightly higher. In Europe, the gains of indices like the Ibex 35 and Mib 30 contrasted with the losses of others, like the Dax 30 and Cac 40. Equity market volatility was not overly affected by the earthquake, just as it had largely withstood the shock waves from the Irish crisis. The exception was Japan, where both the Topix and Nikkei 225 were registering above 50% by the middle of March.

Performance of main stock indices[1] (%) TABLE 2

	2007	2008	2009	2010	1Q10	2Q10	3Q10	4Q10	1Q11 (to 15 March) % prior qt.	% Dec	% y/y[2]
World											
MSCI World	7.1	-42.1	27.0	9.6	2.7	-13.3	13.2	8.6	-0.6	-0.6	7.6
Euro area											
Euro Stoxx 50	6.8	-44.4	21.1	-5.8	-1.1	-12.2	6.8	1.6	-0.3	-0.3	-3.0
Euronext 100	3.4	-45.2	25.5	1.0	2.2	-10.5	7.5	2.8	-1.5	-1.5	-0.1
Dax 30	22.3	-40.4	23.8	16.1	3.3	-3.1	4.4	11.0	-3.9	-3.9	12.6
Cac 40	1.3	-42.7	22.3	-3.3	1.0	-13.4	7.9	2.4	-0.6	-0.6	-2.8
Mib 30	-8.0	-48.7	20.7	-8.7	-0.4	-14.7	6.2	1.1	2.6	2.6	-4.1
Ibex 35	7.3	-39.4	29.8	-17.4	-9.0	-14.8	13.5	-6.2	4.8	4.8	-5.7
United Kingdom											
FTSE 100	3.8	-31.3	22.1	9.0	4.9	-13.4	12.8	6.3	-3.5	-3.5	1.8
United States											
Dow Jones	6.4	-33.8	18.8	11.0	4.1	-10.0	10.4	7.3	2.4	2.4	11.4
S&P 500	3.5	-38.5	23.5	12.8	4.9	-11.9	10.7	10.2	1.9	1.9	11.4
Nasdaq-Cpte	9.8	-40.5	43.9	16.9	5.7	-12.0	12.3	12.0	0.5	0.5	12.9
Japan											
Nikkei 225	-11.1	-42.1	19.0	-3.0	5.2	-15.4	-0.1	9.2	-15.9	-15.9	-20.0
Topix	-12.2	-41.8	5.6	-1.0	7.8	-14.0	-1.4	8.4	-14.7	-14.7	-18.3

Source: Datastream.

1 In local currency.

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

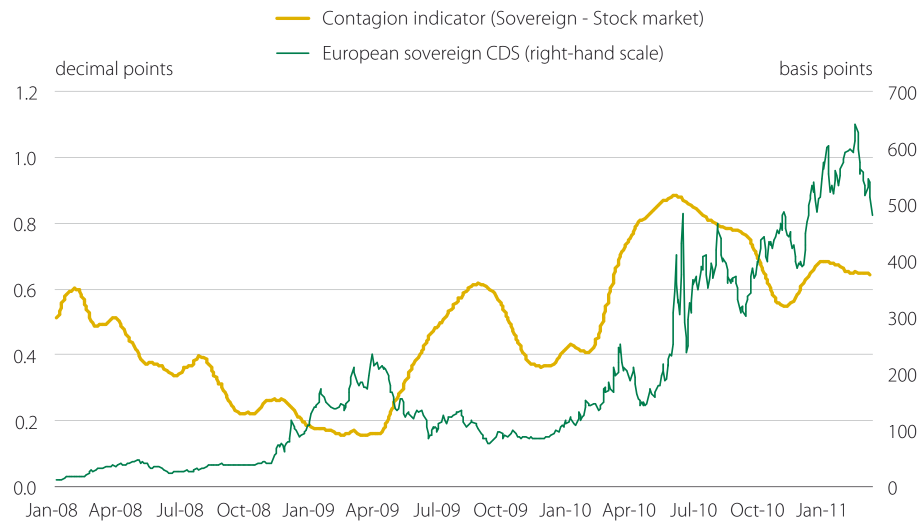
Sovereign risk contagion to equity markets reached its height during the Greek crisis.

Figure 2 offers an estimate of the contagion effect between Europe's sovereign sector and equity markets, based on readings of the sovereign CDS of five European peripheral economies and the performance of the Eurostoxx.[2] What it shows is that

2 The measure we use to gauge this effect is based on calculations of the spillovers of one financial asset on another, starting form the specification used by Diebold and Yilmaz to construct the Global Equity Market Spillover Index, available at: http://data.economicresearchforum.org/en/SpillOverIndex. Spillover is computed by estimating an autoregressive vector model, based on a breakdown of prediction er-

sovereign risk contagion to equity markets was strongest at the height of the Greek crisis (May 2010). In the next turbulence outbreak, coinciding with the Irish crisis, the contagion effect was less severe.

Contagion effect of the sovereign crisis on European equity markets[1] FIGURE 2



Source: CNMV.

1 This figure shows the net percentage change in the European stock index Eurostoxx and the European sovereign CDS index that is not ascribable to these indicators' historic data but to contemporary shocks in their respective returns. The resulting contagion indicator is increasing with the intensity of the effect produced by specific sovereign risk shocks on Eurostoxx returns. The extreme case where the index shows a value of one would indicate that contemporary stock index shocks have a zero impact, while a value of zero would mean sovereign risk shocks have no contemporary influence on the equity market. The sovereign CDS index is obtained from the average of the five peripheral countries: Spain, Greece, Ireland, Italy and Portugal.

In public debt markets, the upswing in aggregate uncertainty caused by successive rounds of the European sovereign debt crisis served to reinforce the "safe haven" status of German, U.S. and, to a lesser extent, British government paper. In effect, last year's turbulence episodes tended to coincide with a fall in the yields of what are viewed as safer assets and a rise in those of the countries displaying elements of fiscal fragility (see figure 3).

The sovereign debt crisis has confirmed the safe haven role of U.S. and German bonds.

January 2011 brought an easing of sovereign risk concerns, possibly motivated by expectations of an expanded and enhanced EU financial assistance mechanism and the bringing forward of domestic reforms. However, since the start of February, premiums have begun to climb again in Greece, Ireland and Italy, while the situation of Spain has stayed reasonably stable (see figure 4).

Sovereign risk indicators have been heading higher since February but Spain has so far escaped the trend.

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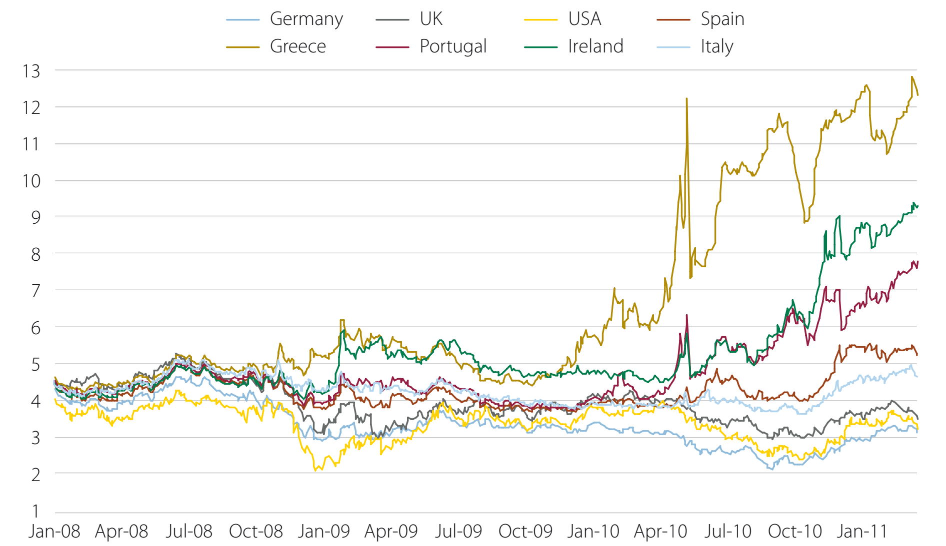
ror variance and on the calculation of the fraction of the prediction error variance of each variable that traces to innovations or shocks in the remaining variables. This methodology allows us to measure those effects that cannot be explained by the past information extracted from these indices, but only by contemporary events which initially affect other variables and are then passed on (contagion effect) to the study variable.

Ten-year government bond yields (%)

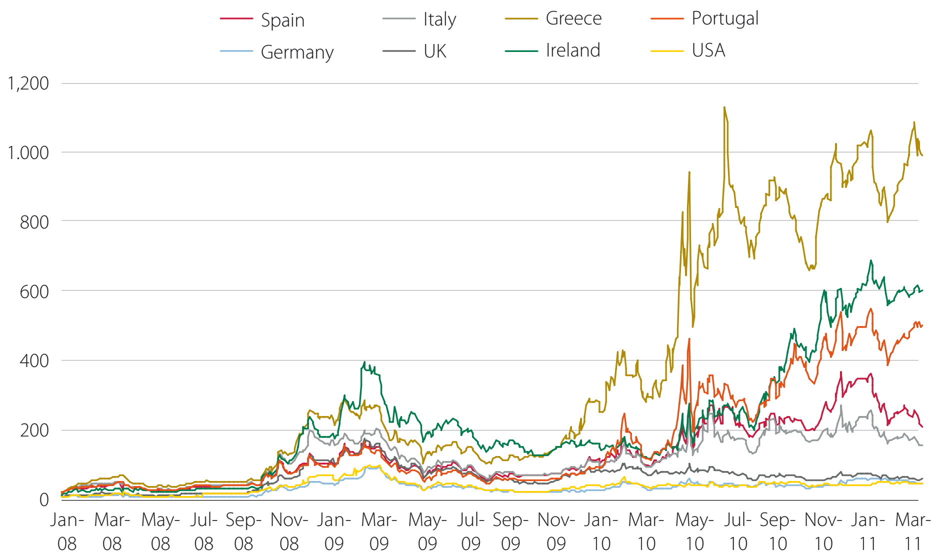
FIGURE 3



Source: Thomson Datastream. Data to 15 March.

Sovereign risk premiums, 5-year CDS

FIGURE 4

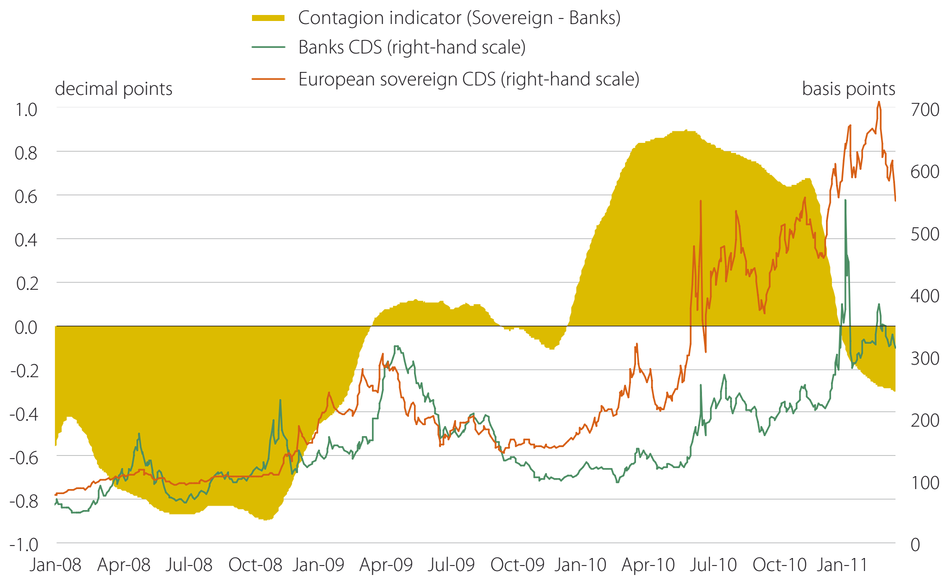


Source: Thomson Datastream. Data to 15 March.

Credit risk transmission between Europe's banks and the public sector has gone through contrasting phases since the crisis broke.

Figure 5, showing the results of a dynamic estimate of credit risk transmission in Europe from the financial to the public sector, reveals that this phenomenon has gone through diverse phases since the crisis broke. In the first, which encompassed the whole of 2008, credit risk was transferred in net terms from the financial sector to sovereign debt. When interpreting these results, it is wise to remember that fears about the health of Europe's banks abounded at that time. The next phase, lasting from the second quarter to year-end 2009, was characterised by the resumption of world growth and a gradual return to stability in the financial systems of many industrialised countries, particularly the United States. As a result, contagion between the two sectors was substantially reduced. In the last phase, starting in early 2010 with the first rumblings of the Greek debt crisis, the source of contagion switched to the public sector of the economy. And it now seems that the direction may have changed once more, since the closing stretch of 2010. One possible cause would be the resurgence of fears about the vulnerability of Europe's banks after the sudden collapse of two Irish entities that had passed the stress tests conducted by European supervisors in July 2010.

Net contagion between the European financial and public sectors[1] FIGURE 5



Source: CNMV.

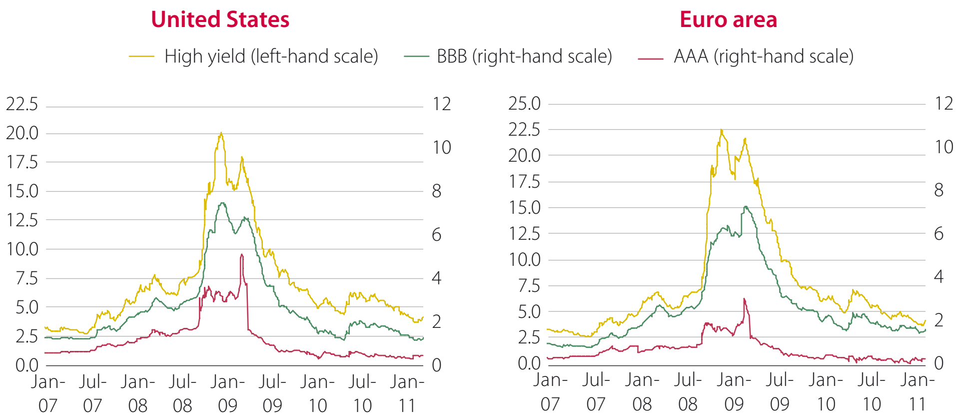
1 This figure shows the net change in the CDS indices of the European banks sector and various sovereign debt benchmarks that is not attributable to their historical information but to contemporary shocks in sovereign and bank sector credit risk. The contagion indicator is positive when the impact of sovereign risk shocks on financial risk indicators exceeds the impact of shocks directly affecting bank sector credit risk. The bank sector CDS index is obtained from the average of the top European Union banks. The sovereign CDS index is the average of the five peripheral countries: Spain, Greece, Ireland, Italy and Portugal.

Corporate spreads are moving close to their pre-crisis levels …

Meantime corporate debt spreads in the United States and euro area closed 2010 at close to their pre-crisis levels across the full range of issuer quality (see figure 6). However, starting in the second quarter, the scale of global corporate debt issuance began to tail off sharply (see figure 7), particularly among European financial entities.

Corporate bond risk premiums[1] (basis points)

FIGURE 6



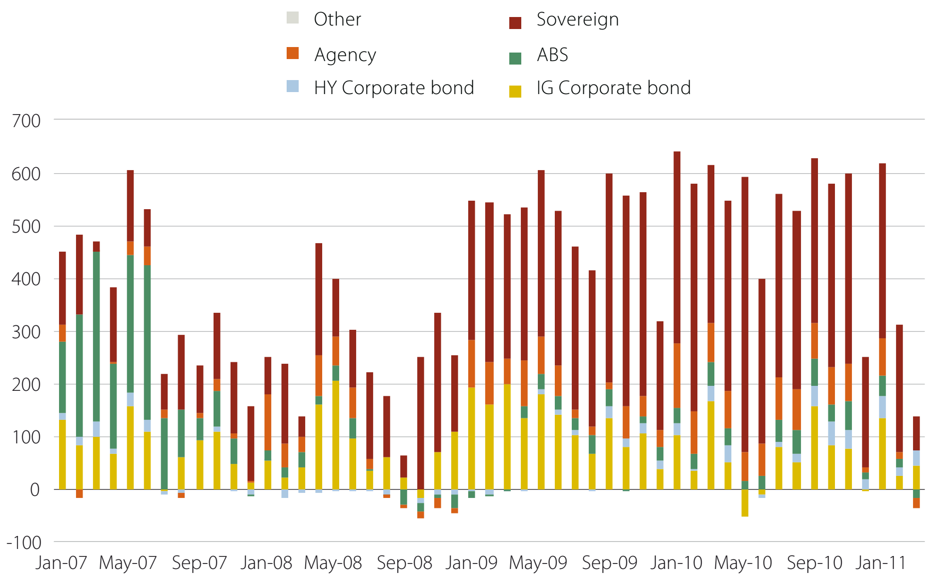
Source: Thomson Datastream (Merrill Lynch, IBOXX indices). Data to 15 March.

