I Securities markets and their agents: situation and outlook

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1 Executive summary

- The international macro and financial landscape has shown signs of stabilisation in recent months. The rate of decline has slowed and in fact some economies were already reporting positive growth rates in the second quarter of 2009, leading to a revise-up in the growth forecasts for 2009 and 2010, especially in Europe, Japan and the emerging Asian economies. Monetary and fiscal policies have stayed notably expansive. Meantime, work has progressed on reforming the financial system on both sides of the Atlantic, with the accent on tighter regulation and a more closely coordinated supervisory effort.
- Against this backdrop, international financial markets have returned to a more even keel than in 2008. Equity prices have rallied strongly accompanied by a decrease in volatility, while fixed-income markets have witnessed a steady run-down in credit risk premiums. In interbank markets, finally, the spread between repo and deposit operations continued to narrow.
- In Spain, Quarterly National Accounts data for the second quarter of 2009 confirm that the fall in GDP was rather less pronounced, thanks basically to a stronger contribution from the net exports side. Domestic demand components, meantime, continued in retreat with some (pertaining to non public investment) betraying serious weakness. Labour market readings (as regards both employed and jobless numbers) declined once more, though at a lower rate, while inflationary pressures stayed tame. The latest European Commission forecasts indicate that Spain's GDP could decline by 3.7% in 2009 and 1% in 2010 (though others augur steeper falls).
- Deposit-taking entities again had to negotiate a tough business landscape, with higher unemployment provoking new rises in non performing loan ratios. However their financing conditions were significantly easier than in previous quarters, due to falling risk premiums, financial system support packages and the menu of borrowing options offered by the Eurosystem. Credit institution earnings have been driven lower year to date by the decline in gains on financial operations and, especially, the impact of loan impairment losses. Capital ratios remain comfortably above the regulatory minimum, though it is clear that some institutions have suffered more than others from the general macro and financial downturn. The Fondo de Reestructuración y Reordenación Bancaria (FROB) has been created precisely to help the financial sector over these risks.
- The growth stall also eroded the profits of non financial listed companies (down 11% in annual terms over the first half of 2009) albeit with major differences from one sector to another. Overall, company leverage rose in this period (to 1.7 times equity from 1.6 in 2008), while coverage ratios showed some improvement. Households had less money to invest despite the increase

in their savings rates and, when they did, maintained a conservative bias in their choice of financial assets. That said, some change is apparent in the decreased flow of assets out of higher-risk instruments.

- Leading institutions augur a modest recovery starting in the second half of 2009, though the prospect of the suspension or reversal of expansionary measures introduces a large dose of forecasting uncertainty. Indeed the downside risks are numerous, starting with what some fear could be a prolonged employment slump. Predictions for Spain suggest recovery will be slower than in other geographical zones, with the lag ascribed mainly to the graver deterioration of its labour market and/or public finances.

- Since the month of March, Spanish stock markets have been enjoying a prolonged price rally, a downturn in volatility and improved liquidity, especially among financial and construction-related companies. The Ibex 35 has recouped 32% of its value as of the lows reached in the years opening months, though it still stands 22% short of its pre-crisis level. With the exception of two shares, all Ibex 35 members are trading lower than they were at the onset of the credit crunch, though some have come back strongly in the last few months. The price-earnings ratio of Spanish shares has been boosted by this price recovery: moreover, rather more intensely than the multiples of other markets. Turnover has built back up after the dip of the year's outset but is still negative in year-on-year terms. Here too, recovery is hedged by uncertainties and contingent on solid improvement in real output indicators and corporate earnings.

- Short-term interest rates continued to fall, in line with the expansionary bent of ECB monetary policy, though the margin for further cuts is inevitably wearing thin. Long government bond yields moved lower in the second and third quarters of 2009, as perceptions of the credit risk of the Spanish economy subsided to some extent. The CDS spreads of Spanish financial and non financial issuers tightened, in line with the prevailing world trend. Bond issuance, finally, held up relatively well in year-on-year terms though the mix has varied substantially, with commercial paper and asset-backed securities losing relative weight in favour of non convertible and mortgage bonds, under the spur of government support measures and new financing options offered by the Eurosystem.

- Assets held in collective investment schemes dropped 5% in the first half relative to December 2008, as far as a mid-year volume of 167 billion euros. This decline was less than in earlier quarters thanks to the more moderate scale of unitholder redemptions and a small increase in portfolio value. The CNMV uses three sets of measures to track funds' portfolio liquidity: an estimation of the overall volume of less liquid instruments, whose relative size (8.7% of total CIS assets) has undergone no major changes in the last six months; controls on the quality and appropriateness of the information managers offer their unitholders; and checks that the underlying structures of guaranteed funds match adequately with market conditions.

- Investor withdrawals have continued to complicate life for real estate funds. Some have had to modify their redemption rules, while others have turned for assistance to the financial parents of their management companies. The outlook for this subset of collective investment schemes remains contingent on the length and intensity of the domestic real estate market correction. In the case of hedge funds, the advance the sector had enjoyed since its end-2006 launch turned to a retreat in the third quarter of 2008 albeit with notable differences between funds of hedge funds and hedge funds per se. The first group was harder hit by losses at foreign CIS investees as well as suffering investor withdrawals on a higher scale (in fact more than half these schemes are in the process of winding up). Meantime, the more moderate decline in hedge fund assets and unitholder numbers may be nearing its end, to judge from the positive net subscriptions of the second quarter.

- Investment firm income statements took a further battering in the first half of 2009, despite operating in a less fraught environment than in prior quarters. Indeed some key fee income captions registered a lower rate of decrease. The aggregate pre-tax profits of broker-dealers to June 2009 (176 million euros) were 42% down versus the year-ago period due to lower fee income and results from financial operations. And the broker sub-sector fared even worse, with first-half income dropping to a point where it barely covered operating expenses. The contraction in demand for investment services has eaten heavily into earnings, with the result that a growing number of firms have reported losses since December 2007. Despite this adverse environment, companies' solvency levels have held up well. But there is still cause to see this sector as overdimensioned, and the opportune strategic decisions should not be too long in coming.
- A similar picture emerges with collective investment scheme management companies. The decline in assets under management has left a large dent in sector income statements, with a fall of almost 50% in aggregate (annualised) profits and around a third of managers reporting losses. As with investment firms, gathering evidence of excess capacity could prompt strategic decisions by parent companies that usher in a period of sector restructuring.
- The first-half period has witnessed a series of international and European regulatory initiatives directed at the practice of short selling. In Europe, supervisors' end-2008 measures to restrict short sales activity was followed by a May 2009 agreement by the Committee of European Securities Regulators to adopt a common disclosure regime for short positions. The regulatory outlook for this kind of trading is hedged by uncertainty, for while a consensus exists about its benefits, and supervisors are generally considered to be justified in imposing restrictions it if poses a threat to financial stability or market integrity, there is no unanimity about the tolerance to be exercised towards naked short selling.

2 Macro-financial setting

2.1 International economic and financial developments

The macroeconomic and financial landscape is more settled than a few months back. The slowdown is levelling off and some economies even achieved positive growth rate in the second quarter of 2009,...

Since the latest instalment of "Securities markets and their agents: situation and outlook" published in the CNMV Bulletin for the third quarter of 2009, the macroeconomic and financial environment has shown some encouraging signs of stabilisation. At least this is the message given out by certain indicators which point to a slower growth decrease in diverse world regions. A number of international analysts have even ventured an end to worldwide recession in the middle months of 2009. Some larger economies like Germany, France and Japan reported positive quarterly growth in the second quarter, surpassing market expectations, on the back of mild improvements in consumption, exports and government investment.

...leading to a revise-up of growth forecasts for 2009 and 2010, especially in Europe, Japan and the emerging Asian economies.

Even so, leading international organisations are still positing a world GDP contraction of near 1.4% over full-year 2009. Most industrialized economies are tipped to obtain positive quarterly growth rates in the second half and experience gradual recovery from there on in. However the IMF's forecast for 2010 (+2.5%) draws largely on an activity upswing in the United States, Japan and emerging nations, while the euro area economy is expected to stay relatively weak.

Gross domestic product (% annual change) TABLE 1

					IMF(*)		OECD(*)	
	2005	2006	2007	2008	2009F	2010F	2009F	2010F
World	4.4	5.0	5.2	3.4	-1.4 (-0.1)	2.5 (+0.6)	-	-
United States	2.9	2.8	2.0	1.1	-2.6 (+0.2)	0.8 (+0.8)	-2.8 (-1.9)	0.9 (-0.7)
Euro area	1.8	3.0	2.6	0.5	-4.8 (-0.6)	-0.3 (+0.1)	-3.9 (-3.3)	0.0 (-1.2)
Germany	0.9	3.2	2.6	1.0	-6.2 (-0.6)	-0.6 (+0.4)	-4.8 (-4.0)	0.2 (-1.0)
France	1.9	2.4	2.3	0.3	-3.0 (+0.0)	0.4 (+0.0)	-2.1 (-1.7)	0.2 (-1.3)
Italy	0.8	2.1	1.5	-1.0	-5.1 (-0.7)	-0.1 (+0.3)	-5.2 (-4.2)	0.4 (-0.4)
Spain	3.6	4.0	3.6	0.9	-4.0 (-0.8)	-0.8 (-0.1)	-4.2 (-3.3)	-0.9 (-1.7)
United Kingdom	2.1	2.8	3.0	0.7	-4.2 (-0.1)	0.2 (+0.6)	-4.7 (-3.6)	0.0 (-0.9)
Japan	1.9	2.0	2.3	-0.7	-6.0 (0.2)	1.7 (+1.2)	-5.6 (-5.5)	0.7 (+0.1)
Emerging	7.1	7.8	8.3	6.0	1.5 (-0.1)	4.7 (+0.7)		

Source: IMF, OECD and Spanish Statistics Office (INE).
(*) In brackets, percentage change versus the last published forecast. IMF, forecasts published July 2009 (versus April 2009). OECD, forecasts published June or September 2009 (versus December 2008).

However much of this improvement must be laid at the door of government support packages...

Much of the recent improvement in the economic situation owes to the expansionary measures taken by governments, many of which have now used up their remaining fiscal policy leeway. For this reason, there are still major doubts about the strength of the recovery once stimulus packages have run their course.

....in a non inflationary setting that has allowed central banks to keep official rates at historic lows...

Inflationary pressures remain practically non existent. The annual inflation rates of developed economies have dropped below zero in recent months due to oil price base effects, while underlying rates are currently running between 1% and 2%. Forecasts, however, point to a slight resurgence in the months ahead. In this context, monetary policies have maintained their expansionary course. In the last six months, official interest rates in the United States, Japan and the United Kingdom have been hovering near zero, while in the euro area the ECB has effected two 25 bp cuts to leave its main refinancing rate at 1.0%. Over this period, central banks have prioritised non conventional monetary measures, involving basically longer dated loans and outright purchases of certain financial assets, so as to induce financial institutions to restart the credit cycle and ease the financing burden on businesses and households.

....and with public finances deep in deficit for cyclical reasons and as a consequence of expansionary measures.

Fiscal policies too remained expansionary. Public deficits and public debt ratios have deteriorated sharply in some economies, partly for cyclical reasons but also due to the stimulus measures set in train. Governments are now likely to react with budgetary adjustment plans to ensure the mid-term stability of public finances.

Financial system reform continued its course on both sides of the Atlantic and on both regulatory and supervisory fronts.

Financial institutions have to date recognised 1.6 trillion dollars in crisis losses[1], and have meantime raised 1.3 trillion dollars in capital, half of it from the public sector (see exhibit 1). In effect, financial system stimulus and restructuring packages continued to do their work in the first half of 2009. In the United States, the government launched a plan to reform financial system regulation under which the Federal Reserve would be assigned wider supervisory powers, and stricter controls brought to bear on complex financial assets. In Europe, the European Commission charged an expert group with drawing up priorities for the future supervisory and regulatory framework. Among the key recommendations in the resulting text (known as the Larosière Report) was the set-up of a European Systemic Risk Council, charged with deploying an effective risk alert system, and a European System of Financial Supervisors as a mechanism for coordinating and harmonising the supervisory action of Member States (see exhibit 2). In Spain, the main line of attack has comprised government guarantees for financial institution debt financing and recapitalisation plans.

Exhibit 1: Financial institutions' crisis losses and the impact of fair value accounting

In the past year and a half, various institutions have come up with estimates of financial institution losses due to the financial crisis, which they later enlarged on several occasions[1]. Specifically, in April 2009[2], the International Monetary Fund (IMF) published prospective figures for financial sector writedowns between end-2007 and 2010 in respect of assets exposed to credit risk (see table)[3]:

FINANCIAL SECTOR POTENCIAL WRITEDOWNS (2007-2010)

(billion dollars)	Outstanding	Estimated writedowns financial institutions	Estimated writedowns banks	Loss rate
Securities	16,884	1,967	1,199	11.6%
Loans	40,835	2,087	1,271	5.1%
Total	**57,719**	**4,054**	**2,470**	**7.0%**

Source: IMF.

These losses can be classified according to whether they originate in bad loans, which are generally stated at their amortised cost, or in securities, which are in most cases stated at fair value. As the IMF figures show, although financial institutions hold much more in loans than they do in securities, potential writedowns are very similar for both groups, i.e. the loss rate in securities is far higher than for loans.

1 From the second quarter of 2007 to 14 September 2009. Source: Bloomberg.

This disjuncture, together with the large increase in securities market liquidity premiums, has spurred discussion on the wisdom, from a financial stability perspective, of using the fair value method[4] to account for listed debt instruments. The underlying argument is that a decline in market value at times of crisis need not wholly correspond with the expected credit loss, but in fact takes in other factors, like liquidity premiums, that will have no real translation to capital losses if the securities are held to maturity.