1 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).

Net international debt issuance, million dollars

By type of financial instrument

FIGURE 7



Source: Dealogic. Monthly data to 15 March.

Exhibit 2: "Changes in the Regulation on credit rating agencies"

The Regulation on credit rating agencies[1] in force in the European Union since late 2009 assigns supervisory and registration powers in respect of these entities to national supervisory authorities. However, following the setup of new EU-wide supervisory authorities, the European Parliament and the Council have amended its terms to the effect that as of 1 July, 2011 these registration and supervisory duties will be transferred to the European Securities and Markets Authority (ESMA). National authorities will continue to resolve on applications for registration received from agencies before 7 September, 2010.

Under the reframed provisions, ESMA will be empowered to request information from the supervised agencies, initiate investigations and conduct on-site inspections. It may also deal with breaches of the Regulation through supervisory measures such as striking agencies off the register, temporarily banning them from issuing ratings valid for the European Union, the publication of warning notices and, finally, the imposition of fines.

Transitional functions of the CNMV

Appointed competent authority in respect of the Regulation on credit rating agencies by Sustainable Economy Law 2/2011 of 4 March, the CNMV is temporarily charged with two kinds of transitional functions. The first relates to rating agency registration and the second to the drafting of the binding technical standards that ESMA will present to the European Commission:

a) Rating agency registration. Applications for registration can come from agencies operating on a stand-alone basis or else belonging to a group. Under the terms of the Regulation, all applications from groups must be examined by colleges of supervisors. The CNMV, for instance, sits on the colleges dealing with the Fitch, Moody's and Standard & Poor's groups. The final decision to grant or refuse registration corresponds to the authority in the agency's home Member State, but must also be agreed consensually by the college. In the absence of such consensus, the competent authority should refuse registration. Between 7 June and 7 September 2010, 45 credit rating agencies applied for registration in the European Union, of which 19 corresponded to individual agencies and the rest to agencies belonging to cross-border groups.

b) Drafting of the binding technical standards that ESMA must present to the European Commission. These standards refer to matters like the information agencies must disclose in their registration applications, the content and format of the statistical data to be published by registered agencies, agency compliance with methodological standards and their reporting requirements with ESMA for supervisory purposes.

Permanent functions of the CNMV

Once the amended Regulation comes into force,[2] the CNMV will retain the following functions with respect to agencies registered in the European Union:

a) Participation in ESMA supervision. ESMA's decisions on rating agencies will be discussed and agreed by members according to the standard decision-making process, with national authorities fully involved at every level: i) on the ESMA Board of Supervisors, national representatives will take top-level decisions concerning agency registration and supervision; ii) on the technical score, ESMA has created a standing committee made up of experts from national authorities, whose job will be to advise the Board on regulatory and strategic matters pertaining to credit rating agencies, as well as on other matters that the Board decides.

b) Obligation to work constructively with ESMA. The Regulation makes it incumbent on national authorities to cooperate with ESMA. This means supplying the new authority with all pertinent information for the fulfillment of its functions and collaborating in supervisory activities. ESMA may also call on the help of CNMV staff for investigative work in Spanish territory, including on-site inspections.

c) Delegation of supervisory tasks. ESMA may delegate certain supervisory tasks (for instance, information requests, investigations or on-site inspections) to national authorities, though note that responsibility will at all times remain with the pan-European authority. Prior to such delegation, ESMA must decide along with the national authority whether this is the most advisable course, and, if so, will subsequently reimburse it for the costs incurred.

d) Reporting infringements of the Regulation. When a competent authority believes it has detected some breach of the Regulation, it should report this to ESMA, proposing supervisory measures or, even, that use of the rating be suspended for regulatory purposes.

1 Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.
2 To be published some time around May 2011 and come into force twenty days later.

The euro has been gaining against the dollar, with occasional setbacks, since mid-2010.

In currency markets, the euro pulled out of its first-half slide against the dollar[3] thanks partly to the decision by the U.S. Federal Reserve to resume its quantitative easing policy. The uptrend, however, was cut short in the closing months by the onset of the Irish crisis (see figure 8). Even so, the European currency gained over 16% against the dollar between the lows of June 2010 and mid-February 2011. Against the yen, it has held relatively flat at around 110 yens/euro since end-May 2010 after depreciating over 18% since the start of that year.

The yen soared after the earthquake on expectations of capital repatriation, but was restored to stability thanks to coordinated moves by the G7 central banks.

The yen appreciated sharply in the days following the Japan earthquake on expectations of a massive sell-off of foreign assets, particularly by insurance companies, to release funds for the country's reconstruction. Subsequently, however, a large liquidity injection from the Bank of Japan and the decision by the G7 countries to intervene jointly to buy dollars helped take some of the heat off the Japanese currency.

2.2 National economic and financial developments

Spanish GDP grows 0.2% in the fourth quarter for a full-year average of -0.1%,...

Quarterly National Accounts data for the fourth quarter of 2010 show that Spain's GDP grew 0.2% in quarterly terms (against the zero rate of the preceding quarter) and 0.6% annually (0.2% in the third quarter), leaving the full-year average at a mildly negative -0.1%. This is a notable improvement on the -3.7% of the previous year, but also puts Spain some way behind a number of its partner economies (the euro area grew 1.7%). As we can see from table 3, the incipient recovery was largely driven by private consumption (up from -4.3% in 2009 to 1.2% in 2010), equipment

3 The euro lost almost 15% against the dollar over the first six months of 2010.

investment (-24.8% to 1.8%), and a positive contribution from the foreign sector, especially on the exports side (up 10.3% in the full-year period).

On the supply side, both industry (0.2%) and services (0.2%) input positively, while the decline in construction value-added slowed to -0.4% from the -1.9% of the third quarter. Over full-year 2010, the industrial and service branches added 0.9% and 0.5% to Spanish GDP against a negative 6.3% from construction.

...with positive input from industry and services.

Inflation built up from around 1% in January 2010 to 3.6% in February 2011 on rising commodity prices, of energy goods particularly, and higher indirect taxation. For the moment, the modest recovery in private consumption has not exerted that great a pressure on domestic prices. Core inflation rates also worked their way up from an initial 0.1% to 1.5% in the month of December (1.8% in February 2011). Spain's inflation differential vs. the euro area, which had moved in negative terrain over 2009, began widening in 2010 as far as 0.7 points at the December close (0.9 points in February 2011).

Rising commodity prices have pushed up Spanish inflation and widened the differential with the euro area.

The mild upturn in domestic activity has brought little relief to labour market figures. The number of employed workers continued to decrease, albeit at a slower pace than in 2009 (2.3% versus 6.8%), while the unemployment rate remained dug in at around 20% of the labour force, two points more than in 2009.

Tentative recovery has yet to spell good news for employment.

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)**	**1.7**
Private consumption	3.7	-0.6	-4.3	1.2	0.9 (-0.3)	1.6
Government consumption	5.5	5.5	3.2	-0.7	-1.3 (-0.1)	-0.3
Gross fixed capital formation, of which:	4.6	-4.4	-16.0	-7.6	-3.1 (-1.3)	2.7
Equipment	9.0	-1.8	-24.8	1.8	3.7 (+3.5)	6.0
Exports	6.6	-1.0	-11.6	10.3	5.5 (+0.8)	5.6
Imports	8.0	-4.9	-17.8	5.4	1.4 (-0.4)	4.5
Net exports (growth contribution, pp)	-0.9	1.4	2.7	1.1	1.1 (+0.4)	0.3
Employment	3.1	-0.5	-6.8	-2.3	-0.3 (-0.2)	1.1
Unemployment rate[1]	**8.3**	**11.3**	**18.0**	**20.1**	**20.2 (+0.4)**	**19.2**
HICP	**2.8**	**4.1**	**-0.2**	**1.8**	**2.4 (+0.9)**	**1.4**
Current account (% GDP)	**-10.0**	**-9.7**	**-5.5**	**-4.5**	**-3.8 (+0.7)**	**-3.6**
General government (% GDP)	**1.9**	**-4.1**	**-11.2**	**-9.2**	**-6.4 (-2.2)**	**-5.5**

Source: Ministry of Economy and Finance, National Statistics Office (INE) and European Commission.
1 Eurostat definition.
* Forecasts published in autumn 2010 (with respect to spring 2010), except GDP and inflation forecasts, published in March 2011 (with respect to autumn 2010).

Spain's public deficit came down almost two percentage points in 2010 after the 2009 leap from 4.2% to 11.1% of GDP, as Government spending cuts began to take effect. Indeed, according to IMF estimates,[4] Spain's fiscal policy stance has been the

Expenditure cuts reduce the public deficit by almost two full points to 9.2%.

4 IMF Fiscal Monitor, January 2011.

most restrictive of any developed economy's.[5] Meantime, public indebtedness moved up from 53.2% of GDP in 2009 to 60% in 2010 - the third consecutive increase albeit on a more moderate scale than the previous year (when the ratio jumped by over 13 points).

The outlook for Spanish deposit-taking entities has been further unsettled by the debt crisis.

National deposit-taking entities have had more uncertainties to contend with since successive waves of the European debt crisis engendered new financing difficulties in segments of the wholesale markets. Further, weak domestic activity and loan book impairment have continued to bear down on sector income statements.

The sector's aggregate net profits decreased sharply in 2010.

Finally, Spanish deposit-taking entities posted aggregate full-year net profits of 9.60 billion euros, 26% less than in 2009. The fall traced mainly to net interest income (down from 43 billion euros in 2009 to 34 billion in 2010), higher provisioning and lower extraordinaries. On the upside, operating expenses held reasonably flat while impairment losses (both financial and non financial) eased considerably.

Outstanding loans have trended lower since mid-2010...

After years of decline, the year-on-year change in aggregate outstanding loans to Spanish businesses and households turned timidly upwards in the year's second half on emerging from its April low (-1.5%). The latest available figures, for December 2010, show a small advance in lending (0.8% year on year), but also major differences in the mix, with loans to business expanding 1%, and loans to households by 0.4%. This two-speed growth, which has been kept up over several quarters, stands in contrast to the experience of the euro area. There, lending growth was higher overall but with business lending in retreat and lending to households up by nearly 3%.

…at a time of persistently advancing bad debt ratios.

The non performing loan ratios of Spanish entities continued to advance, with some interruptions, though at a lower rate than in previous years. Between December 2009 and December 2010, the NPL ratio climbed from 5.1% to 5.8% (3.4% in 2008 and 0.9% in 2007, see figure 9). And in January 2011 it rose again to 6.1%. Construction and real estate developers were again the main source of NPL growth, while the percentage of delinquent home purchase mortgages declined in the year to around 2.6%.

The sovereign debt crisis has made it harder for banks to raise funds on wholesale markets…

Financial entities had to work hard to raise funds in 2010's wholesale markets, due to the uncertain climate in sovereign debt. Overall, Spanish banks made less call on more extraordinary financing sources. Issuance of guaranteed bonds, for instance, barely exceeded 13 billion euros compared to almost 48 billion in 2009, while recourse to Eurosystem credits retreated from the highs of mid-2010 (130 billion) to 49 billion in February 2011 (see figure 8).

…persuading many to step up issuance of higher quality products likes mortgage bonds.

Funding constraints on wholesale markets caused a sizeable dent in financial institutions' outright issuance, down from 376 billion euros in 2009 to 223 billion in 2010. Many Spanish entities did like their European peers and switched their attention to the debt products viewed as strongest in credit quality, particularly mortgage

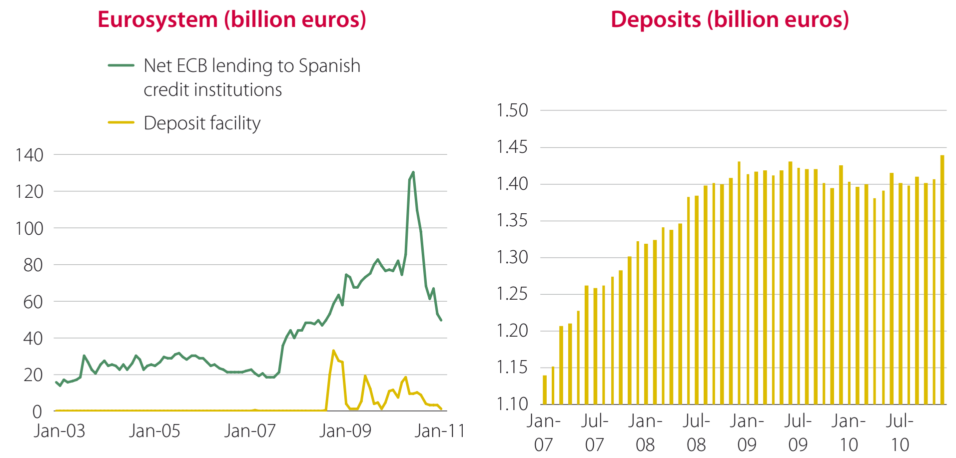
5 The structural deficit of the Spanish economy is estimated to have dropped from 9.7% of GDP in 2009 to 7.5% in 2010, contrasting with this indicator's growth from 5.5% to 5.9% across the world's developed economies (the trend being expansionary in all except the United Kingdom, where it is projected to be neutral).

bonds. As figure 9 shows, covered bond issues expanded their share in the debt mix of Spanish financial entities from 22% in 2009 to 35% in 2010. Among European entities, the equivalent increase was from 20% to 25%.

Finally, some Spanish entities have made increased use of the LCH.Clearnet and Eurex Repo platforms, which channel interbank loans collateralised by government bonds and also cover default risk. In the case of LCH.Clearnet, the value of repos transacted by Spanish banks between August 2010, when this trading modality had its debut, and January 2011 exceeded 800 billion euros.

Larger entities have the advantage of access to platforms like LCH.Clearnet and Eurex Repo.

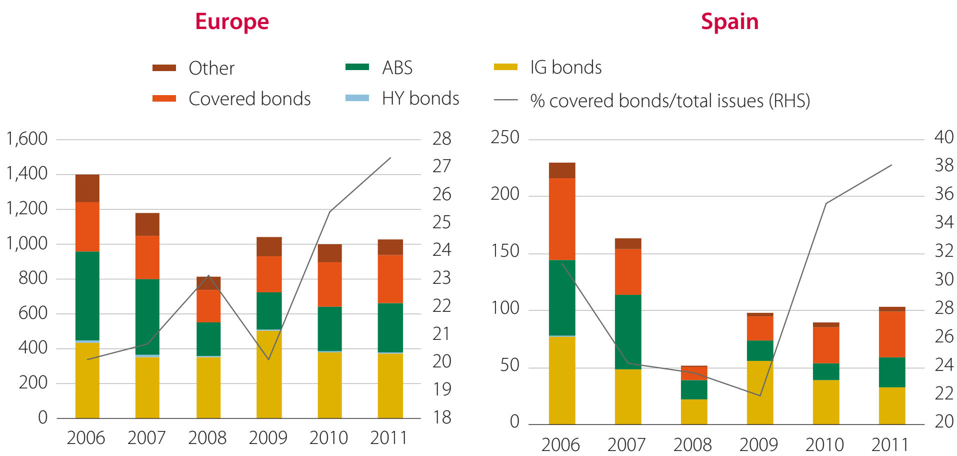
Financing of Spanish credit institutions FIGURE 8



Source: Banco de España. Eurosystem data to February, deposit data to December.

Gross long-term debt issuance by financial entities FIGURE 9

Billion euros



Source: Dealogic. The 2011 figure is the sum of the issuance of the last four quarters to the first quarter of 2011.

The aggregate net profits of non financial listed companies climbed 40.1% vs. 2009 to 33.6 billion euros. As table 5 shows, the earnings advance was common to all sectors, in tune with the general upturn in domestic activity. The strongest contributor in absolute terms was the energy sector, which grew its profits more than four billion to a year-end

Non financial listed companies grow their profits 40% in 2010.

total of 15.76 billion euros. Percentagewise, however, it was industry that took the lead with an earnings leap from 140 million euros in 2009 to 1.61 billion 2010. Also faring well was the retail and services sector with profits up by 27.4% to 14.35 billion euros.

Breaking down listed companies in terms of their net profit for the year (see figure 10, left panel), we find that the number reporting sizeable losses (over 200 million euros) was lower than before, thanks largely to the improved performance of companies in construction and real estate. At the same time, a rather higher number reported smallish profits (from 0 to 100 million euros), including real estate and industrial firms that had posted minor losses (below 100 million) in 2009. Finally, among the listed companies in profit over 2009 and 2010 (see figure 10, right panel), a larger number had managed to grow their earnings from one year to the next.

Earnings by sector:[1] non financial listed companies TABLE 5

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	2009	2010	2009	2010	2009	2010
Energy	28,486	34,974	18,034	23,315	11,472	15,761
Industry	2,712	4,087	1,181	2,453	140	1,607
Retail and services	29,780	34,197	17,933	21,863	11,268	14,356
Construction and real estate	4,644	8,936	1,596	5,658	1,084	1,855
Adjustments	-279	-178	-106	-38	15	16
AGGREGATE TOTAL	**65,343**	**82,016**	**38,638**	**53,251**	**23,979**	**33,595**

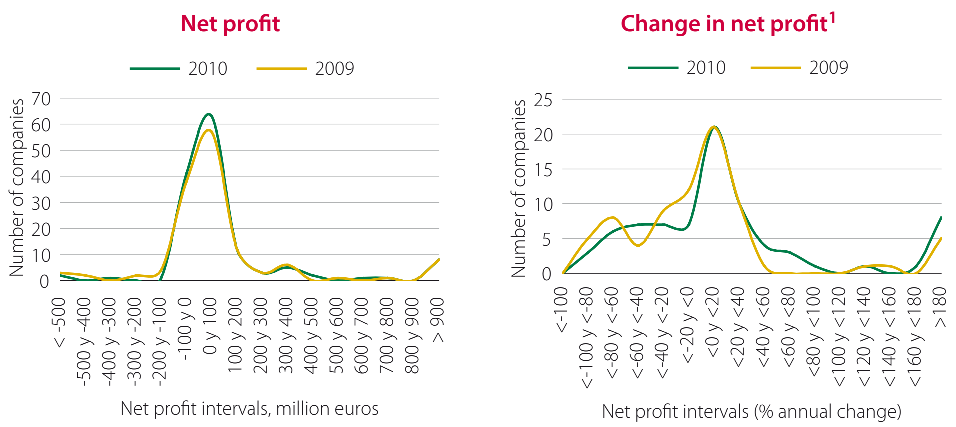
Source: CNMV.

1 Year-to-date.

2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

Non financial listed companies by: FIGURE 10



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 reduce their leverage by a small margin in 2010 (from 1.6 to 1.5)…

The debt of non financial listed companies fell by 0.5% in 2010 to 326.17 billion euros (see table 6), in a break with the rising trend of previous years (between 2005 and 2009 companies' debt grew by 100%). By sector, energy, industrial and real estate and construction firms managed to pay down debt by between 2% and 9%. Conversely, those in retail and services saw their debt swell by 6.3% to 115 billion euros. Financial leverage - the ratio of debt to net equity - dropped from 1.6 in 2009 to 1.5 in 2010, in line with the reduction in aggregate debt, with all sectors except industry sharing in the decrease.

The debt coverage ratio, measuring the years needed to repay existing debt assuming constant EBITDA, fell from 4.8 in 2009 to 4 in 2010, with improvement mainly gleaned from operating profit growth (see table 6). Construction and real estate fared particularly well by this yardstick with a reduction from 22.5 in 2009 to 11.2 in 2010. Meantime, growth in earnings before interest and taxes strengthened non financial companies' interest coverage ratios (EBIT/interest expenses up from 2.4 to 3). All sectors participated in this improvement except for industry, where interest expenses grew faster than EBIT, driving the ratio down from 3.1 to 2.7.

Gross debt by sector: listed companies TABLE 6

Million euros		2006	2007	2008	2009	2010
Energy	Debt	59,191	69,172	82,608	100,572	98,283
	Debt/ Equity	0.9	0.8	0.9	1.1	0.9
	Debt/ EBITDA[1]	2.2	2.5	2.8	3.5	2.8
	EBIT[2]/ Interest expenses	4.7	4.1	3.7	3.4	4.2
Industry	Debt	15,684	13,312	15,645	15,953	14,508
	Debt/ Equity	0.8	0.6	0.7	0.7	0.8
	Debt/ EBITDA	2.1	1.8	2.7	3.0	3.5
	EBIT/ Interest expenses	5.7	5.9	3.4	3.1	2.7
Construction and real estate	Debt	111,000	138,933	119,788	104,762	99,763
	Debt/ Equity	3.1	3.1	3.8	4.1	3.4
	Debt/ EBITDA	11.5	10.8	31.9	22.5	11.2
	EBIT/ Interest expenses	2.0	1.2	0.0	0.3	1.0
Retail and Services	Debt	91,522	96,941	112,322	108,579	115,407
	Debt/ Equity	2.5	1.7	2.1	1.8	1.6
	Debt/ EBITDA	3.6	3.0	3.6	3.7	3.4
	EBIT/ Interest expenses	2.4	3.2	2.9	3.3	3.9
Adjustments[3]	Debt	-11,199,0	-17,391,0	-20,802,0	-1,908	-1,793
AGGREGATE TOTAL[4]	**Debt**	**266,198**	**300,967**	**309,561**	**327,958**	**326,168**
	Debt/ Equity	1.7	1.5	1.6	1.6	1.5
	Debt/ EBITDA	3.9	4.0	4.6	4.8	4.0
	EBIT/ Interest expenses	3.3	3.0	2.0	2.4	3.0

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.

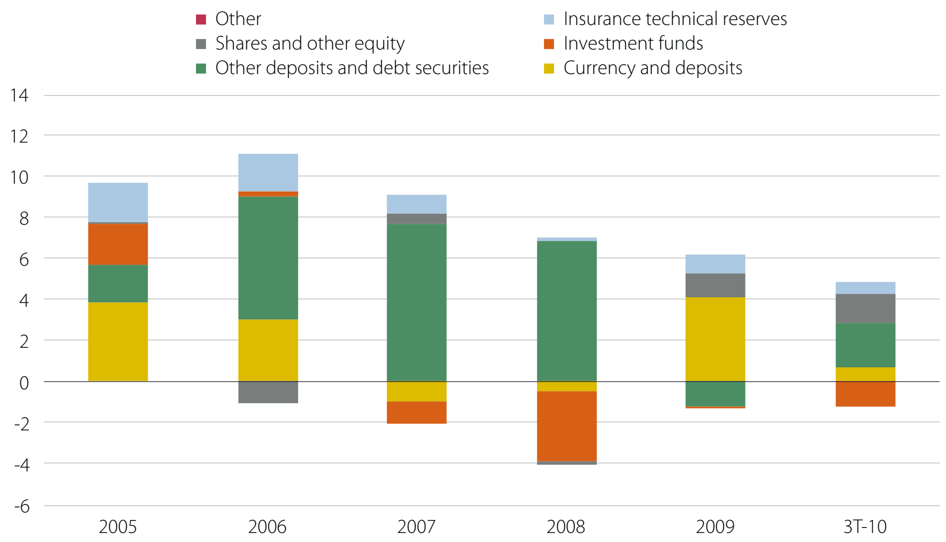
Households are saving less after the large increases of 2008 and 2009, while their indebtedness ratios have tended to stabilise.

Household asset indicators for the third quarter of 2010 show that savings rates prolonged their slide to just under 15% of disposable income, after the strong advances of 2008 and 2009, on a combination of lower income and moderately rising final spending. Household indebtedness had held stable for a number of quarters in the region of 125% of gross disposable income, while the decline in net wealth lasting through 2008 to mid-2009 began to level off thereafter, as the rising prices of financial assets cancelled out the (slower) depreciation of real estate.

Household investment is increasingly geared to term deposits and shares.

Where we can see new patterns emerging is in the make-up of financial assets and liabilities. In particular, households' net financial asset purchases, which by last September were slightly down on the levels of 2009,[6] showed a substantial reallocation from currency and deposits and investment funds into term deposits and shares (see figure 11 and table 13). Part of this shift was presumably due to the abundant choice of high-interest deposits in today's markets. Finally, household liabilities moved up once more (by 0.7% of GDP) after dropping back 1.3 points in 2009.

Households: financial asset acquisitions (% GDP) FIGURE 11



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

2.3 Outlook

Recent forecasts augur world growth of around 4.5% in 2011 and 2012.

The latest forecasts from the IMF and OECD, predating the Japan earthquake and therefore subject to some uncertainty, suggest the world economy will expand around 4.5% in 2011 and 2012, some way below the 2010 estimate (+5%). Emerging economies, they project, will remain notably dynamic, with the Asian contingent pulling ahead with aggregate growth of 6.5%, while the developed economies, led by the United States, will advance at more measured rates of around 2.5%.

The big risks have to do with the Japan earthquake, the outlook for public finances, the build-up of imbalances in some emerging economies and the complex monetary landscape.

Leaving aside the economic effects of the Japanese earthquake - reasonably manageable to judge from the latest data - the main downside risks for forecasters' baseline

6 4.1% of GDP (cumulative four-quarter data) against 4.5% in 2009.

scenarios have to do with: (i) the challenges faced by many economies in securing public finance sustainability while rounding off the restructuring of their financial systems; (ii) the possibility that imbalances may be building up in some emerging markets in view of the abundant capital inflows reaching their economies, the escalating prices of their assets and their rapidly falling risk premiums; and, finally, (iii) the increasingly complex landscape for monetary policy implementation, which will have to carefully calibrate the potential impact on prices of a negative supply disturbance, associated to the escalating oil, commodity and food prices of these last few months, in combination with still weak economic recovery at a time when standard monetary policy transmission mechanisms may see their functionality impaired by fragile elements in the financial system, thinking particularly of interbank markets. This complexity is nowhere more patent than in the euro area, given its considerable heterogeneity with regard to the inflation pass-through of rising oil prices, the pace of economic recovery and the impact of interest-rate movements on household and business wealth. To add to this, concerns about the health of Europe's financial sector and the effectiveness of recent restructuring measures threaten to block the flow of finance to the continent's most vulnerable economies.

Spain is not only set to grow less than other advanced economies, but must contend with the perceived vulnerability of part of its financial system and concerns about its mid-term growth potential.

Leading forecasters are less than optimistic in their 2011 growth projections for the Spanish economy. Specifically, Spain's GDP is tipped to expand between 0.6% and 0.9%, compared to the 1.5% of the euro area and the 3% of the United States. In 2012, however, domestic and euro area growth stand to converge around the 1.5% mark. Note also that employment statistics are not expected to accompany the upturn to any great extent. The risks for this recovery scenario centre on the financial system restructuring still underway and the uncertain outlook for some of the country's key macroeconomic variables. And these factors could hold back a return to normality in public and private sector financing conditions. On the upside, Spain has already made significant strides in fiscal consolidation and structural reforms (labour market, pensions system) and, more recently, has launched its Plan for the Reinforcement of the Financial System, which raises core capital requirements for Spanish entities ahead of the Basel III provisions timetabled for 2013, and imposes an immediate core capital requirement of 8% of risk-weighted assets.

3 Spanish markets

3.1 Stock markets

Spanish stock markets pull out of the dip experienced in the final months of 2010.

After the price falls of late 2010, Spain's stock markets rallied to varying degrees in the first quarter of 2011,[7] outperforming other world bourses more deeply affected in the uncertain aftermath of the Japan earthquake (see table 2 and table 7). The sole exception was the trading segment specialised in Latin American securities.

7 To 15 March.

Performance of Spanish stock indices (%)

TABLE 7

Index	2007	2008	2009	2010	3Q10[1]	4Q10[1]	1Q11 (to 15 March) % prior qt.	% Dec	% y/y
Ibex 35	7.3	-39.4	29.8	-17.4	13.5	-6.2	4.8	4.8	-5.7
Madrid	5.6	-40.6	27.2	-19.2	12.9	-7.5	5.5	5.5	-6.8
Ibex Medium Cap	-10.4	-46.5	13.8	-5.6	13.7	-0.5	2.6	2.6	-2.5
Ibex Small Cap	-5.4	-57.3	17.6	-18.3	3.6	-4.3	9.8	9.8	-7.9
FTSE Latibex All-Share	57.8	-51.8	97.2	9.0	1.5	8.3	-7.0	-7.0	-3.9
FTSE Latibex Top	33.7	-44.7	79.3	9.7	-2.2	7.3	-6.3	-6.3	-1.4
Sector[2]									
Oil and gas	1.8	-30.8	-20.1	0.3	7.1	11.0	15.5	15.5	24.2
Chemicals	-58.4	-67.8	3.4	-60.0	-49.8	-6.2	21.0	21.0	-51.9
Basic materials	-17.2	-45.4	23.1	-5.6	3.0	0.5	2.0	2.0	-0.4
Construction mat. and construction	-12.0	-51.0	25.5	-14.4	15.1	-0.1	9.0	9.0	-0.2
Industrial goods and services	6.9	-41.9	29.3	-1.9	16.9	-1.3	-1.7	-1.7	-1.5
Health	19.2	-45.0	17.7	-22.2	17.1	-9.5	9.5	9.5	-15.0
Utilities	18.5	-31.0	-7.8	-14.3	10.2	3.4	5.8	5.8	-3.5
Banks	-4.5	-47.9	46.3	-32.3	8.8	-16.2	9.9	9.9	-15.6
Insurance	-13.3	-25.0	19.8	-26.8	2.0	-7.1	19.5	19.5	-7.5
Real estate	-42.6	-58.6	-43.8	-53.2	-13.5	-29.7	17.3	17.3	-44.9
Financial services	-35.6	-44.3	20.8	12.8	14.1	2.5	20.1	20.1	26.8
Telecommunications and media	26.3	-31.4	23.5	-13.4	18.1	-5.8	2.0	2.0	-3.1
Discretionary consumption	-7.7	-39.2	37.0	20.6	22.2	-1.7	-3.8	-3.8	10.7
Basic consumption	6.9	-22.5	-8.4	15.8	4.3	10.6	-4.6	-4.6	9.6

Source: Thomson Datastream.

1 Change vs. previous quarter.

2 Classification according to Thomson Datastream.

The Ibex 35 advances 4.8% in the first quarter of 2011 (-17.4% in 2010)...

The Ibex 35 managed a first-quarter gain of 4.8%[8] after slipping back 6.2% in the fourth quarter of 2010 (-17.4% in the full-year period) (see table 7). Looking closer, however, we observe that this index too closed the quarter with falls in the wake of the Japan disaster, after registering advances at some points of nearly 13%. Meantime, small and medium cap indices notched up first-quarter gains of 9.8% and 2.6% on the heels of their 4.3% and 0.5% losses in the fourth quarter of 2010 (-18.3% and -5.6% in the full-year period). In contrast, the bull run enjoyed by Spain's trading platforms for Latin American securities (Latibex) since the year 2009, began to lose steam in 2010. And finally, the FTSE Latibex All-Share and FTSE Latibex Top accumulated first-quarter losses upwards of 6%, after gaining over 8% in the fourth quarter and more than 9% over the length of last year.

...led by chemicals, real estate, insurance and finance.

The sectors spearheading the first-quarter rally were those that lost most heavily in 2010, namely chemicals (21% in the first quarter of 2011 against -60% in 2010), insurance (19.5% after the -26.8% of 2010), real estate (17.3% after -53.2%), banking (9.9% after -32.3%) and construction and related materials (9% after -14.4%). Non

8 The Ibex 35's year-to-date advance to 30 March was 8.9% after prices rallied from mid-month onwards.

bank financial services, energy and healthcare also recorded first-quarter advances, leaving only consumption-related sectors and, to a lesser extent, industrial goods and services in negative terrain.

Financial entities in the Ibex 35...

Figure 12 charts the relative performance of the financial and non financial companies making up the Ibex 35. We can see that the period starting in January 2010 splits into three distinct phases, which are mainly correlated with successive episodes of the European sovereign debt crisis.

... have underperformed non financial listed companies throughout successive rounds of the sovereign debt crisis…

In the first phase, which spanned the first half of 2010 and coincided with the Greek debt crisis, the shares of both groups ran down sharply in a climate of heightened uncertainty that pushed market volatility to the region of 70%. Financial institutions recorded deeper losses during this period (over 35%) than non financial listed companies.

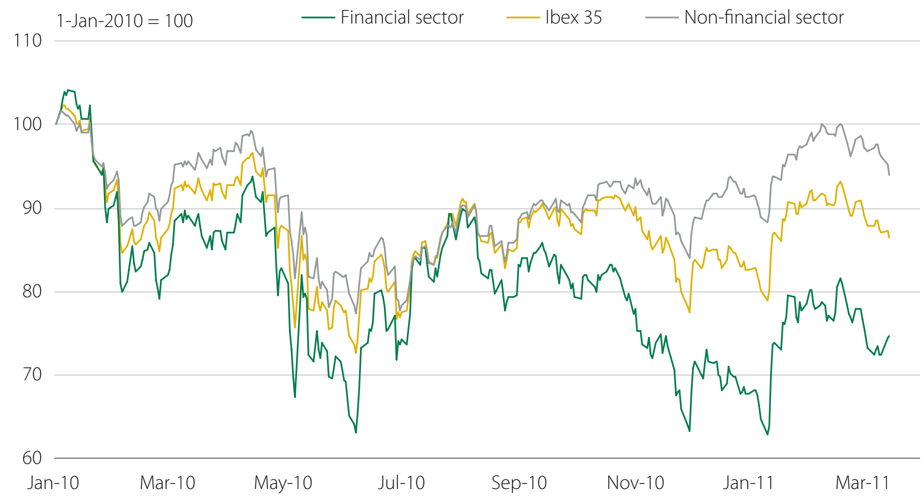
…despite a strong rally in the middle months of 2010.