We can further refine our analysis of the above IMF data by calculating how far the fair value method has contributed to system losses. In order to do so, we must find the percentage of total expected bank sector losses corresponding to factors present in the fair value of listed debt securities that do not generate a decrement in the future cashflow of the underlying loans. This calculation uses the following assumptions:

- All listed debt instruments are stated at fair value.
- The loans underlying listed debt instruments have a loss rate equal to that of unlisted loans stated at their amortised cost.
- The loss rates of banks coincide with those of the financial system.

The results found for the worldwide banks sector are summarised in our next table:

World banks (potential writedowns)	Total amount (billion dollars)	% (loss rate)	Fair value effect (billion dolar)	% (fair value effect/ writedowns)
Securities writedowns	1,199	11.6%	671.85	56.0%
Loan losses	1,271	5.1%	0	0
Total	**2,470**	**7.0%**	**671.85**	**27.2%**

Source: IMF and CNMV.

Under the assumptions stated, 56% of total securities writedowns would be a consequence of market factors, like liquidity premiums, which would not materialise as long as the instruments in question were held to maturity. We can say then that around 27.2% of expected bank sector losses are ascribable to a fair value effect incorporating factors that influence the market price of debt securities but need never translate into loan losses.

These figures should be handled with care, as they will logically vary if we consider loan loss estimates to be over conservative or that securities prices are discounting a higher loss rate.

Similar results emerge if we centre exclusively on the euro area banks[5]. In this case calculations factor banks' recognised losses to May 2009, so we can see how far potential writedowns are being realised.

Euro area banks (potential writedowns)	Total amount (billion dolars)	% (loss rate)	Fair value effect	% (fair value effect/ writedowns)	Recognised losses to May/2009	% Recognised/ potential losses
Securities writedowns	218	12.8%	152.55	70.0%	215	98.6%
Loan writedowns	431	3.3%	-	-	150	34.8%
Total potential writedowns	**649**	**4.4%**	**152.55**	**23.5%**	**365**	**56.2%**

Source: ECB, IMF and CNMV

Specifically, applying a calculation process resembling that described above, we find that the portion of expected writedowns for the 2007-2010 period ascribable to the fair value method stands at approximately 23%. In other words, most losses arise from the materialisation of today's credit risk and not the worsening conditions on securities markets. Stripping out securities originated in the United States in the hands of European institutions, whose loss rate is higher, the fair value effect on euro-area banks' expected writedowns fades to 18.8%.

ECB statistics shed useful light on when different types of losses are being recognised in sector balance sheets. Data for the first quarter of 2009 show that unrecognised losses are almost wholly on the loans side. We can say then that recording at fair value enables early recognition of losses, with 25% of the total at most corresponding to factors other than future loan losses – provided that projected loan loss rates are no higher than expected, in which case the fair value effect for non loan loss factors would be less than stated.

1 See exhibit 1 of the CNMV Bulletin for the first quarter of 2009.
2 Global Financial Stability Report, Responding to the Financial Crisis and Measuring Systemic Risk, April 2009.
3 After the closing date for this report, the IMF published new estimates of banks' potential writedowns that retain the same totals but imply a significant reduction in the fair value effect.
4 Instead of the amortised cost method.
5 According to data published by the European Central Bank in its Financial Stability Review of June 2009. The loss rate of loans originated in the United States, used to calculate the fair value effect in US asset sheld by European banks, has been taken from the IMF's *Global Financial Stability Report* of April 2009.

Exhibit 2: The new European architecture for financial supervision

The financial crisis has revealed serious flaws in financial regulation and supervision. To fix them, the international community, at the urging of the G-20 among others, has launched a battery of initiatives aimed primarily at preventing systemic risk or, failing this, ensuring its correct measurement and management. This was the remit given by the European Commission to a group of experts led by Jacques de Larosière, whose proposals were published in February 2009. The Report identified major shortcomings in the regulatory sphere as well as a plethora of at times inconsistent supervisory rules and practices. Most of its conclusions were subsequently adopted by the Commission in a Communication of May 2009.

The Report proposes a profound change in the EU's supervisory structure, starting with the establishment of a European Systemic Risk Council (ESRC) and a European System of Financial Supervision (ESFS).

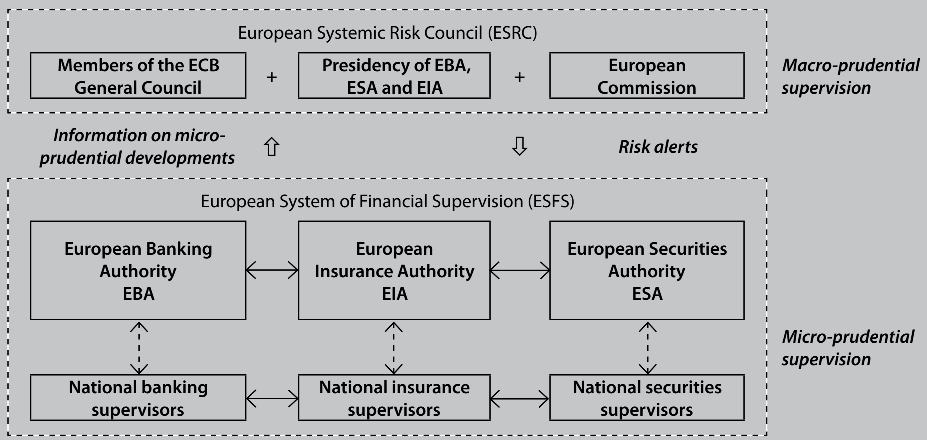
The ESRC will have the task of identifying systemic risks, and issuing warnings and appropriate guidelines for action to the authorities concerned. It will be chaired by the ECB president and made up of the members of the central bank's General Council, the chairmen of sectoral supervisory committees (CESR, CEBS and CEIOPS) and a representative of the European Commission.

The ESFS will take charge of micro-prudential supervision and investor protection, and its design will address the shortcomings detected in the performance of Lamfalussy level 3 committees as well as the inefficiencies of the current legal framework. It will operate on a decentralised basis and will be made up of three new supervisory authorities of Community-wide reach (replacing the current Lamfalussy level 3 committees), existing national supervisors (who will remain in charge of day-to-day supervision) and the colleges of supervisors envisaged in the Capital Requirements Directive for dealing with large cross-border institutions.

The new supervisory authorities will have more bite than current level 3 committees (being legally empowered to take binding decisions), and will work to the objectives of developing a common set of technical standards, improving the supervision of cross-border institutions and ensuring closer cooperation and consistent application of Community rules among national supervisors.

National authorities will, as stated, conserve their primacy in day-to-day supervision, but the Report calls for a decisive advance in the harmonisation of technical standards, powers and supervisory practices. It also calls for an expanded use of colleges of supervisors to oversee cross-border institutions, applying them to all financial groups with a Community-wide reach. The new authorities will also take on direct supervision of credit rating agencies in view of their cross-border nature and organisation.

The Larosière Report proposes a two-stage rollout for these changes. In the first (2009-2010), national supervisors must strengthen the quality of their supervision and embark on a process to align supervisors' competences and powers and establish a common rulebook and sanctions regime for all EU Member States. This last process should be finalised by the start of 2013. In the second stage (2011-2012) the ESFS will be formally constituted, with the level 3 committees being transformed legally into three new authorities: for securities (ESA - European Securities Authority), banking (EBA - European Banking Authority) and insurance (EIA - European Insurance Authority). The European Commission, in a Communication of May this year, announced that it was taking steps to speed up the procedure, and that the new framework for financial supervision should be up and running by 2010. On 23 September, it approved a draft legislative package to allow the creation of the European Systemic Risk Council (ESRC) and the start-up of the European System of Financial Supervision (ESFS) formed by national supervisors and the three new Community-wide authorities (ESA, EBA and EIA).



The course of financial markets has run a lot more smoothly this year to date, and especially since March. Equity markets have experienced a strong price rally on perceptions of a slowly improving macroeconomic outlook and the fact that some shares looked attractively priced after the sharp run-down of the previous months. In effect, after losing between 50% and 60% of their value since the onset of the crisis, main world stock indices staged a strong comeback as of March lows. The Nikkei and Euro Stoxx 50 made up 30% and 40%, respectively, of the ground lost, the Dow Jones around 50% and the Ibex 35 a little under 60%. The price surge was especially dramatic in the financial sector and among cyclical stocks like automobiles or natural resources. Share price recovery was accompanied by a sizeable downturn in the historical volatility[2] of leading indices, which by the closing date for this report[3] was back in the 15%-20% interval. The contraction in turnover (over 45% in annual terms on main world exchanges except some in Asia) casts some doubt on how long the bull trend can last. For it truly to consolidate would in all probability require positive developments on the corporate earnings front (especially among financial institutions) and in other indicators of real activity.

Financial markets have served up a more stable performance in 2009. Equity markets particularly have seen a strong price recovery and the dying-down of volatility...

Performance of main stock indices (%) TABLE 2

								3Q09 (to 15 September)		
	2004	2005	2006	2007	2008	1Q09	2Q09	%/prior qt.	%/Dec	% y/y[1]
World										
MSCI World	12.8	7.6	18.0	7.1	-42.1	-12.5	19.7	16.2	21.7	-9.5
Euro area										
Euro Stoxx 50	6.9	21.3	15.1	6.8	-44.4	-15.4	16.0	18.4	16.2	-9.8
Euronext 100	8.0	23.2	18.8	3.4	-45.2	-12.2	13.3	19.9	19.3	-10.8
Dax 30	7.3	27.1	22.0	22.3	-40.4	-15.1	17.7	17.1	17.0	-7.2
Cac 40	7.4	23.4	17.5	1.3	-42.7	-12.8	11.9	19.5	16.6	-10.0
Mib 30	17.5	13.9	19.0	-8.0	-48.7	-15.6	20.4	17.4	19.3	-14.7
Ibex 35	17.4	18.2	31.8	7.3	-39.4	-15.0	25.2	18.4	26.1	6.4
United Kingdom										
FT 100	7.5	16.7	10.7	3.8	-31.3	-11.5	8.2	18.7	13.7	-3.1
United States										
Dow Jones	3.1	-0.6	16.3	6.4	-33.8	-13.3	11.0	14.6	10.3	-11.3
S&P 500	9.0	3.0	13.6	3.5	-38.5	-11.7	15.2	14.5	16.5	-11.7
Nasdaq-Cpte	8.6	1.4	9.5	9.8	-40.5	-3.1	20.0	14.6	33.3	-3.5
Japan										
Nikkei 225	7.6	40.2	6.9	-11.1	-42.1	-8.5	22.8	2.6	15.3	-16.4
Topix	10.2	43.5	1.9	-12.2	-41.8	-10.0	20.2	0.3	8.5	-20.8

Source: Datastream.

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

In debt markets, the stand-out development of the past months has been sharp yield curve steepening in the United States and Europe, reflecting both the continuing downtrend in short-term rates (in line with official interest rates) and the upward run of long bond yields. This last movement (see figure 1) was initially due to the growing preference for higher risk instruments (and, therefore, a move out of safe-haven assets) and later to the increase in sovereign risk premiums, above all in the economies suffering most deterioration in their deficit and debt. In the last few weeks, however, we have seen some stabilisation in the longest dated instruments. In corporate debt, the more settled climate has translated as a substantial fall in credit risk premiums. As of mid March, the credit spreads of the highest rated North

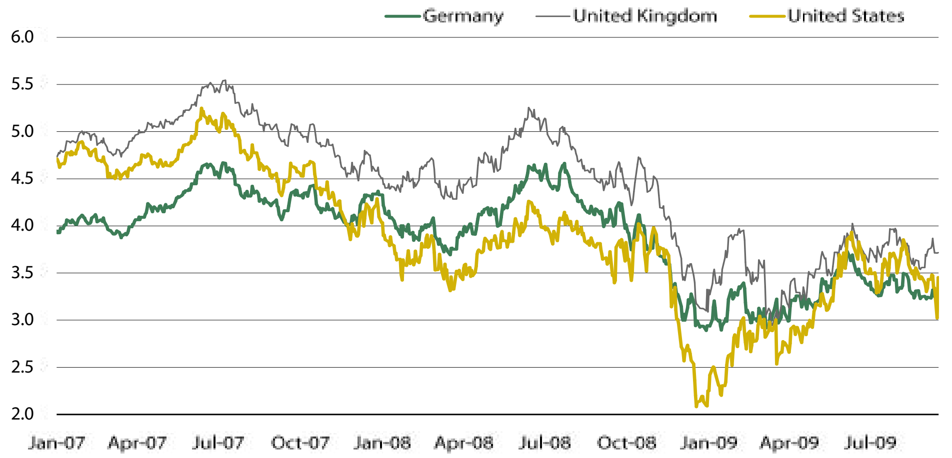
... in debt markets, credit risk premiums have come down substantially as a result of the more settled climate.

2 Defined as the annual standard deviation of daily price changes over the last twenty trading sessions.

3 Data to 15 September.

American companies have dropped from 265 bp to 104 bp (700 bp to 270 bp for lowest rated issuers) while the spreads of European companies have dropped from 200 bp to 85 bp at the top quality end and from 1,100 to 520 further down the ratings table[4].

Ten-year government bond yields (%) FIGURE 1



Source: Thomson Financial Datastream. Data to 15 September.

Signs of normalisation on interbank markets have brought further reductions in the deposit to repo spread, especially in the United States.

Interbank markets have also been showing signs of normalisation, especially in the United States. Interest rates at different maturities as well as the spread between deposit and repo rates have moved steadily lower over the last six months. In North America, this spread has dropped below 10 bp in the three-month term, significantly lower than its values at the crisis outset (between 15 and 20). In Europe, the spread began narrowing in March and was down to 35 bp by the month of September (versus a pre-crisis value of under 10).

Currency markets performed more erratically though some of last year's trends have now reversed.