The second phase occupied the middle months of 2010. At this point several factors combined to power financial sector prices higher, to more or less the level of their non financial peers. Chief among them were the Greek rescue deal, the approval of a European assistance mechanism to operate within the European Union, the adoption of fiscal austerity plans in a series of European economies, ECB measures to boost public debt market liquidity, and publication of the results of the stress tests conducted on Europe's financial institutions.

Financial sector shares are trading 20% lower than at the start of 2010, when the Greek crisis broke.

From September 2010 to date what we see is renewed underperformance by the financial sector. During this time, financial markets were rocked by a new wave of turbulence generated around the Irish crisis, which bore down more heavily on financial sector shares amid growing concerns about the strength of Europe's banking sector. By the end of first quarter 2011, non financial shares were back to the price levels of early 2010, while financial shares were trading 20% lower, despite substantial advances in the intervening period.

Ibex 35: financials vs. non financials[1] FIGURE 12



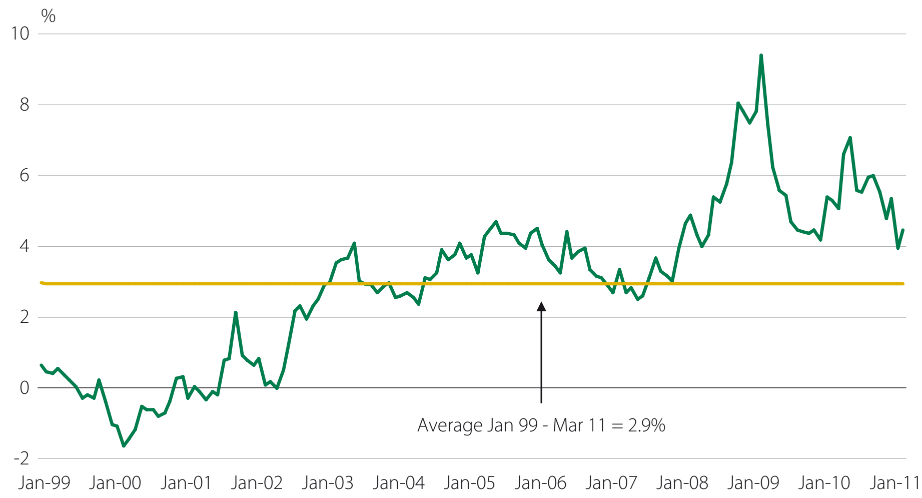
Source: Thomson Datastream. Data to 15 March.

1 Each company is weighted according to the share of its market cap. in the prior-year-end capitalisation of the Ibex 35.

Ibex 35 P/Es are buoyed slightly by the share price rally.

The share price rally of the first quarter of 2011 lifted the price-earnings ratio[9] (P/E), to 10.3 times from the 9.7 of the 2010 close. Despite this growth, the Spanish multiple remained in the lower reaches of the international stock index table. The increase also offset the marginal decline in Spanish ten-year bond yields, causing a fall in the earnings yield gap[10] which reflects the return premium required to be invested in equity versus long-term government bonds (see figure 13). Although this indicator's performance is normally driven by movements in equity rather than government bond prices, in 2010 it was mainly debt markets that called the tune.

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



Source: Thomson Datastream and own preparation.

1 Difference between stock market yield, taken as earnings/price and ten-year Spanish government yields. Monthly data to 15 March 2011.

Spanish stock market volatility settles down near 25% after 2010 peaks coinciding with the worst of the sovereign debt crises...

As we can see from figure 14, stock market volatility fluctuated widely in the course of 2010, surging to peak levels of 70% and 40% respectively during the tensest moments of the Greek and Irish debt crises. In both cases, the spikes in Spanish market volatility came close to mirroring those of the indices in Europe's most vulnerable economies, while other leading world indices were barely perturbed, in particular by the Irish episode. In the first quarter of 2011, Ibex 35 volatility died down once more to the region of 25%.

...while liquidity conditions remain supportive...

Meantime, the bid/ask spread reflecting the liquidity available in the Spanish stock market moved lower in the opening months of 2011 after the slight increase of late 2010, taking monthly averages to their lowest levels in recent years (see figure 15).

---

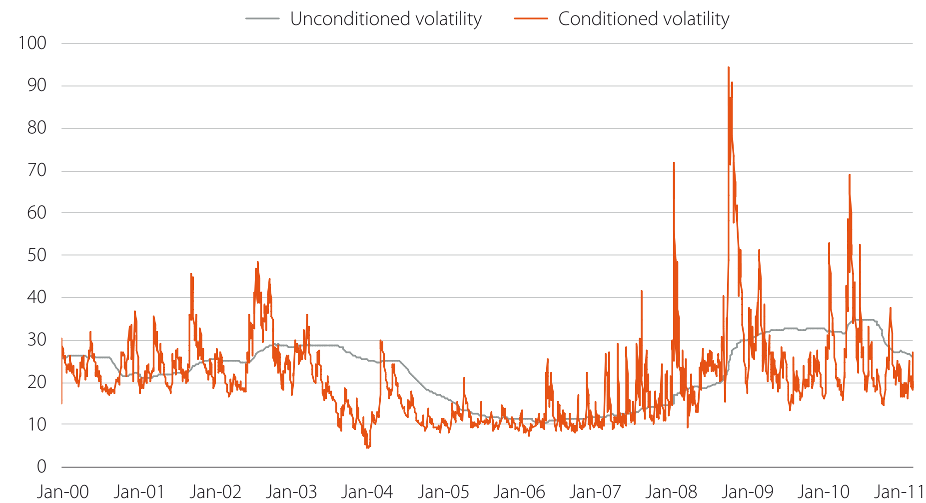
9 On the basis of one-year forward earnings.

10 This indicator rests on the assumption that a share's price (P) is, in any given moment, the present value of the future cashflows (Π) to which its ownership gives rise (see equation 1). The discount factor applied includes both ten-year government bond yields (r) and a risk premium (ρ) known as the earnings yield gap, which seeks to reflect the difference in risk between public debt and shares. Stripping ρ out of equation 1, we find that $\rho = \frac{1}{PER} - r$, where $PER = \frac{P}{\Pi}$.

$$(1)\quad P = \frac{\Pi}{1+r+\rho} + \frac{\Pi}{(1+r+\rho)^2} + \frac{\Pi}{(1+r+\rho)^3} + \frac{\Pi}{(1+r+\rho)^4} + \ldots = \Pi \cdot \sum_{i=1}^{\infty} \frac{1}{(1+r+\rho)^i} = \frac{\Pi}{r+\rho}$$

Historical volatility. Ibex 35

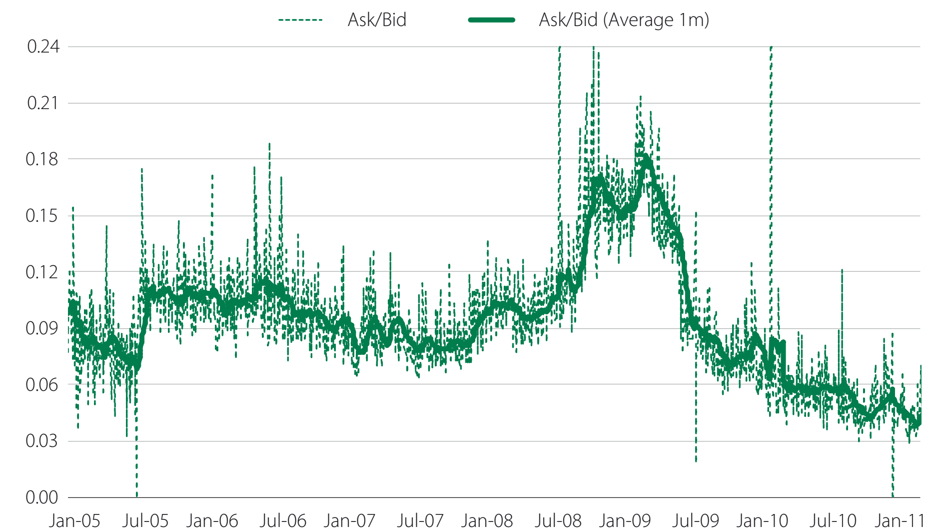
FIGURE 14



Source: Thomson Datastream and CNMV. Data to 15 March.

Ibex 35 liquidity. Bid-ask spread (%)

FIGURE 15



Source: Thomson Datastream and CNMV. Data to 15 March.

…and turnover on the rise.

The Spanish stock market reached 203.90 billion euros turnover in the first three months of 2011 (data to 15 March), 6.7% more than in the same period last year (see table 8). Average daily trading stood at 3.92 billion, significantly down vs. the last quarter of 2010 (4.60 billion) but similar to the 2010 average of 4.05 billion.

Equity issuance picks up slightly in 2010.

Surprisingly perhaps, in view of the uncertainties and falling prices that characterised financial markets for most of 2010, equity issuance staged something of a comeback, to more than 16 billion euros in full-year terms. This was 41% more than in 2009 and on a par with the figure for 2008 (see table 9), though still a long way short of pre-crisis levels.

Turnover on the Spanish stock market

TABLE 8

Million euros

	2007	2008	2009	2010	3Q10	4Q10	1Q11[1]
Electronic market	1,658,019	1,235,330	880,544	1,032,447	214,267	292,819	203,116
Open outcry	1,154	207	73	165	54	82	18
of which SICAVs[2]	362	25	20	8	1	0	2
MAB[3]	6,985	7,060	5,080	4,145	768	1,147	683
Second Market	193	32	3	3	1	1	1
Latibex	868	758	435	521	93	119	85
All exchanges	**1,667,219**	**1,243,387**	**886,135**	**1,037,282**	**215,183**	**294,168**	**203,902**

Pro-memoria: non resident trading (% of all exchanges)

	61.6	65.5	64.2	n.a.	n.a.	n.a.	n.a.

Source: CNMV and Directorate-General of Trade and Investment.

1 Cumulate data from 1 January to 15 March.

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 9

	2007	2008	2009	2010	3Q10	4Q10	1Q11[2]
CASH AMOUNTS[3] (million euros)	**69,955**	**16,349**	**11,391**	**16,018**	**2,323**	**8,339**	**3,217**
Capital increases	67,887	16,340	11,389	15,412	2,323	8,267	3,217
Of which, through POS	8,503	292	17	964	6	20	0
National tranche	4,821	292	15	67	6	19	0
International tranche	3,681	0	2	897	0	0	0
Public offerings	2,068	10	2	606	0	71	0
National tranche	1,517	10	2	79	0	71	0
International tranche	551	0	0	527	0	0	0
NUMBER OF FILINGS[4]	**100**	**54**	**53**	**69**	**12**	**29**	**12**
Capital increases	91	53	53	67	12	28	12
Of which, through POS	8	2	2	12	2	4	0
Of which, bonus issues	19	18	11	15	3	7	2
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 15 March 2011.

3 Excluding amounts recorded in respect of cancelled transactions.

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

Exhibit 3: "Procedures for stock market listing"

In the past few weeks, following approval of Royal Decree Law 2/2011 of 18 February for the reinforcement of the financial system, a number of institutions have expressed an interest in issuing listed shares. The process of stock market flotation must meet a series of conditions whose aim is to guarantee the correct formation of prices and ensure investors adequate protection.

Price formation in the primary market

Among the pre-conditions for orderly price formation in the stock listing process is that placements should incorporate a substantial tranche for professional investors - those with the knowledge and means to competitively determine a reference price for the share at the outset of trading. This will then be the price at which retail investors place their orders. It follows that the greater the number of institutional investors participating in the process, the smaller the difference will be between the placement price and the share's subsequent market quotes.

As we can see from table E3.1, in placements taking place from 2007 to the present day, the tranche reserved for institutional investors averaged 80% of the offering, and was invariably higher than 40%. Further, a third of the transactions registered had no retail tranche, meaning the offering was directed exclusively at professional investors. Finally, the number of financial institutional investors taking part was above 300 in every case, and usually above 1,000.

Stock market listings since 2007 TABLE E3.1

Name	Year	Capitalisation at final price (million euros)	% free float post offering (*)	% professionals targeted in the offering	No. of financial institutional investors
LABORATORIOS FARMACÉUTICOS ROVI, S.A.	2007	480	40	100	506
ALMIRALL, S.A.	2007	2,027	30	75	1,170
FLUIDRA, S.A.	2007	732	43,49	70	1,110
CLÍNICA BAVIERA, S.A.	2007	108	41,33	85	341
CRITERIA CAIXACORP, S.A.	2007	17,259	22	40	2,213
REALIA BUSINESS, S.A.	2007	1,803	47,74	67,73	733
RENTA 4 SERVICIOS DE INVERSIÓN, S.A.	2007	376	43	75	307
CODERE, S.A.	2007	1,156	30,2	100	
IBERDROLA RENOVABLES, S.A.	2007	22,387	20	80	4,209
SOLARIA ENERGÍA Y MEDIOAMBIENTE, S.A.	2007	961	28,75	100	1,234
AMADEUS HOLDING, S.A.	2010	4923,40	29,41	100	1,212

(*) Including the purchase option granted to placement coordinators (greenshoe).

In transactions where the institutional tranche cannot be covered due to insufficient demand, the usual practice is for the issuer to desist and withdraw its offering. This occurred on three occasions during the period considered.

The above points are especially important in the market flotations of financial entities. Firstly, because of the complexities involved in valuing this type of entity and, secondly, because of the conflicts of interest inherent to any retail placement where issuer and distributor are one and the same.

Price formation in the secondary market

The orderly functioning of the market for a newly listed security depends not only on the placement price but also on the fluidity of its trading. For this to be achieved, a sufficient percentage of the shares representing the issuer's capital must be available for transacting, so investors who have taken up the placement or those wishing to acquire shares on the market can find a counterparty for their buy or sell orders.

In this respect, article 9.7 of Royal Decree 1310/2005 of 4 November, partially implementing Securities Market Law 24/1988 of 28 July as regards the admission of securities to trading on regulated markets, public offerings and prospectuses provides that "a requirement for the admission of shares to stock market listing shall be that the said shares are sufficiently widely distributed prior to or, at the very latest, on the date of admission to trading [...]. This condition shall be deemed to be met when at least 25 percent of the shares for which listing is requested are distributed among the public, or when in view of the large number of shares of the same class and the extent of their distribution among the public, the market can operate properly with a lower percentage."

From table E3.1 we can see that the proportion of shares offered in the placements conducted since 2007 was generally equal to or greater than 25% of the issuer's share capital. In fact there are only two cases where the company offered a number of shares falling below this threshold, on the understanding that the market could operate properly with a smaller percentage given the large quantity of shares being issued, far exceeding those involved in the other transactions registered.

Investor protection

To ensure that investors' interests are adequately protected, the entities applying for stock market listing must pay due and careful heed to good corporate governance rules and recommendations, particularly those referring to the number of independent board members and the appointment and make-up of board committees.

Finally, entities taking part in the placement process must adhere to all relevant rules of conduct, including those to do with appropriateness and suitability testing. They should also refer to the good practice standards set out in the CNMV document "Conditions for the marketing of securities market instruments", dated 7 May 2009.[1]

1 Available at: http://www.cnmv.es/Portal/AlDia/Comunicaciones.aspx.

3.2 Fixed-income markets

Interbank markets begin to price in hikes in official rates .

For months now, the rising prices of commodities in general, and energy products in particular, have been putting renewed pressure on euro area inflation. And the odds are increasingly on a near-time hike in official interest rates. Indeed it appears this possibility is already being discounted in interbank markets, where the upward curve initiated in mid-2010 has accelerated in recent weeks.

The rates run-up of fourth-quarter 2010 gives way to renewed decline in short tenors...

In this context, short-term rates in public and private debt markets headed lower in the first quarter of 2011 after a steep run-up at the end of last year coinciding with the Irish crisis. Note that these movements were more intense in government than private instruments, as has indeed been the dominant pattern since the first signs of turmoil on European sovereign debt markets. Hence average rates of Spanish treasury bills (Letras del Tesoro) climbed by 100 to 160 bp, depending on the tenor, from October to December 2010, only to fall back 64 to 140 bp in the first quarter of 2011[11] as far as 1%, 1.4% and 2.1% at three, six and twelve months respectively. Short-term rates on private fixed-income markets traced a similar but smoother course with rises of 16 to 36 bp in the fourth quarter of 2010 giving way to falls of 9 to 50 bp in the first months of 2011 (see table 10).

Short-term interest rates[1] (%) TABLE 10

	Dec-07	Dec-08	Dec-09	Dec-10	Jun-10	Sep-10	Dec-10	Mar-11
Treasury bills								
3 month	3.88	2.03	0.44	1.63	0.79	0.66	1.63	0.99
6 month	4.03	2.10	0.61	2.76	1.41	1.16	2.76	1.36
12 month	4.03	2.09	0.88	3.26	2.27	1.79	3.26	2.06
Commercial paper[2]								
3 month	4.54	3.09	0.76	1.37	0.93	1.21	1.37	1.28
6 month	4.83	3.63	1.25	2.52	1.44	2.21	2.52	2.02
12 month	4.87	3.74	1.63	3.04	3.12	2.68	3.04	2.65

Source: Banco de España and CNMV.

1 Average daily data. March data correspond to the average for the period 1/03 to 15/03.

2 Interest rates at issue.

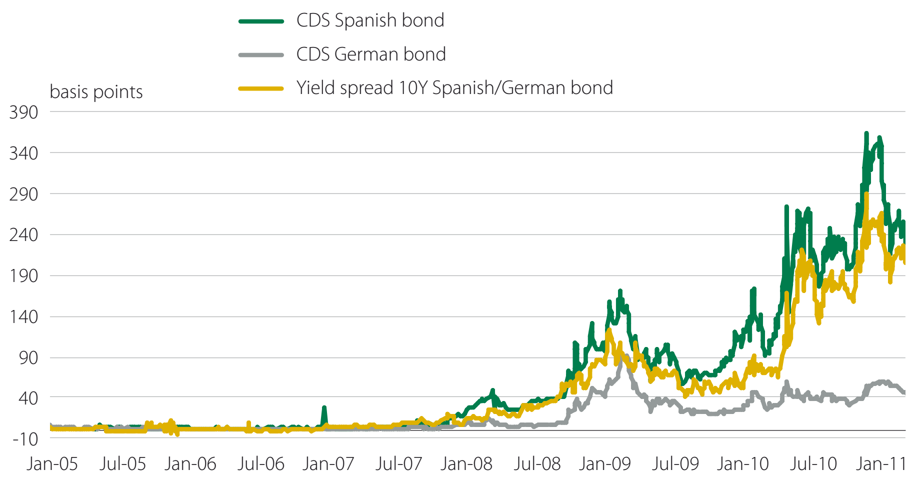
...and in long. Sovereign risk premiums ease in the opening months but remain at highs .

Long-term government yields also moved sharply higher in the last quarter of 2010, with increases ranging from 130 to 150 bp, before dropping back in the first quarter, albeit rather more slowly in shorter maturities. Yields on three-, five- and ten-year instruments closed the first quarter of the year at 3.5%, 4.4% and 5.4% respectively, between 3 and 35 bp down on their end-2010 levels. The risk premium of Spanish public debt, measured as the spread vs. the German ten-year benchmark, accordingly retreated from the 291 bp peak reached in late November 2010 and by March 2011 was hovering just below the 210 bp mark (see figure 16). The credit risk premium inferred from Spanish CDS traced a broadly similar course, peaking at 364 bp towards the end of November and then settling back to around 240 bp on a par with

11 March average up to 15/03.

the levels of mid-year 2010. But these more moderate readings cannot detract from the fact that sovereign risk remains unaccustomedly high.

Risk premium of Spanish government debt[1] FIGURE 16



Source: Thomson Datastream.

1 Data to 15 March.

The outstanding stock of Spanish government bonds has swelled from 28% of GDP in 2007 to 50% in 2011.

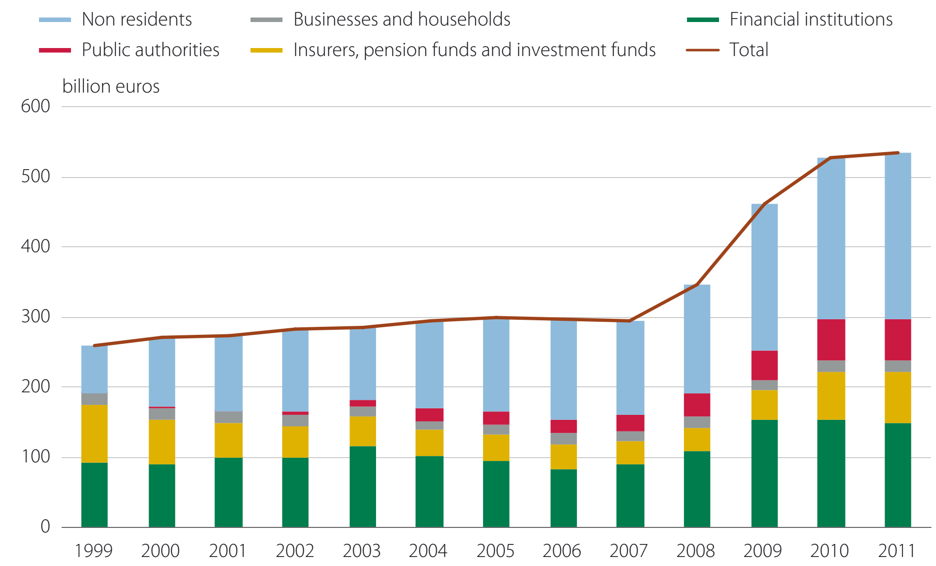
Figure 17 offers a breakdown of Spanish government debt outstandings by investor category from 1999 to January 2011. We can see that the outstanding balance rose from 1999 to 2005 at an annual average rate of 2.4%, then held more or less flat until 2007. From this point on, however, issuance was stepped up sharply to cope with burgeoning government funding requirements. By January 2011, the outstanding stock of Spanish government bonds was up to 535 billion euros (50.4% of GDP) compared to the 294 billion of 2007 (27.9% of GDP). Meantime general government indebtedness amounted to 60% of GDP in 2010 compared to 53.2% the year before (and just 36.1% in 2007).

Debt in non resident hands stays at 45% of the total, accompanied by changes in the mix of resident investors.

Looking at the public debt investor mix, the first thing we note is the onward advance of the non resident sector, whose share of the central government debt has risen from 26% in 1999 to 45% in January 2011. Since 2009, however, we can see that its percentage weight has tended to stabilise, coinciding with a shift in the mix of resident investors, with insurance undertakings, pension funds and investment funds all gaining ground at the expense of resident financial entities. In fact, since November 2010 the public debt holdings of resident financial entities have begun declining in absolute terms.

Spanish public debt holdings by sector[1]

FIGURE 17



Source: Ministry of Economy and Finance (Tesoro Público).

1 Held-to-maturity portfolio. Data for 2011 correspond to the month of January.

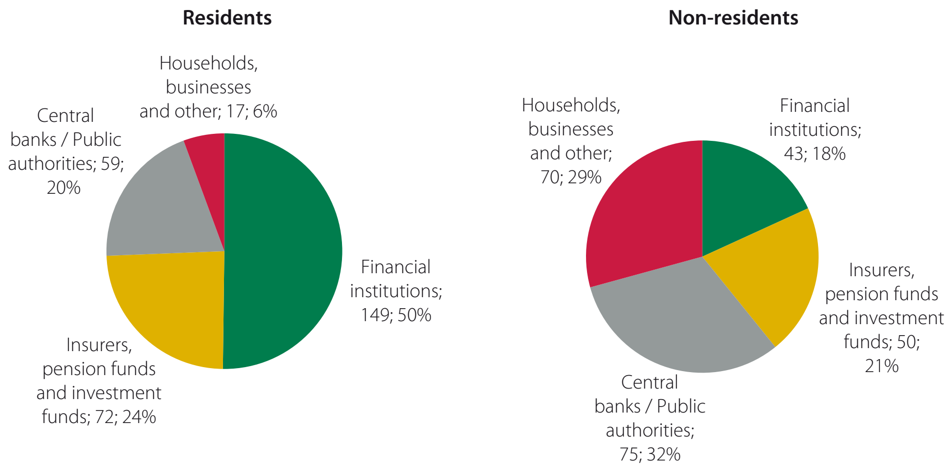
A breakdown of non resident public debt holdings reveals that the ownership share of businesses and households stands higher than among resident investors, while financial institutions take a relatively smaller slice (see figure 18).

Households and companies account for a large share of non resident holdings.

Ownership of Spanish public debt. Residents vs. non residents[1]

FIGURE 18

(billion euros; percent)



Source: Ministry of Economy and Finance (Tesoro Público).

1 Held-to-maturity portfolio. Data for January 2011.

Long-term corporate bond yields raced upwards in the last quarter of 2010 before falling moderately, in line with government yields, in the first three months of 2011. Specifically, three-, five- and ten-year corporate bonds closed last year at 4.3%, 5.4% and 6.4% respectively after gains ranging from 80 to 130 bp, then eased by between 30 and 50 bp in the opening quarter of 2011 (see table 11).

Long corporate bond yields trace a similar course to their sovereign counterparts.

Medium and long corporate bond yields[1]

TABLE 11

%	Dec-07	Dec-08	Dec-09	Dec-10	Jun-10	Sep-10	Dec-10	Mar-11
3 year	5.32	5.45	3.14	4.31	4.13	3.53	4.31	3.87
5 year	5.36	5.99	4.30	5.44	4.59	4.15	5.44	4.92
10 year	5.40	6.08	4.88	6.42	5.16	5.42	6.42	6.10

Source: Reuters and CNMV.

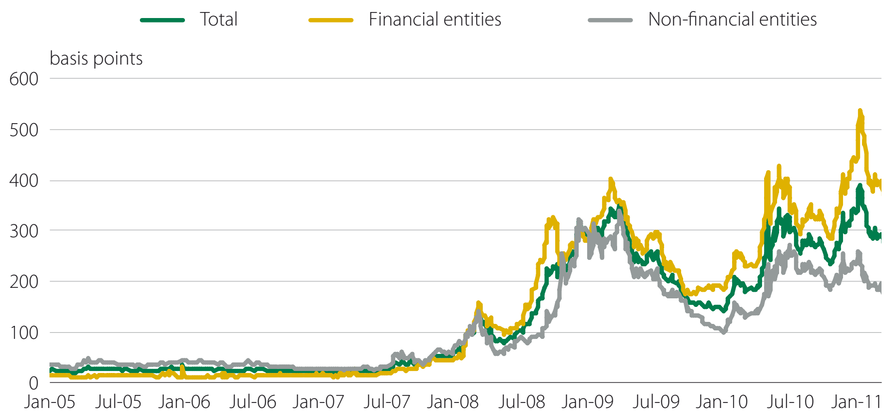
1 Average daily data. March data to 15/03.

The risk premiums of Spanish corporate issuers have likewise moved in line with those of sovereign debt.

In the last two quarters, the risk premiums of Spanish corporate issuers have tended to mirror the progress of sovereign spreads. Looking closer, however, we see a gap opening up between financial and non financial entities, with significantly larger increases in the former case (see figure 19). Indeed the CDS spreads of Spanish financial issuers leapt from around 330 bp at the end of the third quarter of 2010 to peaks nearing 550 bp at the start of 2011, while those of non financial entities traced a more moderate rise from 220 bp to almost 260 bp. Spreads have since come down to 390 bp and 190 bp respectively, i.e., leaving financial entity risk premiums at historic highs, in the same boat as sovereign spreads, while those of non financial entities have eased to below the levels of two years back.

Aggregate risk premium[1] based on the 5-year CDS of Spanish issuers

FIGURE 19



Source: Thomson Datastream and CNMV.

1 Simple average. Data to 15 March.

Exhibit 4: "Good practice criteria for liquidity provision to retail bond investors"

A recent development in the Spanish fixed-income market has been the growing volume of issues directed at retail investors. Normally, the prospectuses on preference share issues filed with the CNMV specify the existence of a liquidity contract whereby an intermediary undertakes to act as counterparty for the buy and sell orders of investors wishing to transact in these securities. In the case of subordinated debt securities it is rare to find reference to this kind of liquidity provider. However, in both these cases, the issuing entity will usually undertake to seek a counterparty for clients through its own branch network.

It was to facilitate such liquidity provision, and to enhance the transparency of the market in fixed-income and mezzanine securities, that the AIAF market launched its electronic debt trading system SEND (Sistema Electrónico de Negociación de Deuda) in May 2010. This multilateral trading facility, based on the Spanish stock exchange's electronic platform for fixed-income instruments, supports trading in a series of securities listed on the AIAF. The system has a central order book in which the best bid and ask prices are collated, giving investors an objective handle on the price a security is likely to fetch.

On 16 June 2010, the CNMV sent a letter to the issuers of retail bonds and their placing agents, updating the conditions to apply in verifying this kind of issue and identifying instances of good practice in their sale and subsequent trading, the aim being to enhance small investor protection through improvements in market liquidity and transparency.

In this letter, the requirement to present a report by an independent expert in issues without institutional tranches was extended to all fixed-income issues targeting the retail public, regardless of their maturity, seniority or the sector the borrower belongs to. It also stipulated that a liquidity provider should in future be appointed for all retail issues, with the obligation, among others, to quote bid and ask prices. Among its good practice indications for assessing the liquidity of an issue was that the provider entity should operate through at least one multilateral trading facility and with multiple participants, so as to ensure adequate price formation and disclosure.

By the same token, it is considered bad practice for a liquidity provider to quote bid and ask prices that deviate significantly from fair value, as gleaned from the security's usual market spreads, or to operate some mechanism for internalising transactions between the retail clients of the securities issuer and/or distributor, or between clients and the entity offering the investment service, unless the potential conflicts of interest are appropriately managed. This condition will be deemed to be met when the result obtained for clients is equal to or better than could be obtained by going to the liquidity provider or multilateral electronic platform, or when the transaction can be shown to have gone through at close to fair value in the event that there is no liquidity contract or its ceiling has been reached.

The CNMV followed this up on 25 October 2010 with a new document titled "Good practice criteria for liquidity provision to retail bond investors", setting out the regulator's good practice recommendations in this respect. Although these are not binding rules, the CNMV is convinced that their application will be a major step to enhancing the transparency and liquidity of fixed-income trading, and ensuring that investor interests are adequately protected. These criteria furthermore can serve as a benchmark for borrowers and financial entities when negotiating liquidity provision contracts for bonds to be quoted on Spanish regulated markets. The document introduces two novelties touching on trading practices and disclosure requirements.

It will be good practice for liquidity providers to discharge this function in any multilateral electronic trading facility that meets the conditions of non-discriminatory access, ongoing display of bid and ask prices, and adequate public disclosure regarding the liquidity entity and the prices and volumes of executed trades.

The document urges liquidity entities to enter buy and sell orders during a preset interval, with a minimum volume and a maximum spread (though note that this last recommendation will not prevent entities varying the spread in extraordinary market circumstances). It also enumerates cases where liquidity providers may be released from their commitments (for instance, when they have reached their contractual ceiling vis à vis securities acquired in own-account transactions, in the event of substantial changes in the legal or economic status of the securities or their issuer, when the issuer's solvency is seriously impaired or in cases of force majeure). In these circumstances, a series of disclosure requirements come into play so the market is immediately advised of the situation, and of subsequent return, as the case may be, to normal operation of the liquidity function.

The communication also comes with a standard liquidity contract drawn up by the CNMV to guide issuers in the application of the above criteria. Its text binds the liquidity provider to a maximum bid/ask spread equivalent to 10% in terms of yield, up to a limit of 50 basis points, and not exceeding 3% in terms of price. It also establishes a standard minimum of 25,000 euros for buy and sell orders, though this can vary depending on the bond's outstanding amount and availability for sale at each point in time.

Funding constraints cause a 42% slump in fixed-income issuance.

Spanish issuers reduced their borrowings in 2010 in response to access constraints in wholesale financing markets. The gross volume of fixed-income issues registered with the CNMV was accordingly 42% lower than in 2009 at 226 billion euros (see table 12). Financial entities, which account for over 98% of total issuance, lowered their issue volumes by 41% to 223 billion euros, while non financial companies lowered theirs by around 70% to 3.50 billion. The issuance slump extended to all debt instruments with the exception of territorial bonds, up from 500 million euros in 2009 to almost six billion euros in 2010, and mortgage bonds, which managed to keep up their 2009 levels (at around 35 billion euros). The biggest slides were reserved for commercial paper, whose issuance was down by 49% to 97 billion euros, and non convertible bonds, down by 61% to 24.3 billion euros. Finally, asset-backed securities closed the year with an issue volume of just over 63 billion, 22% lower than in 2009.