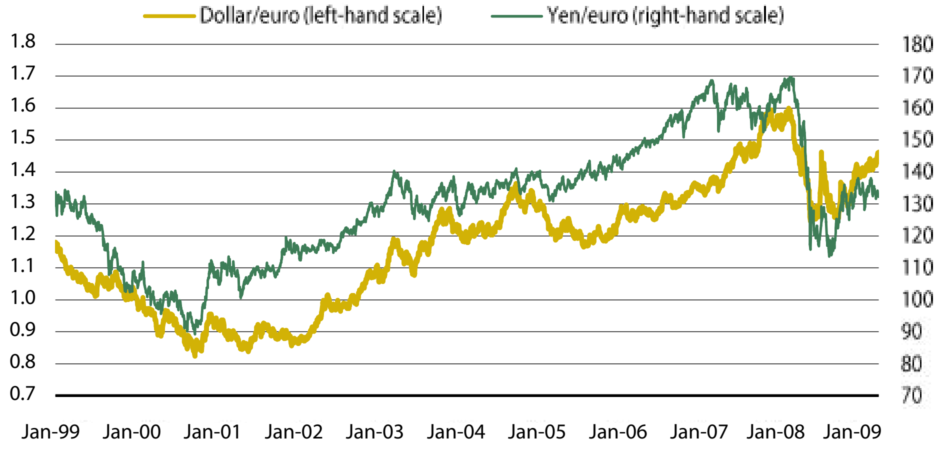
Currency markets kept up a somewhat erratic performance, though some of the main trends noted at the turn of the year have since unwound themselves. After appreciating strongly against the euro in late 2008 and early 2009, the dollar entered a renewed though irregular descent that carried it from under 1.30 dollars/euro in March to over 1.40 dollars/euro. Likewise the yen, which after gaining against the euro, began to fall back from its end January high, depreciating from around 115 yens per euro to 130 in mid September. Part of this last movement has to do with a new wave of carry trade[5] investments encouraged by the low interest rates of the Japanese economy.

4 Reference indices are the CDX and Itraxx in their Investment Grade and Cross Over modalities.

5 When investors borrow in a low-yielding currency to fund the simultaneous acquisition of assets denominated in other, high-yielding currencies.

Euro exchange rates vs. the dollar and yen

FIGURE 2



Source: Thomson Financial Datastream. Data to 15 September.

2.2 National economic and financial developments

In Spain, Quarterly Accounts data for the second quarter of 2009 confirm that the downturn is decelerating,...

National Quarterly Accounts data for the second quarter of 2009 have confirmed that the GDP contraction is less than what it was. Nonetheless, the return to positive growth rates now being enjoyed in other geographical areas may have to wait until the middle of next year. Spain's GDP shrank by 1.1% in the second quarter (the fourth decrease in a row), compared to the -1.6% of the first three months, while the year-on-year decline was 4.2% (3.2% in the first quarter). Domestic demand continued to weaken (detracting 7.3 growth points) against a rather more positive growth contribution from the net exports side (up from 2.9 points in the first quarter to 3.1 in the second). On the supply side, the brunt of the correction fell on the industry and construction branches.

...though this has more to do with the foreign sector. Domestic demand components are still moving in negative territory and some (associated to non government investment) continue to worsen on a quarterly basis.

A closer analysis of demand components shows that household spending reduced in the period (-5.9% year on year) albeit rather less than in previous quarters. Main consumption drivers (disposable income and wealth) weakened anew although confidence indicators showed some improvement. Savings rates continued their ascent, to over 14% of disposable income. Government consumption was yet again the most dynamic domestic demand component (5.1% year on year). The decline in gross fixed capital formation accelerated in the second quarter (from -15.2% to -17.0% in year-on-year terms) though the quarterly fall was slightly less, a pattern repeated with household spending. Equipment investment produced the worst result (-28.9% year on year) in tune with the weakness of imports and industrial production. Construction investment, meantime, dropped by 12%, half a point more than in the previous quarter. Infrastructure investment continued to expand (1.2%), especially at local authority level and linked to the high-speed rail network, while residential investment went on slowing (-25.5% versus -24.3% the previous quarter), due to the intense real estate correction and attendant uncertainties.

Employment destruction continues, though the pace has slackened,...

The latest labour market data (Social Security, National Employment Office [INEM], Labour Force Survey) confirm a global picture of deterioration, though the rate of decline is rather less. According to the Labour Force Survey, the number of people in work fell by 145,000 in the second quarter (1.5 million in the last year), while jobless numbers increased 126,700 (1.7 million in the last year). The annual variation in the total of employed and unemployed persons stood at -7.2% and

73.7% respectively. Employment losses have been felt most intensely in industrial and construction sectors, which together accounted for 72% of the year-long decline. The unemployment rate increased in the second quarter to 17.9% of the labour force, an addition of five decimal points over the previous quarter's rate.

...and inflation remains at bay. The run-down in energy rates may be losing momentum, but other less volatile items look set to take over.

Annual inflation moved up in August from -1.4% to -0.8% with the fading of the energy effect that drove the run-down in rates between July 2008 and July 2009 (from 5.3% to -1.4%). However some moderation is clearly detectable among remaining components of the CPI basket, to the extent that underlying inflation (excluding energy and fresh food items) has eased from 3.5% to 0.4% over the last year. The inflation differential with the euro area has stayed negative for the past nine months.

The European Commission forecasts a GDP contraction of 3.7% in 2009 and 1.0% in 2010, and calls attention to the structural imbalances afflicting the Spanish economy.

The latest European Commission forecasts for Spain project a GDP contraction of 3.7% in 2009 and 1.0% in 2010. However other estimates say the 2009 decline may be greater than 4.0% in view of the rapid deterioration of the labour market and public finances. The unemployment rate is forecast to exceed 20% of the labour force in 2010, while the public deficit is likely to run to nearly 9% in 2009 and 10% in 2010.

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

					European Commission*	
	2005	2006	2007	2008	2009F	2010F
GDP	3.6	4.0	3.6	0.9	-3.7 (-1.7)	-1.0 (-0.8)
Private consumption	4.3	3.8	3.7	-0.6	-3.1 (-0.5)	-1.1 (-1.1)
Government consumption	5.5	4.6	5.5	5.5	5.1 (+2.8)	4.7 (+4.5)
Gross Fixed Capital Formation, of which:	7.0	7.2	4.6	-4.4	-14.7 (-8.7)	-8.0 (-4.3)
Equipment	9.2	9.9	9.0	-1.8	-23.3 (-10.6)	-9.6 (-5.1)
Exports	2.5	6.7	6.6	-1.0	-10.2 (-7.5)	0.1 (-0.5)
Imports	7.7	10.2	8.0	-4.9	-14.5 (-9.9)	-2.4 (-0.3)
Net exports (growth contribution, pp)	-1.7	-1.4	-0.9	1.4	2.0 (+1.2)	0.7 (-0.1)
Employment	3.2	3.2	2.9	-0.6	-5.3 (-1.4)	-2.7 (-0.7)
Unemployment rate[1]	9.2	8.5	8.3	11.3	17.3 (1.2)	20.5 (+1.8)
HICP	3.4	3.6	2.8	4.1	0.0 (-0.6)	1.4 (-1.0)
Current account (% GDP)	-7.5	-9.0	-10.1	-9.5	-6.9 (+0.2)	-6.3 (+0.3)
General government (% GDP)	1.0	2.0	2.2	-3.8	-8.6 (-2.4)	-9.8 (-4.1)

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

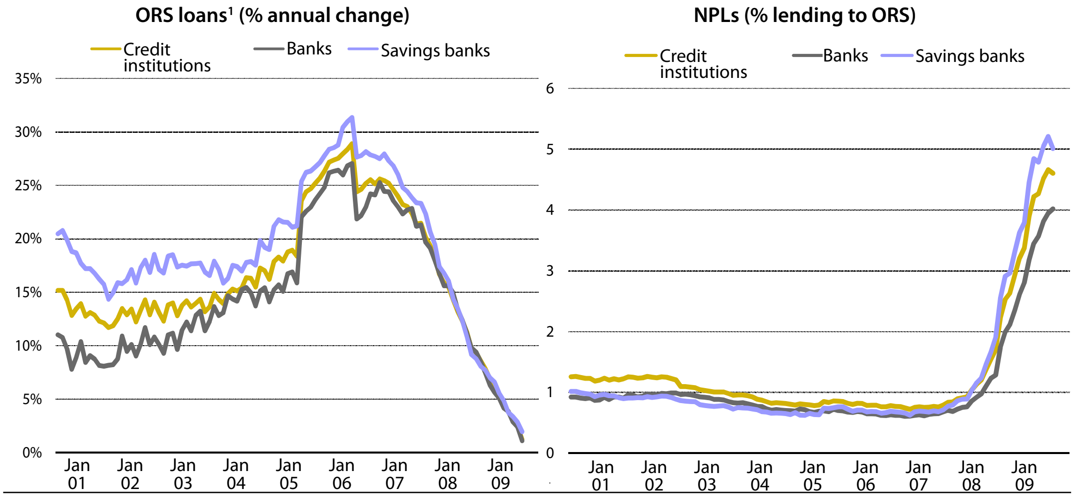
1 Eurostat definition.

* Forecasts published in spring 2009 (versus January 2009), except 2009 forecasts for GDP and inflation, published in September (versus January).

Deposit-taking entities face more bad loans as unemployment takes its toll...

Spanish deposit-taking entities have again had to negotiate a tough business landscape. Although financing difficulties have eased somewhat, fading demand for credit and, above all, rising unemployment have hit at sector activity and results. Lending to businesses and households by Spanish deposit-taking entities has been decelerating steadily since the start of 2007. Year-on-year growth was down to 1.2% in June from 5.4% in January this year (see figure 3). Meantime, non performing loans ratios have expanded to a June level of 4.6% (3.9% in January), with banks faring worse (4% in June versus 3.2% in January) in comparison to savings banks (5% and 4.5% in June and January respectively). In fact, savings bank NPL ratios actually fell slightly between May and June, delivering the first positive sector-wide reading since the outbreak of the subprime crisis.

Deposit-taking entities: loans and NPLs FIGURE 3



Source: Banco de España. Data to August 2009.

1 ORS: Other resident sectors.

The bad loan upswing of the last six months[6] traced mainly, as is becoming customary, to real estate developer financing, followed by loans to households for home purchase and refurbishment and, at a distance, loans to construction-related businesses. The differing loan-book mix of banks and savings banks means the latter are more exposed to payment arrears in household mortgage loans. Banks, conversely, have been worse affected in loans to productive activities other than real estate and construction, and in consumer loans to households for the acquisition of durable goods.

...especially real estate developer financing and, to a lesser extent, loans to households.

The financing conditions of national deposit-taking entities have improved this year with respect to the preceding quarters. Among the factors at work have been the less uncertain climate, which has brought risk premiums down significantly, financial system support packages (basically the granting of government guarantees for entities' long-term debt financing) and, finally, the menu of borrowing options provided by the central bank.

Their financing conditions have improved versus previous quarters thanks to falling risk premiums,...

The amount of government-backed debt issued by Spanish institutions comes to 38.46 billion euros year to date[7]. A total of 39 entities have conducted 122 issues of this kind.

...financial system support measures (basically government guarantees for long-term debt financing), and...

The amount of Eurosystem loans taken by Spanish institutions stands at nearly 75 billion euros. Spanish entities have turned increasingly if irregularly to this source of finance since the start of the crisis (see figure 4). The latest increase owes partly to the extension to one year (agreed in June) of the term for ECB refinancing operations with disbursement in full. Institutions have continued to leave a large part of these funds (over 12 billion euros) in the ECB's own deposit facility. Mortgage bond issues have also gained popularity among deposit-taking entities in recent months following the ECB's launch of a covered bond purchase programme. Since the programme was announced in May, Spanish entities have issues mortgage bonds worth 7.19 billion euros, equivalent to 32% of this year's total issuance.

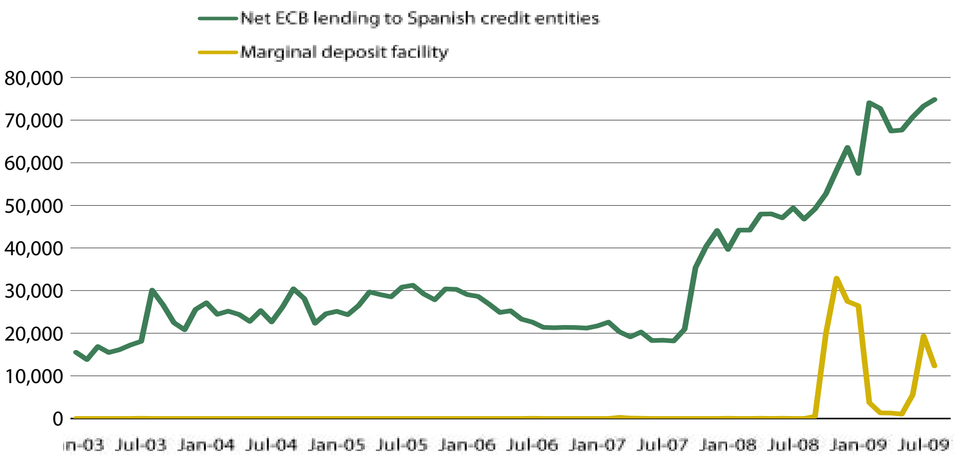
... the range of financing options put in place by the central bank.

6 In this case, the latest available bad loan data by transaction finality correspond to March 2009.

7 To 15 September.

FIGURE 4

Net ECB lending to Spanish credit entities and balance of the deposit facility (million euros)



Source: Banco de España. Data to August 2009.

Credit institutions' first-quarter net profits were 16% down on one year before due to falling profits on financial operations and rising impairment losses.

Credit institutions reported first-quarter net profits of 4.97 billion euros, 16% less than one year before. The decline traced mainly to gross income (-5.2% year on year), after growth in net interest income (24.1% year on year) was partly wiped out by lower inflows from other financial operations. The second big factor impacting on sector income statements was the surge in loan impairment losses (4.15 billion euros in the first quarter of 2009 compared to 2.24 billion over the same period in 2008). Return on equity (ROE), finally, was down to 12.9% by end 2008 from the 19% of 2007.