Mortgage bonds were again among the most popular vehicles in the first quarter of 2011.

Since the start of 2011[12] total debt issuance has reached 54 billion euros, a full 36% more than in the same period last year. By instrument, certain trends have been carried over from last year, among them the dynamism of mortgage bond issuance and the fading popularity of bonds, though we can also point to a certain advance in securitisation issues.

Foreign debt financing declines for the first time in several years.

Foreign debt financing shrank by 15% in 2010 to 128 billion euros in a break with the upward trend of recent years.[13] Note that this fall traced exclusively to shorter-dated instruments (-25%), while long-term issuance climbed by 23% to 51 billion, with bonds and debentures featuring strongly.

12 11 To March 15.

13 Increases of 8% in 2008 and 33% in 2009.

Gross fixed-income issues

TABLE 12

filed[1] with the CNMV	2007	2008	2009	2010	2010 3Q10	2010 4Q10	2011 1Q11[2]
NUMBER OF ISSUES	**335**	**337**	**512**	**349**	**60**	**98**	ƒ
Mortgage bonds	32	47	75	88	24	21	20
Territorial bonds	8	8	1	9	1	2	4
Non convertible bonds and debentures	79	76	244	154	19	38	14
Convertible/exchangeable bonds and debentures	0	1	6	3	0	3	2
Asset-backed securities	101	108	76	36	7	15	6
Commercial paper facilities	107	88	73	59	9	19	15
Securitised	3	2	2	2	0	1	0
Other commercial paper	104	86	71	57	9	18	15
Other fixed-income issues	3	0	0	0	0	0	0
Preference shares	5	9	37	0	0	0	2
FACE VALUE (million euros)	**648,757**	**476,276**	**387,476**	**226,449**	**61,635**	**55,737**	**54,321**
Mortgage bonds	24,696	14,300	35,574	34,378	10,317	8,519	13,280
Territorial bonds	5,060	1,820	500	5,900	300	500	2,935
Non convertible bonds and debentures	27,416	10,490	62,249	24,356	1,287	7,525	2,039
Convertible/exchangeable bonds and debentures	0	1,429	3,200	968	0	968	277
Asset-backed securities	141,627	135,253	81,651	63,261	28,190	16,497	15,335
Domestic tranche	94,049	132,730	77,289	62,743	28,190	16,473	13,662
International tranche	47,578	2,522	4,362	518	0	24	1,673
Commercial paper[3]	442,433	311,738	191,342	97,586	21,541	21,728	20,255
Securitised	465	2,843	4,758	5,057	1,723	1,409	546
Other commercial paper	441,969	308,895	186,583	92,529	19,818	20,319	19,709
Other fixed-income issues	7,300	0	0	0	0	0	0
Preference shares	225	1,246	12,960	0	0	0	200
Pro memoria:							
Subordinated issues	47,158	12,950	20,989	9,154	1,839	2,048	2,155
Covered issues	86,161	9,170	4,794	299	0	0	10

abroad by Spanish issuers	2007	2008	2009	2010	2010 3Q10	2010 4Q10	2011 1Q11[4]
FACE VALUE (million euros)	**103,631**	**112,366**	**149,686**	**127,731**	**38,063**	**28,686**	**8,879**
Long-term	65,629	39,894	47,230	51,107	16,072	10,053	1,769
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	16,072	10,053	1,769
Asset-backed securities	736	464	0	300	0	0	0
Short-term	38,003	72,472	102,456	76,624	21,991	18,633	7,110
Commercial paper	38,003	72,472	102,456	76,624	21,991	18,633	7,110
Securitised	12,119	425	108	248	37	49	0

Source: CNMV and Banco de España.

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

2 Available data to 15 March.

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

4 Data for the month of January.

4 Market agents

4.1 Investment vehicles

Financial UCITS[14]

Investment fund assets shrank by 15.6% in 2010 on the continuing wave of redemptions …

Investment fund assets dropped by over 7% to 144 billion euros from June to December 2010 in line with their first-half performance. The fall was again attributable to abundant net withdrawals - over 13.6 billion euros (see table 13) - far exceeding the portfolio gains of the 3Q10, powered by the rally in equity prices. In full-year terms, investment funds scraped an overall return of 0.3%, while their assets shrank by 15.6% (see table 14).

…with fixed-income funds as the worst affected. Fixed-income guaranteed and international equity funds buck the trend with net subscriptions.

Fixed-income funds, as table 13 shows, suffered the largest outflows in the period, due to stiff competition from the banks and their high-interest deposits. Among remaining fund categories, salient developments were the switch from euro equity to international equity funds and a strong movement into fixed-income guaranteed funds. The result was a substantial shift in the distribution of assets across fund industry categories. Specifically, the share of fixed-income funds fell by over ten points to just under 40%, while fixed-income guaranteed funds moved up six points to 18% of the total.

Investment fund subscriptions and redemptions (million euros)[1] TABLE 13

	Subscriptions				Redemptions			
Category	**1Q10**	**2Q10**	**3Q10**	**4Q10**	**1Q10**	**2Q10**	**3Q10**	**4Q10**
Fixed income[2]	15,240.8	13,605.3	6,206.7	6,603.3	19,940.5	22,951.2	12,006.3	13,908.1
Balanced fxd income[3]	1,243.5	1,082.2	571.7	641.4	1,106.0	1,653.8	812.4	1,383.5
Balanced equity[4]	292.1	556.5	118.5	254.6	225.7	601.2	168.0	316.9
Euro equity [5]	582.5	464.0	291.1	335.4	709.6	673.9	452.4	534.0
Intern. equity[6]	1,259.1	1,190.3	778.5	1,227.3	704.9	991.1	625.5	981.8
Fxd-income guaranteed	2,359.6	3,244.1	3,403.9	2,505.8	2,135.7	1,529.0	1,414.2	1,718.5
Equity guaranteed[7]	1,607.4	1,539.4	726.8	1,246.5	1,818.0	1,852.4	1,399.8	2,550.0
Global funds	545.0	440.6	265.4	1,767.1	269.3	461.1	382.9	1,581.1
Passively managed[8]	242.6	271.1	73.7	96.4	396.2	682.1	141.6	254.2
Absolute return[8]	1,853.3	1,778.8	959.1	1,333.6	1,018.9	1,645.3	1,039.3	1,349.5
Hedge funds	107.9	45.9	20.7	n.a	52.6	81.9	72.2	n.a
Funds of hedge funds	21.4	2.2	13.9	n.a	48.0	36.2	23.7	n.a
TOTAL	**25,355.2**	**24,220.4**	**13,430.0**	**16,011.4**	**28,425.4**	**33,159.2**	**18,538.3**	**24,577.5**

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.
n.a.: Not available.

14 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.

Main investment fund variables

TABLE 14

				2010			2011
Number	**2008**	**2009**	**2010**	**2Q**	**3Q**	**4Q**	**1Q***
Total investment funds	**2,912**	**2,536**	**2,408**	**2,436**	**2,421**	**2,408**	**2,405**
Fixed income[1]	629	582	537	547	540	537	539
Balanced fixed income[2]	195	169	160	168	162	160	160
Balanced equity[3]	202	165	138	143	140	138	138
Euro equity[4]	237	182	172	179	174	172	172
International equity[5]	330	242	232	233	233	232	230
Fixed income guaranteed	260	233	276	251	261	276	280
Equity guaranteed[6]	590	561	499	530	518	499	493
Global funds	469	187	192	181	189	192	192
Passively managed[7]		69	61	64	61	61	61
Absolute return[7]		146		140	143	141	140
Assets (million euros)							
Total investment funds	**175,865.3**	**170,547,7**	**143,918,2**	**155,295.5**	**152,646.5**	**143,918.2**	**143,388.9**
Fixed income[1]	92,813.1	84,657.2	56,614.6	69,654.5	64,102.1	56,614.6	53,941.3
Balanced fixed income[2]	5,803.0	8,695.5	7,319.0	8,264.2	8,109.9	7,319.0	7,118.8
Balanced equity[3]	3,958.8	3,879.6	3,470.5	3,441.5	3,520.2	3,470.5	3,544.3
Euro equity[4]	5,938.9	6,321.6	5,356.8	5,181.2	5,504.4	5,356.8	5,542.9
International equity[5]	4,254.7	5,902.4	8,037.3	6,682.5	7,203.6	8,037.3	8,161.8
Fixed income guaranteed	21,150.3	21,033.4	26,180.2	23,520.3	25,795.6	26,180.2	27,806.4
Equity guaranteed[6]	30,873.7	25,665.8	22,046.5	23,981.7	23,600.0	22,046.5	21,858.1
Global funds	11,072.8	3,872.5	4,440.3	3,991.1	4,093.9	4,440.3	4,887.5
Passively managed[7]		3,216.6	2,104.8	2,350.2	2,323.6	2,104.8	2,203.7
Absolute return[7]		7,303.0	8,348.1	8,228.4	8,393.2	8,348.1	8,324.2
Unitholders							
Total investment funds	**5,923,346**	**5,475,403**	**5,160,888**	**5,422,414**	**5,348,482**	**5,160,888**	**5,158,280**
Fixed income[1]	2,204,652	2,041,487	1,622,664	1,864,776	1,745,366	1,622,664	1,575,523
Balanced fixed income[2]	277,629	290,151	270,341	295,325	280,230	270,341	265,230
Balanced equity[3]	209,782	182,542	171,336	185,118	182,860	171,336	169,221
Euro equity[4]	377,545	299,353	266,395	280,529	280,566	266,395	260,376
International equity[5]	467,691	458,097	501,138	487,813	502,463	501,138	511,086
Fixed income guaranteed	538,799	570,963	790,081	690,600	762,369	790,081	847,655
Equity guaranteed[6]	1,402,948	1,188,304	1,065,426	1,142,072	1,115,180	1,065,426	1,053,235
Global funds	444,300	88,337	105,719	99,163	110,538	105,719	108,756
Passively managed[7]		85,403	90,343	97,949	93,049	90,343	89,026
Absolute return[7]		270,766	277,445	279,069	275,861	277,445	278,172
Return (%)							
Total investment funds	**-4.21**	**5.73**	**0.35**	**-1.83**	**1.64**	**-0.04**	**0.63**
Fixed income[1]	**2.06**	**1.91**	**0.11**	**-0.62**	**0.63**	**-0.35**	**0.18**
Balanced fixed income[2]	-7.14	6.85	-0.54	-2.18	1.82	-0.56	0.68
Balanced equity[3]	-22.21	16.47	-0.98	-6.00	4.67	0.78	2.35
Euro equity[4]	-39.78	32.41	-2.94	-10.66	10.11	1.27	6.47
International equity[5]	-41.71	37.28	14.22	-4.97	5.35	8.01	-0.39
Fixed income guaranteed	3.29	3.81	-0.67	-1.24	0.89	-1.28	0.17
Equity guaranteed[6]	-2.61	3.56	-1.79	-1.91	1.20	-1.45	0.78
Global funds	-8.64	10.90	3.22	-2.82	2.80	1.87	0.54
Passively managed[7]		-	-2.36	-7.28	6.32	0.31	5.01
Absolute return[7]		-	1.53	-1.19	1.17	0.58	-0.03

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 the first quarter of 2011 correspond to the month of January. Provisional data.

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.

Total funds in operation are reduced further by mergers, while unitholder numbers fall once more.

The wave of fund mergers continued its advance, most intensely in the second quarter. A total of 256 operations were reported in the full-year period, with a third of this number corresponding to one UCITS management company. The result was a 5% decrease in the number of funds in operation as far as 2,408 at the 2010 close. Unitholder numbers also declined, from almost 5.5 million in 2009 to 5.2 million in 2010. In both cases (funds and unitholders), the fall was steepest in the fixed-income category, in line with the run-down in managed assets.

Exhibit 5: "Changes in UCITS regulations"

Royal Decree (RD) 749/2010 of 7 June made a series of amendments to Royal Decree 1309/2005 implementing Law 35/2003 on Collective Investment Undertakings. The main novelties introduced are described below:

1) Authorisation of special-purpose UCITS or "side pockets" for the spin-off of assets subject to liquidity or valuation constraints, provided they sum over 5% of the original scheme's net assets. Participants will receive units in the new compartment in proportion to their holdings in the original scheme. These special-purpose UCITS are banned from issuing new units or shares. Instead their function is to liquidate their assets at the earliest opportunity, as the exceptional circumstances giving rise to their segregation progressively remit. The proceeds of such sales will be allocated to unitholders in proportion to their share in the special-purpose scheme. While side pocket investments are being realised in this way, the original UCITS goes on functioning as normal.

2) New measures that pursue greater flexibility in fund operation without reducing the level of investor protection. Main changes to this end are:

   a) The RD regulates the possibility of UCITS management companies entering agreements to refund the fees charged to certain unitholders, as provided for in the scheme prospectus.

   b) The brokerage fees paid by investment funds may henceforth include the provision of financial analysis services under certain conditions.

   c) In the case of investment funds being formally wound up, liquidators are empowered, via liquidations on account, to progressively distribute the proceeds from disposal of the fund's assets, once arrangements have been made to settle all accounts payable.

   d) Disclosure requirements are tightened up in respect of the indirect charges borne by UCITS investing in other UCITS.

   e) Financial UCITS are given greater leeway in diversifying their investments, while schemes whose management is geared to a target return are allowed more flexibility to invest in derivative products.

f) Exchange-Traded Funds (ETFs) are free to operate as open-end investment companies as well as just funds.

g) The regime governing real estate collective investment schemes is made more flexible so they can invest, up to certain limits, in real estate investment companies (SOCIMI in their Spanish initials) and other real estate schemes.

3) The regime for delegating functions of UCITS management companies is amended in order to align their treatment with that given to investment firms under RD 217/2008 on the legal regime of investment firms and other entities providing investment services. The main novelty here is that companies will not longer have to seek prior authorisation from the CNMV to delegate administrative and internal control functions: in its place a simple notification will suffice. However prior authorisation must still be sought for the delegation of asset management. The RD also lifts the requirement to inform the CNMV beforehand of the control procedures in place for externalised activities. Instead, management companies will be obliged to furnish the CNMV on request with all details necessary to monitor the performance of such activities.

4) UCITS management companies engaged in the marketing of shares and units in their own and outside schemes are brought under the rules of conduct set out in Chapter III, Title IV of RD 217/2008 on the legal regime of investment firms, and will accordingly be obliged to carry out suitability and appropriateness tests on the products offered to each client.

The proportion of less-liquid assets in investment fund portfolios closed 2010 at a stable 7.4% of industry assets.

Recent studies on the liquidity conditions of investment funds show that the volume of less-liquid assets held in private fixed-income portfolios receded from 11.42 billion euros in June 2010 to 10.65 billion euros in December, while their share of total investment fund assets oscillated between 7.1% and 7.4% (see table 15). Funds' exposure to less-liquid assets differed widely from one asset category to the next. Specifically, most of the decrease in exposure had its origin in the declining volume of less-liquid asset-backed securities, from 4.71 billion euros in mid-year 2010 to 3.26 billion at the annual close. Conversely, the volume of less-liquid financial fixed-income assets of high credit quality moved up from 650 million to 4.37 billion in the second-half period. The fact that the share of less-liquid assets in fund portfolios has held flat over several quarters at a time of large-scale redemptions, reflects both the improved liquidity conditions prevailing on private fixed-income markets and the liquidity management policies being applied by management companies.

Estimated liquidity of investment fund assets

TABLE 15

	Less-liquid investments					
	Million euros			% total portfolio		
Type of asset	**Jun-10**	**Sep-10**	**Dec-10**	**Jun-10**	**Sep-10**	**Dec-10**
Financial fixed income rated AAA/AA	3,724	4,195	4,374	18.3	22.4	20.4
Financial fixed income rated below AAA/AA	2,740	2,468	2,798	19.6	23.7	17.5
Non financial fixed income	246	225	218	3.5	3.8	3.4
Securitisations	4,711	4,020	3,260	79.9	61.0	66.3
AAA-rated securitisations	2,346	1,867	1,429	79.6	62.8	66.2
Other securitisations	2,366	2,153	1,831	80.2	59.7	66.3
Total	**11,421**	**10,908**	**10,651**	**24.2**	**25.1**	**23.1**
% of investment fund assets	**7.4**	**7.1**	**7.4**			

Source: CNMV.

Exhibit 6: "Review of money market fund regulations in the U.S."

The volume of assets held in U.S. money market funds has been climbing steadily in the past decade, and by end-2009 was around three trillion dollars, equivalent to 20% of American GDP. Money market funds play a key role in the country's short-term funding markets, with particular incidence in commercial paper and repo trading.