Capital ratios remain well clear of the statutory minimum, though some entities are more vulnerable than others to a worsening financial and macro outlook. The FROB will go some way to alleviating these risks.

The total capital ratio of Spanish deposit-taking entities was 11.3% in December 2008, while the core capital ratio (tier 1) stood at 8.4%. These levels were rather higher than one year before (10.6% and 7.5% respectively) and remain well clear of the regulatory minimum. That said, some entities are more exposed than others to a worsening macroeconomic and financial environment. To address this risk, the government has created the Fondo de Reestructuración y Reordenación Bancaria (FROB) in order to reinforce the solvency of the Spanish banking sector[8] and guarantee its proper functioning.

Non financial listed companies suffer further earnings decline albeit with large differences between sectors.

The profits of non financial listed companies continued to sag under the impact of the economic slowdown, though this year inter-sector differences have been especially pronounced. Overall, non financial companies reported first-half profits of almost 14.90 billion euros, a decline of 11% with respect to the same period in 2008 (see table 4). The slide was almost wholly centred on energy sector companies, whose profits slumped from 12.17 billion in first-half 2008 to around 6.75 billion in 2009 (-45%), and to a lesser extent industrial companies (down from 1.75 billion to 493 million euros). By contrast,

8 The plan contemplates three stages: (i) the affected credit institution resolves any problems by its own means; a process not regulated in the Royal Decree-Law, (ii) adoption of measures to tackle weaknesses that could impair the viability of credit institutions participating in Deposit Guarantee Funds, and (iii) restructuring processes with the intervention of the FROB. The fund, with a mixed financing structure, has been allocated an initial sum of 9 billion euros from the National Budget (6.75 billion euros) and amounts contributed to credit institutions by Deposit Guarantee Funds (2.25 billion euros). It will also draw on the retained earnings of the Financial Assets Acquisition Fund (FAAF) and is empowered to aise finance on securities markets in pursuit of its objectives, by issuing debt instruments backed by government guarantee, as well as to receive loans, apply for the opening of credit lines and conduct other borrowing operations for a sum not exceeding three times its endowment in the current year.

companies in the retail and services sector grew their profits 3.8% to 6.23 billion and, more important still, the construction and real estate companies that had suffered the sharpest correction in 2008, fought back from 2008 losses of 3.15 billion to 1.46 billion profits in the first half of 2009. Note, however, that these aggregate figures mask notable differences, with a number of construction and real estate operators still having to cope with seriously deteriorated earnings.

Earnings by sector[1]: listed companies TABLE 4

	EBITDA[2]		EBIT[3]		Profit for the year	
Million euros	**1H08**	**1H09**	**1H08**	**1H09**	**1H08**	**1H09**
Energy	14,782	14,984	10,660	10,111	12,166	6,749
Industry	3,506	2,200	2,444	1,129	1,752	493
Retail and Services	15,274	14,381	9,445	8,652	5,999	6,228
Construction and Real estate	707	2,736	-727	1,289	-3,154	1,465
Adjustments	-470	-360	-326	-220	-30	-40
AGGREGATE TOTAL	**33,799**	**33,941**	**21,496**	**20,961**	**16,733**	**14,895**

Source: CNMV.

1 Year-to-date earnings.

2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

The combined debt of these companies rises 4.4% in first-half 2009, with energy firms almost wholly responsible,...

The debt of non financial listed companies swelled to 323.1 billion euros in June 2009 (4.4% more than at end 2008), representing 1.7 times their aggregate equity (1.6 times in 2008). As table 5 shows, the largest increase in both absolute and relative terms corresponded to companies in the energy sector, whose combined debt rose 25% in the first six months to nearly 103 billion euros, almost a third of the all-company total. Conversely, companies in retail and services and, more so, construction and real estate managed to reduce their debt in the same period, by 3.1% and 12.3% respectively. Despite this decline in the latters' external borrowings, the drain on equity raised their leverage from 3.8 times in December 2008 to 4.3 times in mid-year 2009.

... but coverage ratios improve overall except in the construction and real estate sectors.

Debt coverage ratios, meantime, have improved on their start-out levels (except among the industrial contingent) thank to the downward trend in interest rates. Specifically, earnings before interest and taxes (EBIT) stood 2.6 time higher than companies' aggregate interest expenses. Construction and real estate related firms were hardest pressed, with EBIT failing to cover more than half of their interest expenses, though here too we can detect some improvement.

Gross debt by sector: listed companies

TABLE 5

Million euros		2005	2006	2007	2008	1H09[5]
Energy	Debt	58,586	59,191	69,172	82,608	102,933
	Debt/Equity	0.9	0.9	0.8	0.9	1.1
	Debt/EBITDA[1]	2.4	2.2	2.5	2.8	3.4
	EBIT[2]/Interest expenses	4.0	4.7	4.1	3.7	3.8
Industry	Debt	12,760	15,684	13,312	15,645	15,880
	Debt/Equity	0.8	0.8	0.6	0.7	0.8
	Debt/EBITDA	2.1	2.1	1.8	2.7	3.6
	EBIT/Interest expenses	6.5	5.7	5.9	3.4	2.5
Construction and real estate	Debt	48,324	111,000	138,933	119,788	105,056
	Debt/Equity	2.2	3.1	3.1	3.8	4.3
	Debt/EBITDA	6.5	11.5	10.8	31.9	19.2
	EBIT/Interest expenses	2.8	2.0	1.2	0.0	0.5
Retail and Services	Debt	55,710	91,522	96,941	112,322	108,831
	Debt/Equity	1.7	2.5	1.7	2.1	2.1
	Debt/EBITDA	2.7	3.6	3.0	3.6	3.8
	EBIT/Interest expenses	3.4	2.4	3.2	2.9	3.1
Adjustments[3]	Debt	-7,942	-11,199	-17,391	-20,802	-9,583
AGGREGATE TOTAL[4]	Debt	**167,438**	**266,198**	**300,967**	**309,561**	**323,117**
	Debt/Equity	1.3	1.7	1.5	1.6	1.7
	Debt/EBITDA	2.9	3.9	4.0	4.6	4.8
	EBIT/Interest expenses	3.8	3.3	3.0	2.0	2.6

Source: CNMV.

1 Earnings before interest, taxes, depreciation and amortisation.

2 Earnings before interest and taxes.

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

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

5 EBITDA has been annualised in this case for the purpose of calculating Debt/EBITDA.

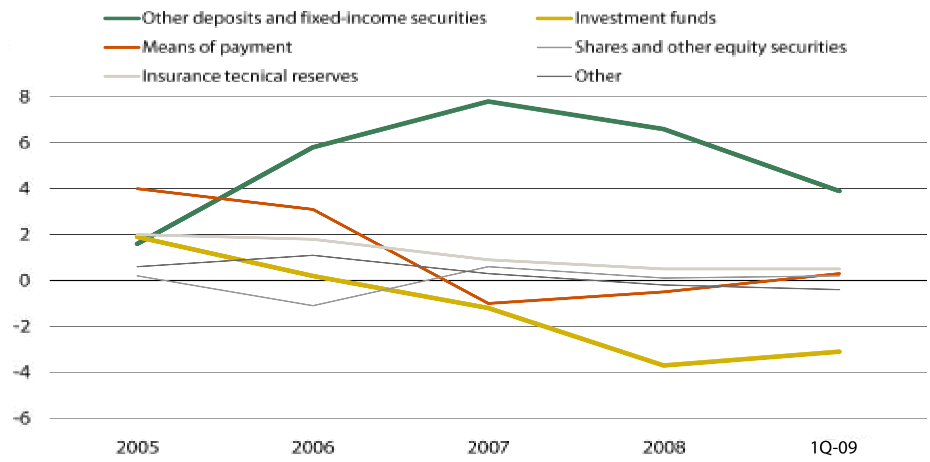
Households make a greater saving effort, but borrowing constraints bar them from investing more in financial and other assets. Their investment portfolios retain a conservative bias, though with less outflow from higher risk instruments.

Household asset indicators stayed pointing in the same direction as all though the crisis: an increase in the savings rate (now above 14% of gross disposable income), a decrease in indebtedness ratios to around 125% of gross disposable income (from highs of over 130% in 2007 and 2008) and a loss of wealth caused by the falling prices of financial assets and, above all, real estate properties. Financial asset purchases were again constrained by households' more limited resources and prolonged the decline begun in 2007 to end the first quarter of 2009[9] at 1.3% of GDP (against 2.8% in 2008 or the 7.4% of 2007). Retail investor portfolios have reduced their ultra conservative bias in recent months in response to the rather more settled market climate. So while low-risk assets continue to dominate in households' investment mix, we can detect a certain shift from term deposits to investment funds: inflows to the first are down considerably while withdrawals from collective investment products are beginning to slow (see figure 5).

9 Cumulative four-quarter data.

Household financial asset acquisitions (% GDP)

FIGURE 5



Source: Banco de España, Financial Accounts.

Investment fund subscriptions and redemptions (million euros)

TABLE 6

Category	Subscriptions				Redemptions			
	3Q08	4Q08	1Q09	2Q09[8]	3Q08	4Q08	1Q09	2Q09[8]
Fixed income[1]	17,342.5	24,475.2	18,299.3	15,572.6	24,503.3	32,332.9	19,963.9	19,433.2
Balanced fixed income[2]	239.0	739.4	361.9	515.0	1,437.2	1,946.2	806.2	549.3
Balanced equity[3]	272.4	192.9	71.0	156.3	900.0	854.7	493.0	284.4
Euro equity[4]	461.6	576.2	362.1	489.3	1,610	1,151.9	751.4	515.9
International equity[5]	621.7	336.1	390.8	598.4	1,642	965.6	506.3	592.0
Fixed income guaranteed	2,692.4	2,974.9	3,180.6	3.783.2	1,785.4	3,760.4	3,587.1	3,300.3
Equity guaranteed[6]	1,549.5	785.4	636.5	1.369.3	3,924.0	4,715.6	2,372.5	2,944.0
Global funds	738.3	997.5	600.6	971.5	3,570.2	3,670.3	1,538.5	588.0
Passively managed[7]				62.1				307.8
Absolute return[7]				567.8				627.3
Hedge funds	8.2	21.6	23.5	40.7	14.5	47.6	108.3	7.5
Funds of hedge funds	165.9	161.5	35.5		101.5	215.9	294.6	
TOTAL	**24,091.6**	**31,260.7**	**23,961.8**	**24,085.5**	**39,487.6**	**49,661.1**	**30,421.8**	**29,142.2**

Source: CNMV.

1 To 1Q09: Short and long fixed income, international fixed income and money market funds. From 2Q09: Euro and international fixed income and money market funds.

2 To 1Q09: Balanced fixed income and balanced international fixed income. From 2Q09: Balanced euro fixed income and balanced international fixed income.

3 To 1Q09: Balanced equity and balanced international equity. From 2Q09: Balanced euro equity and ba–lanced international equity.

4 To 1Q09: Spanish equity and euro equity. From 2Q09: Euro equity (including Spanish equity).

5 To 1Q09: International equity Europe, Japan, United States, emerging markets and others. From 2Q09: International equity.

6 To 1Q09: Guaranteed equity. From 2Q09: Guaranteed and partially guaranteed equity.

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

8 Hedge fund subscription and redemption data corresponds to the months of April and May. Itemised information for funds of hedge funds (subscriptions and redemptions) is only available on a full quarter basis. Estimates for 2Q09 indicate that net redemptions from the hedge fund segment of the CIS market totalled some 72 million euros.

Exhibit 3: Regulation of credit rating agencies in Europe

The risk assessment labours of rating agencies have for years been of vital help in reducing information asymmetries between the offerors and users of rated financial products, thus facilitating their placement. In addition, the ratings they assign have been used to establish the risk weightings of different assets for the purpose of determining capital requirements, or to cap institutional investment in certain types of assets by the likes of pension funds or insurance companies. This is also a highly concentrated sector in which three major agencies command a market share of 95%.

Rating agencies operate a complex incentives structure in that it is the issuer not the investor who pays their fees. This could cause agencies to err on the side of generosity when rating the instruments issued by a client. The subprime crisis brought to light other problems in the way they function. In particular, criticisms were levelled at their ratings of structured products (whereby pools of loans are securitised then sold after grading by a rating agency), which turned out to be largely inaccurate as well as seriously miscalculating how the bonds might perform in certain adverse scenarios.

The financial crisis has prompted diverse initiatives to tighten up the rules on agency registration and supervision in a break with the self-regulation regime that had previously characterised the industry. In Europe, the need to bring agencies under stricter control was addressed in a Regulation still pending formal approval, but which will likely come into force at the end of this October. Its text confines the validity of ratings for regulatory purposes to those issued by registered agencies domiciled in the EU or a third country[1]. Further, issuers will be obliged to state whether a rating has been assigned by a registered agency on the occasion of public offers of securities or their admission to trading on a regulated market, and publish this information in the corresponding prospectus .

The new norm sets conditions for the issuing of credit ratings and regulates agency organisation and activities with the following goals in mind[2]:

a) To foster independence and avoid conflicts of interest by means of the following provisions, among others:

a.1) At least two independent directors on the administrative or supervisory board, whose remuneration does not depend on the business performance of the agency.

a.2) Agencies should not provide consultancy or advisory services except wherethere can be no conflict of interest with the issue of ratings.

a.3) They should disclose the names of any rated entities that account for over 5% of their annual revenue.

a.4) Employee remuneration should not be contingent on the revenue obtained from rated entities.

a.5) Agencies should rotate analysts on a staggered or individual basis .

b) To improve the reliability of the methodologies, models and key assumptions used in drawing up ratings, by means of:

b.1) Rigorous, systematic and continuous models subject to validation against historical experience.

b.2) Adoption of measures to ensure the input information for ratings is of sufficient quality and comes from reliable sources.

b.3) Monitoring of ratings and methodologies so they are kept responsive tochanged conditions.

c) To increase transparency by setting the following disclosure obligations:

c.1) Full and public disclosure of business information (list of ancillary services, methodologies, code of conduct...). Information on methodologies will allow ratings users to verify their reliability. Agencies will be exempt from disclosing confidential commercial information so as not to discourage innovation.

c.2) Differentiation between ratings of structured finance instruments and others. Agencies should provide the CESR with regular standard informationon the performance of rated entities. CESR will create a central repository where these records will be available for public consultation.

c.3) Publication of an annual transparency report on their legal structure, recordkeeping policy and internal quality control system which also includes financial information on the agency's revenue, distinguishing between ratingand ancillary activities.