The current financial crisis has made plain that certain features of U.S. money market funds can trigger "runs by investors" on these markets, at times when unitholder redemption orders are building up sharply. We can pinpoint two traits that make these instruments especially vulnerable to swift changes in investor expectations and behaviour. Firstly, money market funds are not only exposed to credit and interest-rate risk, but also carry liquidity risk in the shape of a maturity mismatch between assets and liabilities. And secondly, most U.S. money market funds have a stable net asset value (NAV), which is usually equal to one dollar. This heightens the risk of unitholder flights, on fears that the fund may not be able to meet all redemption orders at a preset NAV in adverse market circumstances, when its share price could drop below this level (breaking the buck).

In effect, two kinds of problems have come to light with stable NAV funds. One is that this fund structure encourages a "jump ship" attitude among investors, with each one rushing to be the first to withdraw at the first signs of trouble. The other is that a stable NAV is not a reliable guide to the performance of the fund portfolio, and in some circumstances may engender a false sense of security.

The credit and liquidity risk profile of money market funds was the subject of a review in February 2010, following a series of SEC amendments to the existing legislation (Rule 2a-7 of the Investment Company Act). The changes introduced were of two kinds. Firstly, tougher constraints were imposed regarding the quality of assets funds can hold in their portfolios, along with new measures restricting the collateral acceptable for their repo transactions. And secondly, liquidity requirements have been tightened up to ensure more cash is on hand to cope with large-scale redemption orders. Specifically, funds are now obliged to keep 10% of their portfolio in assets that convert into cash within one day, and 30% in assets that convert into cash within a week. Also, funds will have the option to suspend redemptions if their market value falls below a given threshold, allowing them to move to an orderly process of asset liquidation.

Later on, in October 2010, the SEC published a report (*President's Working Group on Financial Markets, PWG*) with additional reform proposals centring on the controversial issue of whether to retain or scrap the stable NAV requirement. The most simple of the alternatives put forward was directly to do away with stable net asset values and thereby prevent or reduce investor "runs on funds". The problem is that this could prompt an outflow from funds into bank deposits, since investors see a stable NAV as an element of security. The second alternative would be a two-tier system, in which stable NAV funds coexist with others with a floating NAV. Either investors could choose in which kind of fund to invest or stable NAV funds could be reserved exclusively for the retail segment, given that institutional investors pose more risk of capital flight. A third alternative would be to keep stable NAV funds, but force them to turn into special purpose banks subject to bank supervision and regulation. This measure too has been strongly opposed (see Macey, 2011)[1] on the grounds that the activity of a money market fund is in no direct sense comparable to that of a bank.

Money market funds in Europe differ from their U.S. counterparts in tending not to operate with a stable NAV. Some jurisdictions, however, allow short-term instruments to be stated at their amortised cost when this is reasonably aligned with their market price. In Spain, as in many other European countries, all assets held in UCITS portfolios must be stated at their market value, to prevent the investor conflicts of interest generated by amortised cost valuation and their potentially harmful impact on market stability – concerns, precisely, that are coming to dominate the U.S. regulatory debate.

1 Macey (2011), *Reducing Systemic Risk: The role of money market mutual funds as substitutes for federally insured bank deposits,* John M. Olin Center for Studies in Law, Economics, and Public Policy, Research Paper No. 422, January 2011.

Real estate investment schemes

Real estate schemes continue to suffer the effects of the property market downturn and mounting redemption orders.

Real estate schemes continue to operate in a troubled environment, coloured by the prolonged downturn in Spanish real estate and a gathering outflow of investors since 2008. In this situation, some funds have faced problems fulfilling their redemption commitments. Indeed since 2009 the sector has more or less split between funds that remain fully operative and those that have suspended or deferred redemptions.

Fund assets fell by 5.4% in 2010 while unitholder numbers dropped by just under 10%.

Finally, assets under management in real estate funds fell by 5.4% to 6.12 billion euros in the course of 2010, while unitholder numbers dropped by 9.9% to 75,280 (see table 16). The year closed with eight funds on the register, the same number as at end-2009, although one of this group had in fact been liquidated in December[15] and a further three had suspended or deferred redemptions. Aggregate fund returns remained stuck in negative territory (-4.7%), albeit less deeply than one year before (-8.3%).

Three of the real estate funds still going have the backing of their manager's financial group.

The four funds in active operation at the 2010 close accounted for around 28% of real estate fund assets and 41% of unitholders. Also, three of these four enjoyed the backing of their manager's financial groups, which at end-2010 were in possession respectively of 43%, 83% and 84% of their assets.

Funds with redemptions suspended or deferred have experienced mixed fortunes.

The three real estate funds with redemptions suspended or deferred have fared quite differently. One resumed operations in March 2010 and has been granted a two-year liquidity guarantee, part of another has been spun off[16] and the third will in theory renew redemptions starting in April 2011.

Main real estate scheme variables TABLE 16

					2010			
	2007	2008	2009	2010	1Q	2Q	3Q	4Q[1]
FUNDS								
Number	9	9	8	8	8	8	8	8
Unitholders	145,510	97,390	83,583	75,280	81,647	76,772	76,182	75,280
Assets (million euros)	8,608.5	7,406.9	6,465.1	6,115.6	6,363.7	6,279.6	6,201.5	6,115.6
Return (%)	1.3	0.7	-8.3	-4.7	-1.63	-0.99	-1.31	-0.9
COMPANIES								
Number	9	9	8	8	8	8	8	8
Unitholders	843	937	928	943	927	942	934	943
Assets (million euros)	512.9	371.9	308.6	321.9	304.6	327.0	322.7	321.9

Source: CNMV.

1 One of the eight real estate funds on the register at end-2010 was actually liquidated in December.

Hedge funds

Hedge fund categories have coped differently with the crisis. Funds of hedge funds have had a very tough ride.

Hedge funds have performed unevenly throughout the crisis, with funds of hedge funds coming out comparatively worse. These schemes have experienced serious difficulties of asset liquidity and valuation due to restrictions imposed by foreign hedge fund investees, as well as having to cope with a flood of redemption orders. The upshot is that funds of hedge funds have suffered a two-year drain in assets under management which may not be over yet, to judge from the large number in liquidation. Meantime, hedge funds *per se* have seen their figures worsen in the past few quarters after keeping up a reasonable, if not continuous, rate of expansion throughout the crisis.

15 Although it remained on the register during that month.

16 The real estate fund has remained with the management company's financial group, while part of its assets have been transferred to a newly created balanced euro fixed income fund, grouping participants who did not take up the extraordinary exit windows.

Against this backdrop, the number of funds of hedge funds on the register fell from 38 in 2009 to 33 at end-2010.[17] Of this total, thirteen were by that point formally in liquidation or else engaged in an orderly disposal of their assets.[18] Funds of hedge funds finally closed the year with 709 million euros in assets, almost 100 million down on the 2009 figure. Unitholder numbers fell from 5,321 to 4,605 in the same period, while fund returns sagged from 7.8% to 3.4%.

Their main variables continued to worsen over 2010, with numerous schemes forced into liquidation.

After weathering the storm with some success, hedge fund business contracted slightly from the second quarter onwards. True, the number of schemes continued to augment (from 29 to 32), but their year-end assets of 617 million were short of the 652 million of 2009, while the sub-sector's 2010 return of 2.4% compared unfavourably with the previous year's 14.9%.

After negotiating the crisis with some success, hedge funds too suffered a mild contraction in 2010.

Main hedge fund variables

TABLE 17

				2009	2010			
	2007	2008	2009	4Q	1Q	2Q	3Q	4Q [1]
FUNDS OF HEDGE FUNDS								
Number	31	40	38	38	37	34	33	33
Unitholders	3,950	8,151	5,321	5,321	5,311	5,109	4,901	4,605
Assets (million euros)	1,000.6	1,021.3	810.2	810.2	793.9	738.0	726.8	709.2
Return (%)	-0.43	-17.80	7.85	0.83	1.72	-0.61	-0.1	1.59
HEDGE FUNDS								
Number	21	24	29	29	31	31	33	32
Unitholders	1,127	1,589	1,917	1,917	2,137	2,061	1,925	1,873
Assets (million euros)	445.8	539.4	652.0	652.0	722.4	674.1	639.3	617
Return (%)	0.84	-4.82	14.94	1.45	2.38	-3.06	2.97	0.11

Source: CNMV.

1 Available data to November 2010. The 4Q return stated refers to October-November.

Foreign UCITS marketed in Spain

The investment of foreign UCITS marketed in Spain swelled once more to 36.7 billion euros, 46% more than in 2009. Likewise assets under management in these foreign schemes fought back to double the figure for 2008, though this was still far from matching the record levels of mid-2007 (approaching 50 billion euros). Even so, foreign UCITS fared significantly better than their Spanish peers, to the extent that their combined assets stood at 20% of those of Spanish schemes registered with the CNMV compared to just 12% in 2009.

The total investment of foreign UCITS marketed in Spain expanded 41% in 2010.

Among the reasons for this outperformance we can cite an attractive fund offering that competes successfully with the national product, particularly in the equity segment, and, perhaps, the 2010 upswing in perceptions of domestic sovereign risk, which has sent investors casting round for more international exposure and away from nationally-managed to foreign-managed schemes.

These products are mounting a strong challenge to domestic UCITS.

17 November data at the closing date for this report.

18 The scheme's liquidation has not been formally agreed but unitholders have issued a total redemption order.

Outlook

A muddied outlook for the domestic collective investment industry.

The outlook for the domestic collective investment industry remains clouded by uncertainty. On the one hand, preliminary data for the first two months of 2011 point to some tailing-off of unitholder redemptions. And this, together with the gains marked up by equity funds, may have some short-term effect in stemming the outflow of assets. However, stiff competition from alternative products like foreign UCITS, along with the recently observed decline in household savings rates, could put a lid on mid-term recovery prospects. The worst prospects are reserved for real estate investment schemes, which have still not got over the redemption spike of the preceding quarters or the effects of the ongoing adjustment in Spanish real estate.

4.2 Investment firms

Investment firms continue to feel the effects of the crisis, though light is appearing in certain areas.

The crisis continued to take its toll of investment firm business, though rather less intensely than in 2009 or 2008. Also, a performance gap began to open up between entities and business lines. So while the aggregate earnings of broker-dealers and brokers continued to fall, the decline was not only smaller than in 2009 but also different in its origins. Among broker-dealers, the profit slide was mainly in proprietary trading, while investment service business actually picked up in the year. In the case of the brokers, conversely, strong operating cost contention failed to offset the decline extending across all main revenue lines. Sector solvency conditions again held up reasonably well throughout.

Broker-dealer profits slide by 20%, but ordinary revenues show encouraging improvement.

Broker-dealers' aggregate pre-tax profits fell by 20% in the year to 279 million euros (see table 18). This rate of decline, rather less than in 2009, was primarily due to net interest income, down by a hefty 38% to 102 million euros. In contrast, ordinary revenues, that is, those deriving from investment service provision, managed a 2% advance to 798 million euros, breaking with the downward trend of the two previous years. In fact, net fee income on almost all investment services recorded some measure of year-on-year growth, the sole exceptions being issue placement and underwriting, reflecting the slowness of primary markets, and investment advice. Fees from order processing and execution, this segment's largest revenue source, moved up 1.3% to 555 million euros.

Gross income, which includes income from proprietary and customer transactions, closed at 711 million euros, 10% less than in 2009. Net operating income too was down by 19% to 276 million, despite lower net impairment losses and operating cost contention, due to the worse relative result under depreciation and other charges.

Aggregate income statement (2010)

TABLE 18

	Broker-dealers			Brokers			Portfolio managers		
Thousand euros	**Dec-09**	**Dec-10**	**% var.**	**Dec-09**	**Dec-10**	**% var.**	**Dec-09**	**Dec-10**	**% var.**
1. Net interest income	163,272	102,054	-37.5	2,654	1,629	-38.6	341	407	19.5
2. Net fee income	562,082	533,858	-5.0	127,457	109,165	-14.4	10,734	10,097	-5.9
2.1. Fee income	782,214	798,152	2.0	144,351	126,055	-12.7	21,750	20,994	-3.5
2.1.1. Order processing and execution	548,362	555,207	1.3	53,855	38,176	-29.1	–	–	–
2.1.2. Distribution and underwriting	26,326	8,499	-67.7	2,950	2,748	-6.9	–	–	–
2.1.3. Securities custody and administration	16,183	22,367	38.2	509	366	-28.1	–	–	–
2.1.4. Portfolio management	11,768	13,880	18.0	19,584	19,489	-0.5	18,463	18,020	-2.4
2.1.5. Design and advising	57,051	49,433	-13.4	2,750	2,790	1.5	2,698	1,160	-57.0
2.1.6. Search and placement	10	36	258.9	0	304	–	–	–	–
2.1.7. Margin trading	14	9	-31.2	28	27	-4.0	–	–	–
2.1.8. Fund subscriptions and redemptions	63,341	65,487	3.4	23,968	23,946	-0.1	18	34	93.5
2.1.9. Others	59,159	83,233	40.7	40,707	38,209	-6.1	571	1,779	211.8
2.2. Fee expense	220,133	264,294	20.1	16,894	16,890	0.0	11,016	10,897	-1.1
3. Result of financial investments	45,266	48,588	7.3	1,866	456	-75.6	92	51	-44.8
4. Net exchange income	22,582	24,445	8.3	-296	-3	99.1	5	9	54.8
5. Other operating income and expense	-762	1,635	–	-1,042	-1,413	-35.6	-389	13	103.3
GROSS INCOME	**792,440**	**710,580**	**-10.3**	**130,640**	**109,834**	**-15.9**	**10,784**	**10,577**	**-1.9**
6. Operating expenses	412,998	415,433	0.6	119,224	97,582	-18.2	9,144	9,305	1.8
7. Depreciation and other charges	-48,401	6,006	–	2,651	2,817	6.3	208	118	-43.4
8. Impairment losses	88,137	12,888	-85.4	55	-23	–	135	0	–
NET OPERATING INCOME	**339,706**	**276,253**	**-18.7**	**8,709**	**9,457**	**8.6**	**1,296**	**1,154**	**-11.0**
9. Other profit and loss	10,256	2,265	-77.9	1,412	19	-98.7	-15	38	347.6
PROFITS BEFORE TAXES	**349,962**	**278,519**	**-20.4**	**10,121**	**9,476**	**-6.4**	**1,281**	**1,192**	**-6.9**
10. Corporate income tax	98,977	81,685	-17.5	5,747	3,024	-47.4	392	254	-35.4
PROFITS FROM ONGOING ACTIVITIES	**250,984**	**196,834**	**-21.6**	**4,374**	**6,452**	**47.5**	**889**	**939**	**5.6**
11. Profits from discontinued activities	0	0	–	0	0	–	0	0	–
NET PROFIT FOR THE YEAR	**250,984**	**196,834**	**-21.6**	**4,374**	**6,452**	**47.5**	**889**	**939**	**5.6**

Source: CNMV.

The 6% decline in **broker** pre-tax profits, to an aggregate end-2010 total of 9.5 million, marked a substantial improvement on the 54% slide of the previous year. Fee income from investment services provision, companies' single largest revenue item, dropped back 13% to 126 million euros. Indeed fee income fell across all business lines except investment advisory services, with order transmission and execution faring worst of all in volume terms (-29% to 38 million euros).

Broker pre-tax profits fell 6% in 2010, with decline in main revenue lines …

Falling fee income made further inroads into brokers' gross income, which decreased by 16% to 110 million euros. However, by keeping a firm grip on operating expenses (down 18% to 98 million) firms managed a 9% advance at the net operating income line. Indeed the year-on-year decline in their pre-tax profits traced mainly to the absence of extraordinary income (1.4 million euros in 2009, see table 18).

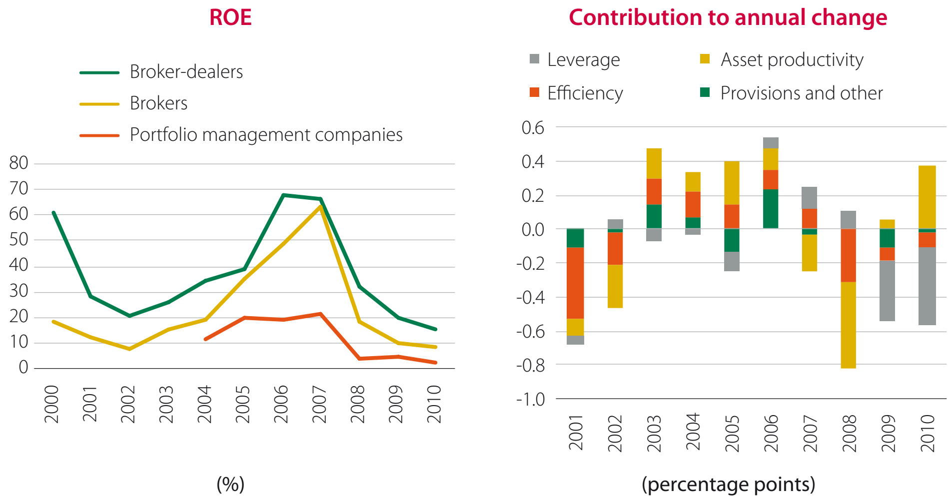
…outstripping the savings achieved in operating expenses.