The competent authorities of the home Member State shall be responsible for registering and supervising credit rating agencies, though remaining national authorities may also participate through designated colleges of supervisors. In the event that the members of such colleges do not agree about the measures to apply, the Regulation states that the matter should be referred to the CESR and a mediator of its designation. The text, as such, tasks CESR with coordinating between college supervision and that of the competent authorities, i.e., it permits Community-wide supervision, although the CESR or mediator's opinions shall not be binding, and the final power of decision will remain with the competent authorities. Smooth cooperation will thus be required at the college level to avoid discrepancies between national decision-makers. Note finally that the supervisory architecture envisaged in the Regulation will be subject to far-reaching reforms in the light of the conclusions of the Larosière Report. Indeed, the preference now is for a more centralised model that entrusts the registration and supervision of credit rating agencies to a sole European body –possibly a transformed version of the CESR.

As of the Regulation's entry to force, agency subsidiaries established in Spain will come under the supervision of the CNMV, which will work closely in tandem with the Banco de España and with other European securities supervisors to ensure effective global oversight.

1 Two procedures are established whereby European issuers can use ratings issued by agencies domiciled in third countries for the purpose of regulatory compliance, the idea being in both cases to ensure the equivalence of their respective legal and supervisory frameworks. One of them, known as the endorsement system, is designed for large agencies deemed to have important links with the financial stability or integrity of Member State financial markets. The other, certification system is envisaged for small agencies that have no plans to set up subsidiaries in the EU.

2 The rules introduced in the Regulation draw heavily on the voluntary standards set out in IOSCO's Code of Conduct for Credit Rating Agencies.

2.3 Outlook

International forecasts point to a modest recovery in world GDP growth, though the suspension or reversal of expansionary policies introduces a substantial element of uncertainty.

The forecasts of leading international organisations suggest the downturn may have bottomed in the middle months of 2009, ushering in a recovery in world GDP that will be modest only except for the emerging economies. One source of uncertainty is how much this mooted growth may rely on the expansionary policies adopted by governments to help their economies out the recession, which cannot be prolonged indefinitely. Choosing the moment to suspend or reverse these policies is a delicate operation: too soon and they risk puncturing the nascent recovery; too late and inflation rates may rebound in excess.

Among the many downside risks for these projections is the prospect of a prolonged labour-market slump.

Although there are also upside risks for the above projections –for instance that government stimulus packages turn out more effective than expected, or financial institutions take less time to set their balance sheet to rights– the truth is that the downside risks are both numerous and significant. Among them we can cite a prolonged labour market downturn, a loss of confidence due to deteriorating public finances, the resurgence of protectionist temptations and the spread of deflationary expectations. Any combination of these factors could serve to reignite financial market turmoil.

Nationally, recovery is forecast to be somewhat slower than in other geographical zones, with a deeper decline in employment and/or public finances as the main factors ranged against. The FROB, meantime, will help attenuate the

Current forecasts suggest that the Spanish economy may be over the worst of the recession, but recovery will be somewhat slower than in other developed countries. The fundamental risks for this scenario are a larger-than-projected labour-market slump, especially when government support begins to run out; the possibility that public finances may sink deeper into the red, even threatening the sustainability of the public debt; and, finally, continuing difficulties at financial institutions requiring an added recapitalisation effort. In this last respect, a backstop is provided by the approval of the FROB.

Supply-side policies should now come to the fore.

As in other economies, demand policies have all but used up their room for manoeuvre, and supply-side policies must now step in to boost the country's economic competitiveness and its potential output rate.

3 Performance of national markets

3.1 Equity markets

Spanish equity prices have been rising significantly since March, accompanied by lesser volatility and improved conditions of liquidity.

All this year[10], and especially since March, Spain's financial markets have been showing signs of recovery, in line with other international markets. Stock markets particularly have been enjoying a prolonged price rally, accompanied by reduced volatility and improved liquidity conditions.

The Ibex 35 began to stir around mid-March, and has since risen 25.2% to June and 18.4% so far this quarter. The index's year to date gain (26.1%) outperforms all leading market indices except the Nasdaq (see table 2). Small and medium cap indices have moved up 29.9% and 19.5% respectively year to date, while the FTSE Latibex Top and All Share have surged 48.4% and 65.2% respectively after initiating their rally one quarter earlier.

10 The closing date for the report corresponds to 15 September.

Financial and construction-related stocks were in the vanguard of the recovery (see table 7), with industrial goods, discretionary consumer goods and insurance companies also faring well. This year's steepest losses were recorded by cyclical sectors like basic consumer goods, companies engaging in energy production and supply (oil, gas and utilities) and real estate operators.

Financial and construction companies lead the recovery, while cyclical stocks bring up the rear.

Table 8 below shows the price lows, current quotes and, by differences, the scale of recovery achieved by Ibex 35 shares between the onset of the crisis and the closing date for this report (quotes are normalised at a baseline 100 on 31 July 2007). The results permit some interesting conclusions. First of all, we can see that the Ibex 35 shed 54% of its summer 2007 baseline value as far as a period low of 46 points, before regaining 32 points to reach its current level of 78. However this last value is still 22% below its pre-crisis levels.

The Ibex 35 has recouped 32% of its value since the lows of the year's first months, but still stands 22% short of its pre-crisis level.

Performance of Spanish stock market indices and sectors (%) TABLE 7

							3Q09 (to 15 September)		
Indices	**2005**	**2006**	**2007**	**2008**	**1Q09[1]**	**2Q09[1]**	**%/prior qt.**	**%/Dec**	**% y/y**
Ibex 35	18.2	31.8	7.3	-39.4	-15.0	25.2	18.4	26.1	6.4
Madrid	20.6	34.5	5.6	-40.6	-16.2	24.4	19.3	24.2	3.4
Ibex Medium Cap	37.1	42.1	-10.4	-46.5	-12.5	23.8	10.3	19.5	-5.2
Ibex Small Cap	42.5	54.4	-5.4	-57.3	-6.0	19.5	15.7	29.9	-13.4
FTSE Latibex All-Share	83.9	23.8	57.8	-51.8	16.6	27.6	11.0	65.2	0.7
FTSE Latibex Top	77.9	18.2	33.7	-44.7	6.4	27.5	9.4	48.4	-7.6
Sectors[2]									
Oil and gas	29.1	18.3	1.8	-30.8	-32.4	12.6	12.5	-14.4	-29.2
Chemicals	176.1	-20.4	-58.4	-67.8	-15.5	13.2	14.2	9.3	-42.1
Basic materials	20.0	69.3	-17.2	-45.4	-20.9	37.6	21.0	31.7	3.1
Construction and constr. materials	50.4	61.6	-12.0	-51.0	-7.9	28.6	7.7	27.5	-0.2
Industrial goods and services	18.4	28.4	6.9	-41.9	-6.4	17.0	13.7	24.5	9.9
Health	19.0	40.7	19.2	-45.0	-5.5	29.2	-1.4	20.4	-20.7
Utilities	27.2	42.0	18.5	-31.0	-23.6	1.5	14.5	-11.2	-21.2
Banks	19.2	27.6	-4.5	-47.9	-23.4	48.8	25.7	43.2	10.2
Insurance	39.9	44.7	-13.3	-25.0	-32.6	41.6	27.1	21.3	1.4
Real estate	58.9	100.4	-42.6	-58.6	-36.3	-10.9	41.3	-19.7	-39.6
Financial services	58.6	91.1	-35.6	-44.3	-9.6	31.3	7.5	27.5	4.5
Telecommunications and media	-0.7	29.4	26.3	-31.4	-6.2	8.9	15.8	18.3	9.8
Discretionary consumption	24.8	21.2	-7.7	-39.2	-12.3	22.6	17.2	26.0	21.7
Basic consumption	19.0	12.9	6.9	-22.5	-19.4	2.3	11.9	-7.8	-23.4

Source: Thomson Datastream.

1 Change on previous quarter.

2 Classification obtained from Thomson Datastream.

Overall, banks and construction took the hardest beating in the thick of the crisis, with losses at times exceeding 75% (Sacyr shed almost 85% of its value and OHL 80%), while the lows reached by energy and, above all, communications companies stood considerably higher. The subsequent recovery trend was led by the two banking majors (Santander with 52 points and BBVA with 43), an insurance undertaking (Mapfre with 47 points), two industrial companies (Técnicas Reunidas with 50 points and Acerinox with 37) and one contractor (OHL). Finally, only two Ibex 35 shares are trading higher than they were at the start of the crisis (Telefónica and Red Eléctrica Corporación).

Although only two Ibex 35 stocks are trading higher than before the crisis, others have come back strongly in recent months.

Performance of Ibex 35 shares since the start of the crisis

TABLE 8

31/07/2007=100

Company	Low	Current value[1]	Recovery from low	Weighting (%)
SACYR-Vallehermoso	15.6	36.3	20.6	0.4
OHL	20.6	57.7	37.1	0.3
Telecinco	22.2	43.9	21.8	0.3
Gas Natural	23.5	40.5	17.0	1.3
Grupo Ferrovial	24.3	39.6	15.3	0.7
Abengoa	24.5	59.1	34.5	0.4
Banco Popular	25.2	53.7	28.5	2.1
BBVA	25.8	68.6	42.8	11.7
Gamesa	26.8	54.3	27.4	1.0
FCC	27.5	42.1	14.6	0.6
Arcelor Mittal	27.8	61.3	33.5	1.0
Técnicas Reunidas	28.7	78.3	49.7	0.4
Acciona	29.1	50.7	21.7	1.2
Cintra	30.5	63.4	32.9	0.5
Banco Santander	30.8	83.1	52.2	22.4
Banesto	32.3	58.7	26.4	0.3
BME	32.3	60.1	27.8	0.5
Iberia	36.1	57.8	21.7	0.4
Banco de Sabadell	37.4	61.6	24.3	1.5
Iberdrola Renovables[2]	38.8	65.2	26.4	0.7
Criteria[2]	39.0	65.7	26.7	1.2
Mapfre	40.6	87.4	46.8	0.8
Repsol	41.7	65.2	23.6	5.4
Acerinox	42.2	78.9	36.7	0.8
Iberdrola	43.3	63.8	20.6	8.5
Endesa	44.7	71.4	26.7	0.3
Bankinter	45.7	73.1	27.4	1.0
Abertis	49.1	77.6	28.6	2.2
Inditex	53.4	87.1	33.7	3.8
ACS	58.7	81.5	22.8	2.5
Enagás	60.9	80.3	19.5	0.9
Grifols	66.5	82.6	16.2	0.7
Indra	68.5	86.9	18.4	0.7
Telefónica	73.6	107.8	34.1	22.2
Red Eléctrica	81.6	100.7	19.1	1.2
Ibex 35	**46.1**	**78.3**	**32.3**	**100.0**

Source: Thomson Datastream, Sociedad de Bolsas and CNMV.

Companies are listed from lowest to highest according to their price low in the period. Shaded boxes indicate a recovery ahead of the Ibex 35.

1 Data to 15 September.

2 Changes in Criteria and Iberdrola Renovables calculated as of 10/10/2007 and 13/12/2007 respectively.

Share price recovery pushes up the price-earnings ratio on a scale outstripping other international markets ...

The price-earnings ratio (P/E) of Spanish shares surged from 8.2 at the end of the first quarter to 12.1 in mid September on the back of the intervening price rally, to recoup the levels registered in early 2008. The increase was greater than at other leading international markets, though the Spanish multiple still lags some way behind all but the Euro Stoxx 50.

... helping the earnings yield gap back into line with the average of recent years.

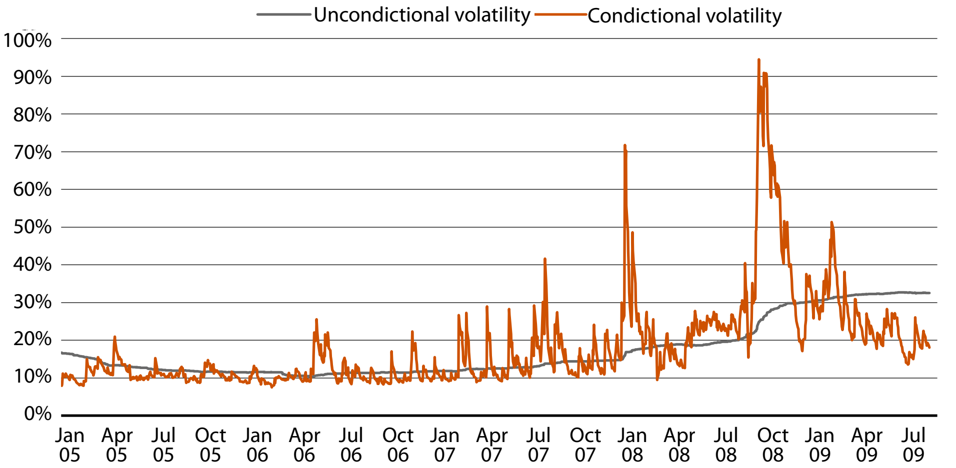
The earnings yield gap (reflecting the return premium required to be invested in equity versus long-term government bonds) headed steadily lower over the second and third quarter to a mid-year level of 4.4%. This marks the reversal of a run-up initiated in mid 2008, which reached its peak level in February last (8.7). The renewed descent is mainly explained by the above increase in market P/E and restores this indicator to its recent-year average (4.4% since 2005).

Volatility on Spanish equity markets eased to below 20% in mid September (see figure 6), continuing the journey back to normality after the peak levels of October 2008. The sensitivity of index volatility to falling prices repeated the readings of the first quarter close (see figure 7). And the bid-ask spread capturing equity market liquidity conditions indicated a solid improvement since March last, with monthly averages pulling back into line with their pre-crisis levels (see figure 8).

Volatility and liquidity conditions have improved substantially since March.

Historical volatility. Ibex 35

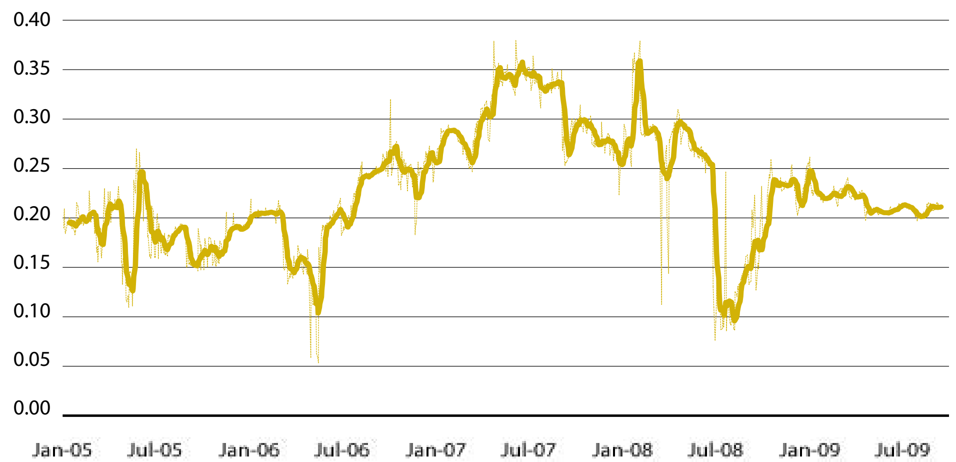
FIGURE 6



Source: Thomson Financial Datastream. Data to 15 September.

Volatility asymmetry of the Ibex 35

FIGURE 7



Source: Thomson Financial Datastream. Data to 15 September.

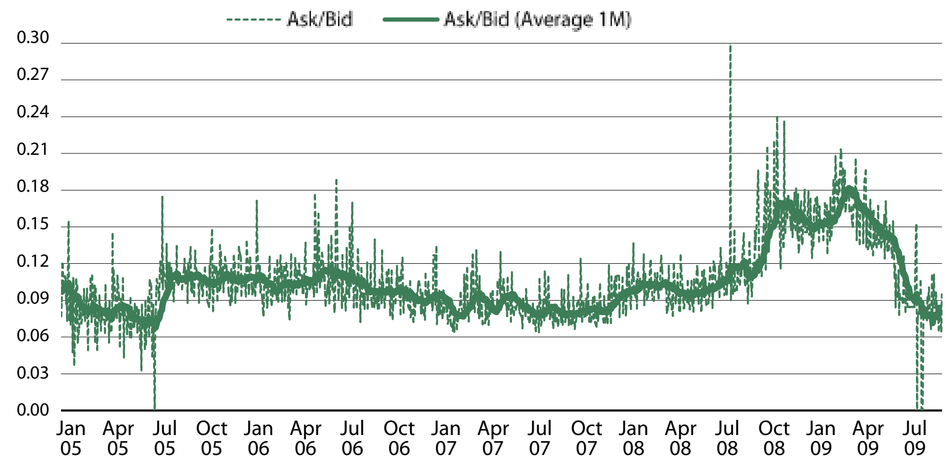
The parameter shown measures the sensitivity of conditional volatility to negative surprises in returns, in an asymmetric GARCH model (*).

(*) The specified equation is: $\ln(P_t / P_{t-1}) = \alpha + \varepsilon_t$,

with variance: $\sigma_t^2 = \omega + \theta \cdot \varepsilon_{t-1}^2 + \beta \cdot \sigma_{t-1}^2 + \eta \cdot \varepsilon_{t-1}^2 \cdot [1 \Leftrightarrow \varepsilon_{t-1} < 0] + u_t$

Ibex 35 liquidity. Bid/ask spread (%)

FIGURE 8



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

Stock market turnover picks up in the second quarter after a prolonged decline, then falters somewhat in the following months.

Spanish stock market turnover picked up appreciably in the second quarter, as far as a daily average of 3.64 billion euros (2.93 billion in the previous quarter), after a decline lasting through all 2008 and into the first months of 2009. In the third quarter to date, and more so since August, activity has receded once more, returning daily average volume to around 3.26 billion euros[11]. Turnover velocity, the ratio between trading and capitalisation (in the electronic market), has traced very much the same course.

Turnover on the Spanish stock market

TABLE 9

Million euros	2005	2006	2007	2008	1Q09	2Q09	3Q09[1]
All exchanges	854,145	1,154,294	1,667,219	1,243,387	184,654	225,638	179,193
Electronic market	847,664	1,146,390	1,658,019	1,235,330	183,367	224,385	178,220
Open outcry	5,899	5,318	1,154	207	19	27	12
of which SICAVs[2]	4,864	3,980	362	25	7	3	7
MAB[3]	-	1,814	6,985	7,060	1,178	1,109	883
Second Market	26	49	193	32	1	1	0
Latibex	557	723	868	758	89	115	78
Pro-memoria: non resident trading (% of all exchanges)							
	57.4	58.4	61.6	65.5	61.7	n.a.	n.a.

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

1 Cumulate data from 1 July to 15 September.

2 Open-end investment companies.

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

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

The improved climate on financial markets has failed to spark a revival in equity issuance.

Neither the mooted normalisation of financial markets nor the recovery of share prices have had much of an impact on equity issuance. The return of issuers (mainly financials) to primary markets has been above all through the vehicle of debt instruments. The result is that equity issuance year to date has been a no more than modest 9.07 billion euros, a long way short of pre-crisis levels but some improvement on the year-ago total of 7.15 billion.

11 Average daily trading on the stock market came to 6.59 billion euros in 2007 and 4.89 billion in 2008.

Equations issues and public offerings[1]

TABLE 10

	2005	2006	2007	2008	2009 1Q09	2009 2Q09	2009 3Q09[2]
CASH AMOUNTS[3] (million euros)	3,282	29,219	69,650	16,349	5,932	2,060	1,080
Capital increases	3,125	26,760	67,582	16,340	5,932	2,060	1,080
Of which, rights offerings	0	645	8,503	292	0	0	0
National tranche	0	303	4,821	292	0	0	0
International tranche	0	342	3,681	0	0	0	0
Public offerings	157	2,459	2,068	10	0	0	0
National tranche	55	1,568	1,517	10	0	0	0
International tranche	102	891	551	0	0	0	0
NUMBER OF FILINGS[4]	51	84	99	54	9	14	10
Capital increases	49	75	90	53	9	14	10
Of which, rights offerings	0	8	8	2	0	0	0
Of which, bonus issues	16	20	19	18	1	3	4
Public offerings	2	14	12	2	0	0	0

1 Incorporating issues admitted to trading without a prospectus being filed.
2 Data to 15 September 2009.
3 Excluding amounts recorded in respect of cancelled transactions.
4 Including all transactions registered, whether or not they eventually went ahead.

Doubts persist about the enduring strength of the Spanish stock market recovery.

Despite the apparent strength of the share price recovery, its sustainability is hedged by uncertainties, as evidenced by the dispersion of analysts' forecasts. Turnover continues weak, despite the modest upswing of the second quarter, indicating that improvement is fragile at best and we cannot rule out new, though presumably less intense episodes of market turbulence. The publication of real activity indicators confirming the cycle change and positive newsflow on second-half corporate earnings (in the banks sector especially) are the balm the markets need to complete a confident return to normality.

3.2 Fixed-income markets

Short rates continue to fall in tune with the ECB's expansionary policy, but the downside is getting thinner.

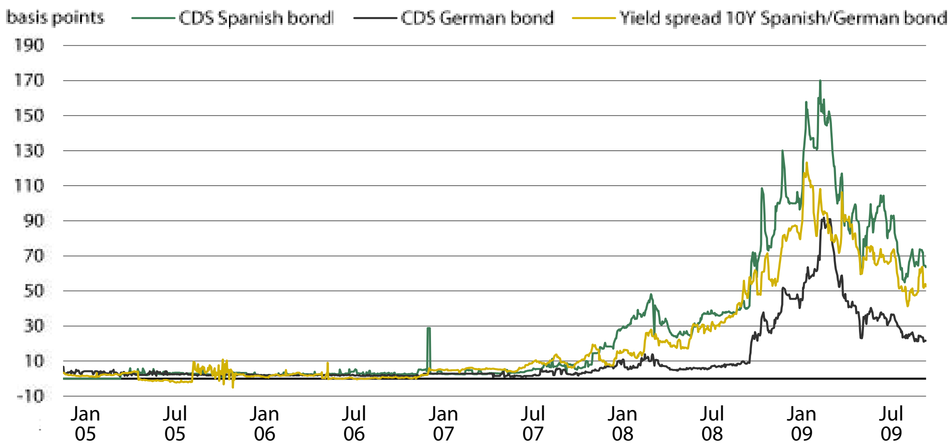
Short-term rates in public and private fixed-income markets stayed within the downward trend initiated in the last quarter of 2008 in line with the expansionary course of ECB monetary policy. However, the downside remaining is logically less, and falls since March has been contained at between 50 and 70 bp depending on the maturity. Hence the average August rates on Letras del Tesoro stood at 0.4%, 0.5% and 0.7% respectively in the three, six and twelve month tenors, while corporate debt rates in the same terms were 1.0%, 1.2% and 1.5%.

Long government yields move lower in the second and third quarter, due mainly to the perceived subsiding of credit risk on the Spanish economy and, to a lesser extent, the weakness of the economic activity and doubts about the timing and strength of the recovery.

Long-term government yields also came down in the second and third quarters of 2009 (except for June), though rather less so at the longest end. Much of this decrease can be traced to the lesser credit risk perception weighing on the Spanish economy, borne out by narrowing spreads between the Spanish and German benchmark (down to just over 50 bp from the 80 bp approximately of end March) and the sizeable reduction in the CDS spreads of the Spanish bond (see figure 9), down by over 50 bp to less than 70 bp. Other factors fuelling the decline in long government yields are the persistent weakness of economic activity and doubts about the timing and strength of recovery, against a backdrop of little or no inflationary pressure.

Risk premium of Spanish government debt[1]

FIGURE 9



Source: Thomson Datastream

1 Data to 15 September.

Long-term corporate bond yields rise in the second quarter then fall back slightly in the third, ...

In private fixed income, conversely, the interest rates of longer dated instruments moved higher in the second quarter before inching lower in the third. In all, the average rate on three-year bonds dropped from 3.24% in March to 3.17% in September against 0.27 and 0.35 point increases in five- and ten-year maturities as far as 4.27% and 5.11% respectively (see figure 11).

Interest rates on corporate debt[1]

TABLE 11

%

	Dec 05	Dec 06	Dec 07	Dec 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
Short term: commercial paper [2]									
3 months	2.58	3.78	4.97	3.45	5.24	3.45	1.70	1.28	0.97
6 months	2.74	3.91	4.91	3.54	5.45	3.54	1.86	1.52	1.23
12 months	2.93	4.00	4.85	3.68	5.63	3.68	2.10	1.80	1.47
Medium and long-term[3]									
3 years	3.15	4.04	4.59	3.79	5.39	3.79	3.24	3.40	3.17
5 years	3.48	4.14	4.65	4.17	5.48	4.17	4.00	4.46	4.27
10 years	3.89	4.26	4.94	4.73	5.65	4.73	4.76	5.24	5.11

Source: AIAF.

1 Average daily data. Data for September correspond to the average level from 1/9 to 15/9.

2 Traded on private fixed-income market AIAF.

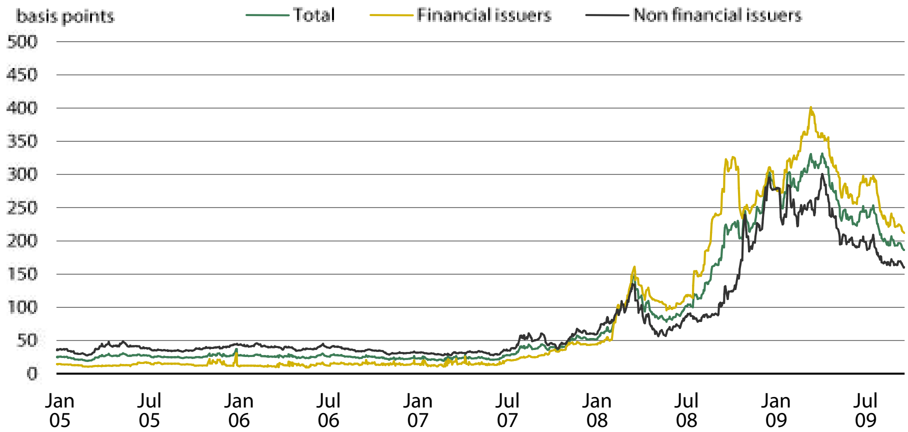
3 Bond and debenture trades to maturity on AIAF.

... while the CDS spreads of Spanish financial and non financial issuers join in the general easing trend.

The CDS spreads of Spanish issuers joined in the general easing trend, with average premiums falling from their March highs of 325 bp to 180 bp in mid September, similar to the levels in place before the Lehman Brothers collapse though still high by historical standards. The scale of decrease was similar across financial and non financial entities.

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

FIGURE 10



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

1 Simple average.

Corporate issues generate similar volumes but with a very different mix. Commercial paper and asset-backed securities lose ground in favour of non convertible and mortgage bonds under the spur of government support measures and new Eurosystem financing options.