Portfolio management companies join in the profits slide (-11%).

Finally, **portfolio management companies** were unable to repeat the successes of 2009, when they outperformed their sector peers with 20% growth at the pre-tax profit line. The 11% fall in their 2010 pre-tax profits, to 1.2 million euros, had its origins in a 3.5% decline in fee income and, particularly, a 1.9% increase in operating expenses, contrasting with the -19% of 2009.

Pre-tax ROE of investment firms

FIGURE 20



Source: CNMV.

Return on equity falls less than in the two preceding years.

Earnings erosion made further inroads into the **return on equity**[19] (ROE) of the investment firm sector, though on a significantly smaller scale than in 2009 (see figure 20). ROE fell from 19.6% to 15.3% at broker-dealers, from 9.6% to 8.1% at brokers and from 4.5% to 2.2% at portfolio management companies, in this case unwinding the advance of the previous year. A look at the 2009 and 2010 change factors for ROE in broker-dealer and broker contingents shows that the same forces were operating but with a rather different intensity. As we can see from figure 20 (right-hand panel), the factors detracting from investment firm profitability were primarily leverage, a slightly diminishing efficiency (less so in 2010) and negative extraordinaries. Asset productivity contributed positively in both years, although far more strongly in 2010.[20]

19 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.

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

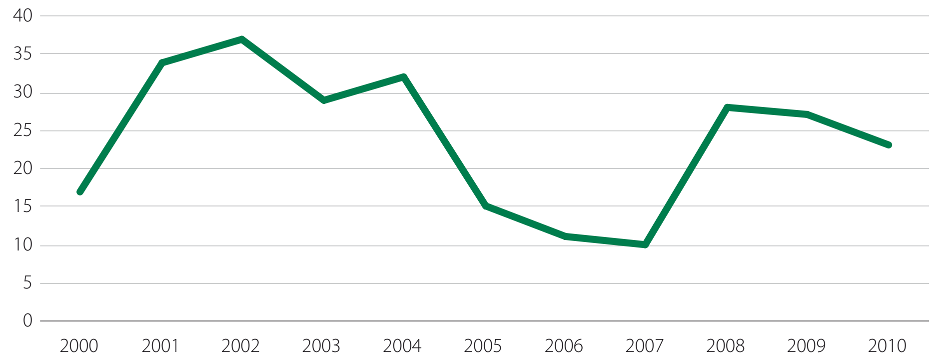
$$ROE = \frac{PBT}{Equity} = \frac{PBT}{\textit{Net operating inc.}}(1) \times \frac{\textit{Net operating inc.}}{\textit{Gross income}}(2) \times \frac{\textit{Gross income}}{Assets}(3) \times \frac{Assets}{Equity}(4)$$

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.

As figure 21 shows, the number of firms reporting (pre-tax) losses was smaller in 2010, prolonging the improvement trend initiated after the 2008 peak. Of the 23 firms in losses at the end of the year (four fewer than in December 2009) from a total of 100 in operation, ten were broker-dealers (the same number as in 2009), twelve were brokers (three fewer than in 2009) and one was a portfolio management company (two in 2009). The aggregate losses of this group were also less severe at 16 million euros compared to 26 million the previous year, and amounted to around 5.5% of the sector's aggregate pre-tax earnings.

The number of loss-making firms reduces, as does the extent of their losses.

Number of investment firms in losses FIGURE 21



Source: CNMV.

Investment firms remained comfortably compliant with capital standards, though note that the stricter capital requirements imposed under 2009 rules has made some inroads into aggregate margin. At the 2010 close, the own funds of broker-dealers stood 3.2 times above the minimum requirement (3.4 times in 2009), while those of brokerage firms were 1.9 times higher (improving on the 1.5 times of the previous year) and those of portfolio management companies 1.2 times higher (1.5 times in 2009). No Spanish firms reported a year-end deficit position, and of the six with an own funds deficit at the 2009 close (five brokers and one broker-dealer), four ceased trading in 2010 and two were restored to compliance after implementing the mandatory viability plan.

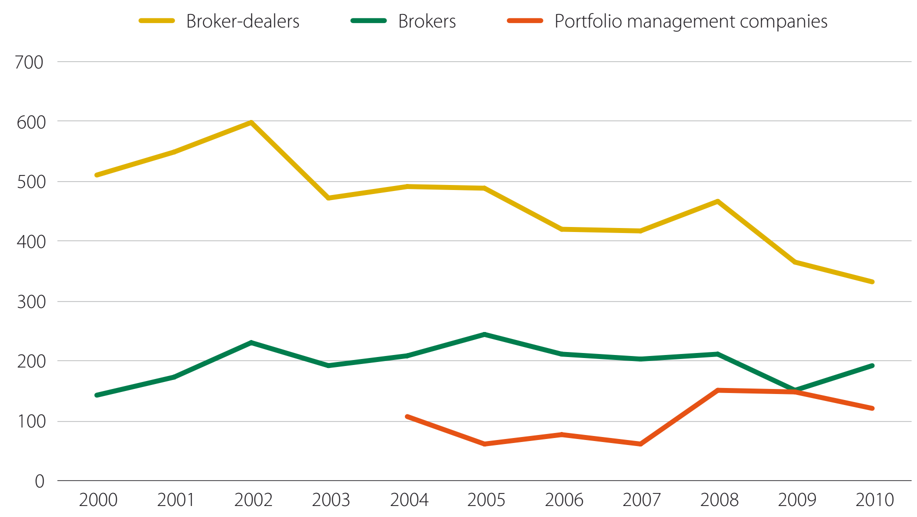
Sector solvency remains robust overall. No one entity reported an own funds deficit at end-2010.

Investment advisory firms had their debut in the Spanish market in 2009 following the transposition of the Directive on Markets in Financial Instruments (MiFID). They are authorised solely to dispense investment advice and guidance, that is, to make bespoke recommendations to clients regarding transactions in financial instruments. At the 2010 close, 52 such enterprises were registered on the CNMV books, none of them belonging to financial groups. Almost all advisory contracts signed has been concluded retail clients (97% of a total of 2,423), though note that this segment accounted for a relatively small share of assets under advice - 15.85 billion euros or just 11% of the 2010 total.

New arrivals investment advisory firms were advising some 16 billion euros in assets by the 2010 close.

Investment firm capital adequacy FIGURE 22

(surplus of qualifying equity to the minimum requirement, %)



Source: CNMV.

The sector outlook is a little more encouraging with improvement coming through in main business lines.

The outlook for investment firms is better than for some time, with a tentative upturn in revenues from main business lines, especially those tied in with financial market turnover and UCITS sales. Further support comes from operating cost contention, which has been particularly strong among the broker group. The (customer) business faring worst is issue placement and underwriting, which continues to betray the effects of primary market slowdown. However, some traditionally lower-earning lines have been gaining in dynamism over the past two years - the case of investment advisory and portfolio management fees. Among broker-dealers, the proprietary trading business that has been weighing on income statements will foreseeably pick up in the coming months. For brokers, however, the outlook is rather less encouraging, in the absence of a clear recovery in their main business lines. Excess capacity and the mergers under way at Spanish savings banks, with ownership stakes in 14 investment firms, could give rise to a degree of restructuring further ahead.

4.3 UCITS management companies

Assets under management in UCITS management companies dropped by 13% in 2010, to 178 billion euros...

Aggregate 2010 figures for UCITS management companies put their assets under management at 178 billion, 13% less than in 2009 in what was the fourth consecutive annual decline. In straight-number terms, the fall in managed assets exceeded 25 billion euros and was the second largest of the past decade (behind only 2008), taking this variable back to the levels of the late 1990s (see table 19).

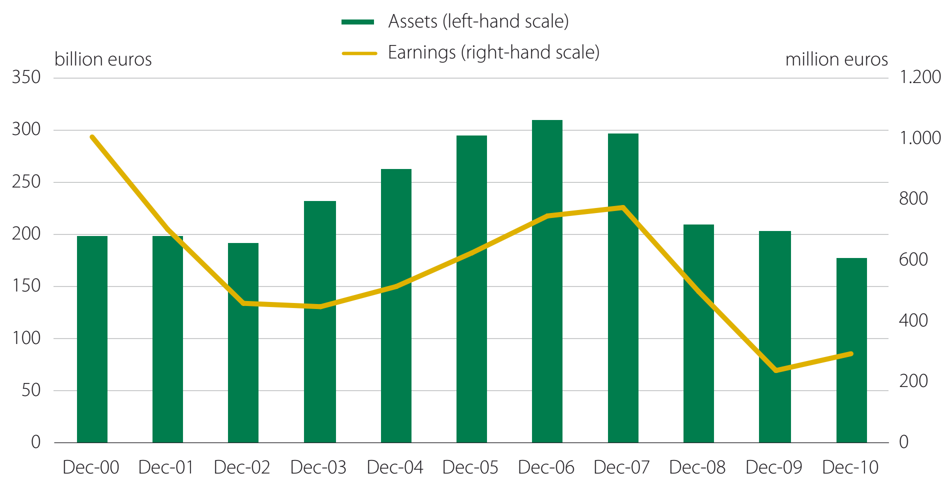
...despite which these entities grew their profits 24.5% in aggregate terms.

Despite the fall in assets, UCITS managers secured a 24.5% advance in pre-tax profits to 294 million euros (see figure 23), after the negative outcome of the two previous years. Earnings improvement drew on a small annual increase in net fee income[21] (0.9%), operating costs savings (-1.7%) and the practical disappearance of impair-

21 Fees paid fell faster than fees charged (-5.6% vs. -3.4%), translating as a net increase of 0.9%.

ment losses, after a 2009 figure upwards of 24 million euros. Aggregate return on equity climbed from 16% to just under 20% on the strength of the year's higher earnings. And, finally, although the number of loss-making companies rose from 31 to 34, their combined losses dropped to half (from 41.4 million to 20.2 million euros).

UCITS management companies: assets under management and pre-tax profits FIGURE 23



Source: CNMV.

It has been evident for some time that UCITS managers are working hard to rationalise their investment fund offerings through product mergers and operating cost contention. That said, we would not rule out a process of sector restructuring further ahead, as advised by the excess capacity in the system and in view of the gathering consolidation wave among Spanish banks and savings banks, which will certainly lead to changes of control[22] and, possibly, more than one casualty.

Managers have been working hard to cut costs and rationalise their fund offering, but sector restructuring still looks a likely option.

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

Million euros

	Assets under management	CIS management fee income	Average CIS management fee (%)	Fee ratio (%)[1]
2001	198,115	2,465	1.24	65.8
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

Source: CNMV.

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

22 Of the 15 changes of control in the UCITS management company sector in 2010, eight were a by-product of savings bank mergers.

Exhibit 7: "Enquiries regarding CNMV Circular 6/2009 on internal controls in UCITS management companies: some reflections"

In December 2010, the CNMV posted a document on its website setting out the regulator's response to the main queries launched by the sector regarding its Circular 6/2009 on the internal controls of UCITS management companies and investment companies,[1] in force as of 22 December 2009. The purpose of its publication was to guide obligated entities in interpreting the Circular's content. As such, the explanations it gives have no legal force, but are intended to help them understand and apply the rules with respect to their own organisational structures and internal control procedures.

The most frequent enquiries turned on the delegation of legal compliance, risk management and internal audit functions which, the Circular states, should be subject to certain restrictions or precautions. The document makes plain that in no case may such functions be delegated to an entity with which some conflict of interest may exist, and that their execution must at all times be governed by the principles of autonomy, separation and independence. With this overriding consideration in mind, and allowing for the constraints imposed by the text *per se*, the following clarifications are offered.

Regarding the possibility that audit and legal compliance functions can be entrusted to the same entity, if the manager's internal audit is taken on by the entity that handles the internal auditing of its group, and that entity or another within its group is simultaneously charged with the legal compliance function, no conflict of interest need be surmised, provided that: (i) the internal audit function is carried out by a separate department, (ii) its position allows it to oversee other internal control functions with sufficient autonomy and authority, and (iii) its remuneration system poses no conflicts of interest with the areas under review.

On the contrary, if the internal audit function is delegated to a service provider outside the manager's group and this provider or some other with which it has common interests attempts to simultaneously take on other internal control functions (legal compliance and/or risk management), this would clearly engender a conflict of interest and a breach of the principle of independence.

It is also specified that the entity conducting the internal audit function may not simultaneously be charged with responsibility for risk management. Indeed the Circular explicitly states that these two functions may not be handled by the same provider.

Further, if the management company and custodian belong to the same group, the audit function may be taken on by the custodian's internal audit unit, assuming this same unit is also responsible for internal auditing on a group-wide basis. In any event, the function should be performed by a department at arm's length from the rest, whose position within the entity assures it sufficient autonomy and authority to oversee other internal control functions.

The document also advises that the global nature of the review, extending to all the entity's systems and procedures, requires that the internal audit should be conducted in a unified, integral manner and should conclude in a single, comprehensive report signed by one entity. It follows that the internal audit function cannot be delegated to two auditors and nor can there be two reports.

When it is administrative functions that are being delegated, responsibility for having the policies and procedures in place that the Circular specifies for administrative and accounting matters, asset valuation and the calculation of net asset value will lie with the contracted entity. In this respect, the delegating management company should verify before any agreement is signed that the contracted entity effectively operates such policies and procedures, and thereafter check that they are being applied as appropriate to the delegated tasks. Such checks should be run on the progress of all delegated activities.

Finally, the document addresses the sector's concerns about how to distinguish between the delegation of functions and the simple provision of services, in order to demarcate the cases where the CNMV must be informed that a function has been delegated (instances of mere service provision need not be notified to the regulator). What separates these two situations is where decision-making power is vested. Hence when a function is delegated, the contracted entity is not only responsible for its execution but also for taking decisions on how such execution should proceed. Conversely, when a third-party service is being provided, the contracting management company retains the final power of decision.

1 www.cnmv.es/Portal/AlDia/Comunicaciones.aspx

4.4 Other intermediaries: venture capital

The number of venture capital entities continues to expand.

The register of venture capital entities (VCEs) recorded 22 new entrants and 17 retirals in 2010. A total of 75 venture capital funds were in operation at the end of the year, one more than in 2009, venture capital companies summed 150, three fewer than in 2009, and VCE managers increase their number by seven to a year-end total of 108 (see table 21). New entrants tended to be specialised in early-stage small and medium-size enterprises, whose sphere of operations is basically national. Among the year's developments was the first appearance of venture capital funds for entrepreneurs, focusing on small technology-based firms, and the return of the leveraged buyout specialists absent from the scene since first-half 2008.

Movements in the VCE register in 2010 TABLE 21

	Situation at 31/12/2009	Entries	Retirals	Situation at 31/12/2010
Entities	**328**	**22**	**17**	**333**
Venture capital funds	74	4	3	75
Venture capital companies	153	8	11	150
Venture capital management companies	101	10	3	108

Source: CNMV.

Investment by venture capital companies climbs to 3.43 billion euros in 2010, led by large-scale leveraged transactions.

According to data furnished by the Asociación Española de Entidades de Capital Riesgo (ASCRI), venture capital companies increased their investment in Spain by 106% to 3.43 billion euros, contrasting with the lean years of 2008 and 2009.[23] Behind this figure was a jump (from one to six) in large leveraged transactions (over 100 million euros), which together accounted for 57% of the sector's annual investment. So though overall transaction numbers fell from 923 to 823, their average size was greater. New funds raised came to 3.07 billion, 161% more than in 2009, with 76% corresponding to pan-European operators. Finally, divestments in the year summed 1.39 billion euros, an increase of 61% with respect to 2009. That said, a number of scheduled disposals had to be called off because the fund could not find the buyers for a public offering.

A good overall outlook for the sector, though difficulties persist with transaction financing and divestment processes.

The upswing in venture capital activity, nationally and across Europe, configures a generally positive outlook for the industry. Reasons for optimism include the presence of top international funds and the resumption of large-scale transactions, denoting the existence of attractive investment opportunities in Spain, and a tentative improvement in the funding conditions for private equity. However, capital market divestments are proving a tough proposition, to the extent that some seller funds had to call off the public offerings scheduled for 2010.

23 Investment fell 32% in 2008 and 47% in 2009.