Fixed-income issues registered with the CNMV sum 297 billion euros year to date[12], compared to the 329 billion of the same period in 2008[13]. Although volumes are similar in annual terms, the issuance mix is starkly different, with commercial paper and asset-backed securities losing relative weight (together just over 70% of issuance against 94% in 2008) and bonds and mortgage bonds scaling up from 5% to 24%. Sales of non convertible bonds in particular have grown almost five times over versus 2008 to as far as 50 billion euros in September. This dynamism responds to a timid return to the issuance market as financing conditions improve, but, above all, to the granting of government guarantees on bank issuance of this kind of instrument. In effect, almost 80% of this year's bond issues have had some such guarantee attached. Meantime, the mortgage bond market has enjoyed a double stimulus from the Financial Asset Acquisition Fund (FAAF) and, more recently, the Eurosystem with its covered bond purchase programme. Sales this year sum 22.57 billion to date (7.6% of the total), surpassing the 14.30 billion issued in full-year 2008.

12 To 15 September.

13 One of this year's big developments has been the step-up in foreign placements. In the first three quarters of 2009 (data to 15 September) foreign issues exceeded 103 billion euros, 20.1% more than in the same period in 2008, breaking down 32.6 billion in short-term and 70.8 billion in long-term instruments.

Gross fixed-income issues filed[1] with the CNMV

TABLE 12

	2005	2006	2007	2008	2009 1Q09	2009 2Q09	2009 3Q09[2]
NUMBER OF ISSUES	**263**	**335**	**334**	**337**	**111**	**180**	**88**
Mortgage bonds	21	37	32	47	31	11	9
Territorial bonds	3	6	8	8	0	1	0
Non convertible bonds and debentures	93	115	79	76	31	106	47
Convertible/exchangeable bonds and debentures	4	1	0	1	0	1	1
Asset-backed securities	54	82	101	108	21	26	12
Commercial paper facilities	80	83	106	88	20	16	11
Securitised	3	3	3	2	0	1	0
Other commercial paper	77	80	103	86	20	15	11
Other fixed-income issues	1	0	3	0	0	0	0
Preference shares	7	11	5	9	8	19	8
FACE VALUE (million euros)	**414,254**	**523,131**	**648,757**	**476,276**	**116,427**	**130,129**	**50,180**
Mortgage bonds	35,560	44,250	24,696	14,300	10,474	10,175	1,920
Territorial bonds	1,775	5,150	5,060	1,820	0	500	0
Non convertible bonds and debentures	41,907	46,688	27,416	10,490	15,492	28,249	4,845
Convertible/exchangeable bonds and debentures	163	68	0	1,429	0	300	200
Asset-backed securities	69,044	91,608	141,627	135,253	27,358	31,035	7,786
Domestic tranche	28,746	30,886	94,049	132,730	27,358	28,484	6,581
International tranche	40,298	60,722	47,578	2,522	0	2,551	1,206
Commercial paper[3]	264,360	334,457	442,433	311,738	61,552	49,697	34,242
Securitised	2,768	1,993	465	2,843	1,334	1,227	799
Other commercial paper	261,592	332,464	441,969	308,895	60,218	48,470	33,443
Other fixed-income issues	89	0	7,300	0	0	0	0
Preference shares	1,356	911	225	1,246	1,550	10,173	1,187
Pro memoria:							
Subordinated issues	11,079	27,361	47,158	12,950	8,484	5,571	1,082
Covered issues	94,368	92,213	86,161	9,170	0	2,559	1,450

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

2 Available data to 15 September 2009.

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

Exhibit 4: Recent changes in CDS contracts and conventions

A Credit Default Swap (CDS) is a trade contract conferring protection against credit risk (credit event) in a given company (reference entity). The buyer undertakes to pay a periodic premium until the contract's expiry or until the credit event occurs, in which case it has the right to sell the counterparty a particular obligation (bond or loan) issued by the reference entity for its par value[1]. The notional value of credit risk premiums have been climbing steadily from below one trillion dollars in 2001 to almost 40 trillion in 2008 (by way of a 60 trillion peak in 2007).

The financial crisis has brought to light a series of shortcomings in the functioning of these markets, and persuaded regulators of the need to make improvements in their infrastructure. Among them, a reduction in the notional value of outstanding positions, the cutting to the minimum of delays in trade confirmation and, above all, the clearing of positions by central counterparties (CCP).

The first step is to achieve more homogeneous contracts. In this respect, two protocols recently approved by the ISDA (International Swaps and Derivatives

Association) could mark a major step forward in standardisation. The first protocol, known as Big Bang, came into force on April 8 this year, and introduced global changes in contracts as well as a series of modifications in the trading convention for North American CDS. The second protocol, with the name Small Bang, is an addition to its predecessor, and addresses the need to conserve debt restructuring at a distressed underlying company as a credit event in the European system, while applying convention changes to European CDS similar to those effected for North American instruments. Contract changes came into force on 31 July, and convention changes in Europe on 20 June.

The most significant changes brought by both protocols appear in the text box below:

Global changes in contracts:

Big Bang	*Small Bang*
1. **Creation of Regional Determination Committees** empowered to decide whether a credit event has taken place, in which case it will also decide whether to hold an auction, the terms of the same and the bucket of bonds deliverable. Members will be twelve representatives of protection sellers, six of protection buyers and one representative from the ISDA. A committee will be set up for each of the following zones: Americas, Europe, Middle East and Africa, Japan, Asia (ex Japan), and Australia and New Zealand.	1. **Settlement by auction in the case of a credit restructuring event.** After restructuring, with no need for a Committee ruling, each contract will be grouped into one of nine buckets depending on maturity (0-2.5; 2.5; 5; 7.5; 10; 12.5; 15; 20 and 30 years). The Committee will decide whether to auction each bucket and the associated deliverables, while the buyers or sellers of protection will decide whether they wish to trigger the contract[2].
2. **Hardwiring of the auction mechanism** in most contracts, except for those specific terms that depend on the nature of the credit event.	2. **Decision powers of the Determination Committee. The Committee** will decide whether a credit event has occurred or not. It will also decide which bonds or loans (underlying CDS assets) will be delivered into which bucket within two weeks of the restructuring event.
3. **Change in the effective date** to trigger a credit event, which will no longer be the business day following the trade date. Now, protection of all outstanding positions on any date will commence 60 days before that date in the case of a credit event, and 90 days before in the case of a succession event.	3. **Time limit for triggering contract settlement** after a restructuring event. Protection buyer and sellers will have five business days in which to trigger their contracts. Should they decide not to do so, they may not go to auction to trigger a subsequent credit event in respect of these same contracts.

Changes in the convention for North American and European CDS:

Big Bang: North American CDS	*Small Bang: European CDS*
1. **Changes in periodic payments (coupons or spreads)**. The periodic payments from the protection buyer to the seller at spreads to the contract par were in most cases traded on a single name basis, such that the present value of the CDS at the contract outset was zero for the buyer and the seller (par spread). Under the new convention, coupons are fixed at 100 or 500 bp annually plus an upfront fee.	1. **Periodic payments** are established as annual fixed coupons of 25, 100, 300, 500, 750 or 1000 bp plus an upfront fee. The reason for this multi-step structure in Europe vs. the simpler North American format is the greater diversity in European CDS trades.
2. **The dates set for coupon strikes** (and for contract expiry) are those of the International Monetary Market (IMM): 20 March, 20 June, 20 September and 20 December. Under the previous convention, the first coupon payment was counted from the trade date.	2. Europe will switch over to the American convention of **full coupon payment** enshrined in the Big Bang protocol for North American CDS.
	3. **The restructuring clause convention will continue to be MMR** (Modified Modified Restructuring) for European corporate and sovereign CDS. Almost all European contracts are currently traded under this convention. Europe's diverse regulatory treatments of corporate bankruptcy and their scant overlap with United States federal bankruptcy laws means

3. **Elimination of underlying company restructuring as a credit event**. United States bankruptcy law obviates the need to incorporate this kind of event. Protection buyers are deemed to be sufficiently protected even if their contracts do not include restructuring as a credit event. In fact, most North American high-yield CDS are traded without this kind of clause. restructuring must be incorporated as a credit event in order to adequately safeguard the buyer side of a European CDS.

These two protocols entail large changes in the operational, trading and legal structure of the CDS market, favouring the consistency, standardisation and fungibility of contracts and, ultimately, the efficiency of the CCP clearing system.

1 In the absence of a material obligation, settlement is by differences, with the buyer receiving the agreed par value less a recovery fee as specified in the contract or determined by an auction of the underlying reference obligation.
2 In essence this means no change with respect to the old conventions of MMR (Modified Modified Restructuring), the European standard, and MR (Modified Restructuring), the North American standard, which placed limits on the obligations deliverable on a restructuring event as a function of their matu– rity. The MR convention was stricter than MMR regarding the obligations deliverable on the occurrence of a credit event.

4 Market agents

4.1 Investment vehicles

Financial collective investment schemes[14]

Investment fund assets fell 5% over first-half 2009 to 167 billion, representing a rather slower rate of decline. Redemptions were once again the main contributing factor, though signs are that investor opinion is turning less hostile.

Financial CIS closed the first half of 2009 with assets under management of 167.2 billion euros, 5% less than one year before (see table 13). Mutual fund assets have now chalked up eight successive monthly declines, though the rate of deceleration has reduced considerably (from the -31% of 2008). The decrease in assets was again mainly down to unitholder withdrawals. However these were less abundant than in 2008 thanks to the more settled market climate and the fading attraction of alternative investments, particularly deposits. Fund portfolios declined in value over the year's opening quarter, but made up the ground lost thereafter on the back of the stock market rally to close the six-month period in positive territory.

The fall was sharpest in pure fixed income categories. Other movements in the period owed more to the recent rejigging of funds by investment objective.

The largest falls in straight volume terms were in pure fixed income categories (see table 13), which missed the benefit of rising equity prices as well as registering net redemptions of over 5.50 billion euros. Global funds too experienced a sharp drop in assets, though the cause in this case was mainly the reclassifying of investment fund objectives[15]. Note in this respect that a new fund category has come into being ("absolute return") which groups funds previously classed as global. The assets under management in absolute return funds was nearly 5.60 billion euros by the first-half close. Among the period's few winners were guaranteed fixed-income funds which gained almost 400 million euros.

Unitholder numbers dropped less than in preceding quarters ...

Unitholder numbers also continued to fall, albeit less intensely than in preceding quarters. At June 30 2009, the number of CIS investors stood at just under 5.5 million or 425,000 less than at end 2008 (compared to an outflow of over 2.1 million in full-year 2008).

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.
15 In force as of 1 April 2009.

Main investment fund variables

TABLE 13

	2007	2008	2008			2009
Number			III	IV	I	II
Total investment funds	**2,926**	**2,912**	**2,932**	**2,912**	**2,830**	**2,735**
Fixed income[1]	600	629	616	629	631	612
Balanced fixed income[2]	204	195	195	195	193	190
Balanced equity[3]	207	202	204	202	191	181
Euro equity[4]	247	237	239	237	235	193
International equity[5]	357	330	347	330	304	271
Fixed income guaranteed	251	260	255	260	249	253
Equity guaranteed[6]	590	590	600	590	586	610
Global funds	470	469	476	469	441	208
Passively managed[7]						69
Absolute return[7]						148
Assets (million euros)						
Total investment funds	**255,040.9**	**175,865.3**	**197,305.6**	**175,865.3**	**168,829.3**	**167,161.0**
Fixed income[1]	113,234.1	92,813.1	100,931.9	92,813.1	91,473.0	86,711.3
Balanced fixed income[2]	13,011.9	5,803.0	7,175.8	5,803.0	5,282.6	5,421.8
Balanced equity[3]	8,848.0	3,958.8	5,092.8	3,958.8	3,301.7	3,480.1
Euro equity[4]	16,589.7	5,938.9	7,853.3	5,937.0	4,778.1	4,946.0
International equity[5]	13,948.1	4,254.7	6,231.9	4,256.6	3,808.8	4,108.3
Fixed income guaranteed	17,674.4	21,150.3	20,968.0	21,281.7	20,952.0	21,664.1
Equity guaranteed[6]	42,042.1	30,873.7	33,782.8	30,742.4	29,433.3	29,120.6
Global funds	29,692.6	11,072.8	15,269.2	11,072.8	9,799.9	3,350.7
Passively managed[7]						2,714.5
Absolute return[7]						5,643.6
Unitholders						
Total investment funds	**8,053,049**	**5,923,346**	**6,520,089**	**5,923,346**	**5,626,786**	**5,498,325**
Fixed income[1]	2,763,442	2,204,652	2,389,795	2,204,652	2,145,607	2,067,091
Balanced fixed income[2]	493,786	277,629	319,445	277,629	247,833	241,097
Balanced equity[3]	331,214	209,782	236,645	209,782	194,064	187,244
Euro equity[4]	577,522	377,545	412,239	377,545	339,285	270,079
International equity[5]	800,556	467,691	526,696	467,691	431,575	419,928
Fixed income guaranteed	549,108	538,799	552,515	538,799	525,387	540,428
Equity guaranteed[6]	1,715,144	1,402,948	1,513,064	1,402,948	1,339,367	1,339,321
Global funds	822,277	444,300	569,690	444,300	403,668	96,581
Passively managed[7]						91,738
Absolute return[7]						244,818
Return (%)[8]						
Total investment funds	**2.63**	**-4.21**	**-0.79**	**-0.96**	**-0.32**	**2.43**
Fixed income[1]	2.68	2.06	0.48	0.45	0.23	0.55
Balanced fixed income[2]	2.01	-7.14	-1.29	-2.43	-1.51	3.48
Balanced equity[3]	2.79	-22.21	-4.73	-9.02	-5.66	9.86
Euro equity[4]	6.05	-39.78	-10.04	-17.45	-13.02	23.34
International equity[5]	1.31	-41.71	-11.95	-20.82	-6.60	20.08
Fixed income guaranteed	2.80	3.29	0.80	1.45	1.14	0.94
Equity guaranteed[6]	2.46	-2.61	0.42	1.50	1.11	0.85
Global funds	1.58	-8.64	-2.17	-3.88	-1.33	4.90
Passively managed[7]						16.50
Absolute return[7]						1.54

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:

1 To 1Q09: Short and long fixed income, international fixed income and money market funds. From 2Q09: Euro and international fixed income and money market funds.

2 To 1Q09: Balanced fixed income and balanced international fixed income. From 2Q09: Balanced euro fixed income and balanced international fixed income.

3 To 1Q09: Balanced equity and balanced international equity. From 2Q09: Balanced euro equity and balanced international equity.

4 To 1Q09: Spanish equity and euro equity. From 2Q09: Euro equity (including Spanish equity).

5 To 1Q09: International equity Europe, Japan, United States, emerging markets and others. From 2Q09: International equity.

6 To 1Q09: Guaranteed equity. From 2Q09: Guaranteed and partially guaranteed equity.

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

8 Annual return for 2007 and 2008 and non annualised quarterly return for each quarter of 2008 and 2009.

... while fund numbers fell more steeply, especially in equity categories.

The number of funds fell to 2,735 at end June, 177 fewer than in 2008, after a wave of mergers in the intervening months (224 in all). Although the reclassification of fund objectives hinders comparison, it seems that decreases were mainly bunched in equity categories.

The liquidity of instruments held in investment fund portfolios is controlled by three distinct means:

The liquidity of investment fund holdings is a supervisory priority for the CNMV in today's complex landscape. The agency uses three sets of measures to track funds' portfolio liquidity: an estimation of the overall volume of less-liquid assets; controls on the quality and appropriateness of the information managers offer their unitholders; and checks that the underlying structures of guaranteed funds match adequately with market conditions, with special attention to guaranteed fixed-income funds.

...1) quantifying exposure to less-liquid assets (8.7% of the investment fund total); in this case largely unchanged over the last six months,...

Our estimates put the volume of less-liquid assets at around 14.58 billion in the second quarter of 2009, almost 900 million down on the figure for year-end 2008. The relative weight of these assets varied only a little (8.7% of total investment fund assets in June 2009, compared to 9.1% in March 2009 and 8.6% in December 2008). Of the total volume of less-liquid assets, about 43% are securitisation-related. A further 31% are financial fixed-income instruments rated below AA, and the other 24% are financial fixed income in the AAA/AA bracket (see table 14). To the relative stability of this variable over time we can add the lower concentration of less-liquid assets among the managers most exposed.

...2) verifying the quality of the information given out to unitholders, and ...

In the last six months, the CNMV has been especially attentive to the quality of manager information to unitholders about their exposure to assets caught up in the liquidity crisis, basically through periodic reporting (coinciding with the entry to force of new rules on the contents of CIS reports).

...3) checking that the underlying structures of guaranteed funds are correctly aligned with financial market conditions.

It has also issued specific guidelines to the managers of fixed-income guaranteed funds to ensure that their underlying structures are adequately matched to the conditions prevailing in certain private fixed-income market segments. Promoters have accordingly established financial collateral in the form of cash or government debt securities, over and above the standard third-party guarantee, to be exercised in the event that the fund is obliged to sell off assets at a market price lower than their valuation for NAV purposes. This collateral stands as a supplementary level of protection that should serve to smooth out fund volatility

Estimated liquidity of investment fund assets

TABLE 14

Type of asset	Less-liquid investments					
	Million euros			% total portfolio		
	Nov 08	Mar 09	Jun 09	Nov 08	Mar 09	Jun 09
Financial fixed income rated AAA/AA	456.8	3,062.6	3,504.4[1]	2.9	18.3	19.0
Financial fixed income rated below AA	4,520.6	4,639.2	4,504.1	35.1	40.4	37.4
Non financial fixed income	128.7	396.3	260.7	3.1	8.9	5.4
Securitisations	10,351.7	7,309.3	6,314.4	88.4	81.1	78.6
AAA-rated securitisations	8,183.7	5,291.8	4,491.1	86.7	79.5	76.3
Other securitisations	2,168.0	2,017.5	1,823.3	95.3	85.6	84.9
TOTAL	**15,457.8**	**15,407.5**	**14,583.6**	**34.9**	**36.9**	**33.6**
% of investment fund assets	**8.6**	**9.1**	**8.7**			

Source: CNMV.

1 Of this amount, 2.18 billion correspond to government-backed issues.

The short-term outlook for the collective investment industry is rather brighter than in past quarters. Although the adverse macroeconomic and financial conditions mean there is less money to invest, there are signs that higher-risk instruments are regaining some of their lost popularity as agent uncertainties subside. Also, the bank deposits that for the last two years have been taking funds away from collective investment now offer significantly lower interest rates, making them less attractive for the investor public. This being so, and given that fund liquidity conditions have held up well, it is reasonable to expect that the redemption wave will continue to abate.

In a setting of less risk aversion and more abundant liquidity, the pace of redemptions may continue to slow in coming months, as more investors switch out of lower-earning bank deposits.

Real estate collective investment schemes

The situation of real estate schemes has been complicated by a continuous stream of redemption orders, which some funds are having difficulties in meeting, due to their intrinsic nature (investing in less liquid assets) and the downturn in the housing market.

The scale of redemption orders remains a major headache for real estate investment schemes.

The surge in withdrawals has led some managers to modify their redemption conditions. Two real estate schemes, one of them a major, have approached the CNMV so far this year requesting the suspension of redemptions due to their inability to meet current orders. Other funds have been able to avoid this step thanks only to the support received from managers' financial parents.

Some have had to amend their redemption conditions while others have turned for support to their managers' financial parent institutions.

In this context, the number of real estate funds dropped from nine to eight over the first half of 2009. Their assets contracted to 6.55 billion euros, almost 860 million less than at end 2008, and unitholder numbers shrank by 6,900 to fewer than 90,000. Fund returns were again negative (for the third quarter in a row) in line with the falling prices of real estate assets. That said, second-quarter returns were less steeply negative than those of the preceding quarters (see table 15).

Further decline in the number, assets and unitholders of both real estate funds...

The same nine real estate investment companies stayed in business over the first half of 2009, though their assets shrank to 258 million euros (372 million in 2008) and unitholder numbers fell to 770 (937 at end 2008).

...and real estate investment companies).

The short-term outlook for this CIS sector remains clouded by uncertainty. The pace of redemptions might slow in the course of the year, as has happened with other forms of collective investment, and this would especially benefit those that have struggled most to preserve their liquidity. However, there is little likelihood of any large-scale inflow of cash, at least until the real estate market issues clear signals that its adjustment process is safely over.

The outlook for these CIS will remain conditioned by the duration and intensity of the downturn in Spanish real estate.

Main real estate fund variables TABLE 15

					2008		2009	
	2005	2006	2007	2008	III	IV	I	II
FUNDS								
Number	7	9	9	9	9	9	9	8
Unitholders	118,857	150,304	145,510	96,361	135,307	96,361	95,284	89,461
Assets (million euros)	6,476.9	8,595.9	8,608.5	7,406.9	8,166.7	7,406.9	6,758.1	6,547.2
Return (%)	5.35	6.12	5.30	0.65	0.35	-1.71	-4.5	-1.23
COMPANIES								
Number	6	8	9	9	8	9	9	9
Unitholders	256	749	843	937	938	937	938	770
Assets (million euros)	213.9	456.1	512.9	371.9	363.8	371.9	369.1	258.0

Source: CNMV.

Hedge funds

After its initial growth spurt as of end 2006, the hedge fund sector entered a contraction phase in the third quarter of 2008 which has left the funds of funds segment in a worse condition.

After the growth spurt that followed its end 2006 launch, market turmoil, borrowing constraints, the illiquidity of certain investments and temporary restrictions on short selling sent the hedge fund industry into a phase of decline (in terms of assets and unitholders) as of the third quarter of 2008, albeit with a divergent performance from hedge funds and funds of hedge funds. The former were harder hit by the negative performance of foreign CIS investees, as well as registering a large spate of investor withdrawals. The latter also lost business, but at a far slower rate, and even managed to grow their assets and unitholder numbers in the second quarter of 2009, as one of the few industry segments obtaining positive net subscriptions.

Specifically, funds of hedge funds have been labouring under the negative performance of foreign investees as well as struggling to cope with large-scale redemptions. The result is that over half their number are currently in liquidation.

Although the number of funds of hedge funds at June 2009 was unchanged with respect to end 2008 (40 schemes), 21[16] had been forced to wind up by the end of the period[17], unable to cope with the scale of redemptions, while another five had issued at least one significant event notice on receiving sell orders on over 20% of their assets. Unitholder numbers fell from 8,516 at end 2008 to 5,630 in June 2009. Fund of hedge fund returns, however, fought back to positive territory after the red numbers of the first quarter, caused by the poor showing of foreign investees.

Hedge funds too have faced large withdrawals but have generally held up better, to the extent of capturing net subscriptions in the second quarter.

Meantime, 26 hedge funds remained on the register at mid-year 2009 (two more than at end 2008). Of this number, five were in liquidation and another four had notified at least one significant event for redemption orders exceeding 20% of their assets. Unitholder numbers continued to move in the same 1,500 to 1,600 interval as in the last 12 months, while their assets closed the first half at 480 million euros, compared to the 539 million of December 2008. The encouraging note came from a second-quarter upswing in both assets and unitholder numbers, breaking with the downward trend of the previous six months.

Despite the prevailing uncertainty, the timid normalisation of market conditions could prevent greater setbacks in 2009.

The outlook for the hedge fund industry remains fairy unsettled. The number of schemes in liquidation suggests asset volumes have further to fall, especially among funds of hedge funds. But once this process is over, the flow of redemptions may slow (as seems to be happening in the hedge funds segment), which, together with some normalisation of financial markets, could provide a backstop for the sector in 2009 and even permit a mild expansion in 2009.

Main hedge fund variables TABLE 16

	2007	2008				2009	
	IV	I	II	III	IV	I	II[1]
Funds of hedge funds							
Number	31	38	39	41	40	40	40
Unitholders	3,950	5,488	8,582	9,739	8,516	5,646	5,630
Assets (million euros)	1,000.0	1,129.6	1,389.6	1,427.5	1,021.1	775.2	759.8
Return[1] (%)	1.22	-2.31	2.2	-7.56	-9.89	1.34	1,733
Hedge funds							
Number	21	25	23	25	24	26	26
Unitholders	1.127	1.335	1.429	1.583	1.589	1.551	1.602
Assets (million euros)	445.8	546.3	603.9	597.7	539.4	451.4	480.0
Return[2] (%)	-1.31	-1.95	1.48	-0.29	-3.59	-0.4	0.08

Source: CNMV.

1 Figure for April.

2 Non annualised quarterly return. Second-quarter returns are those for April restated on a quarterly basis.

16 Accounting for around a third of fund of hedge fund assets as at April 2009.

17 Of this number, 10 have not signed a liquidation agreement but have advised the CNMV of their plans to do so.

Exhibit 5: Comparison between the proposed EU Directive on alternative investment fund managers, the IOSCO principles and Spanish regulations

Main arguments of the Proposal for a Directive on Alternative Investment Fund Managers

In the light of the current financial crisis and the debates now proceeding in leading European and international forums (G-20, IOSCO, Financial Stability Forum, etc.), the European Commission published a proposed Directive on 30 April last in order to harmonise requirements for the entities managing and administering alternative investment funds (AIFs), in the process obtaining vital information for the monitoring and control of systemic risk. AIFs are defined as funds outside the regulatory scope of Directive 85/611/EEC (UCITS Directive). The term, as such, includes hedge funds, private equity funds, real estate funds, commodity funds, infrastructure funds and, in general, any fund not falling within the remit of the UCITS Directive.

The proposed Directive applies to alternative fund managers (AIFM) rather than AIFs per se. Under its terms, AIFMs must be authorised by a competent authority and be equipped with risk control and management mechanisms, rules of conduct and arrangements for the valuation and safe-keeping of assets, as well as complying with a series of transparency obligations towards their investors and the competent authority. Additional obligations will apply to AIFMs managing leveraged AIFs and controlling stakes in companies.

Under its terms, an AIFM authorised in its home Member State can market its AIFs to professional investors (as per the MiFID definition) in any other EU Member State. However, it makes no provision for their sale to the retail public, leaving rights on this point in the hands of each national regulator. AIFMs may, moreover, manage AIFs established in other Member States (manager passport).

It is also envisaged that EU-headquartered AIFMs may manage and market AIFs domiciled in third countries (offshore funds) after a three-year transition phase starting from the Directive's transposition deadline. This same transition period will apply to third-country AIFMs which will be able to market their funds in Europe on condition that the regulatory framework and cooperation with European supervisors are commensurate with the corresponding provisions of the Directive, and that European managers enjoy comparable access to that country's market.

Current Spanish regulations on AIFMs and impact of the proposed Directive

Most of the measures referring to hedge funds in the proposed Directive have already been implemented in Spain through Royal Decree 1309/2005 of 4 November. The specific rules applying to hedge fund managers are laid down in CNMV Circular 1/2006 of 3 May on alternative collective investment schemes, and are in some respects more stringent that those envisaged in the draft.

Venture capital funds and their management companies are regulated in Law 25/2005 of 24 November. It bears mention, however, that the proposed Directive imposes a series of transparency obligations on venture capital managers that do not currently apply in Spain.

The big novelty in national regulations will be the passport given to Spanish AIFMs (investment fund and venture capital managers) to manage AIFs established in other EU Member States or third countries. Another will be the possibility for the free marketing in Spain to professional investors of EU-headquartered AIFs, subject only to a notification to the competent home country authority, at the same time as national AIFs can be marketed in any other Member State following the same notification in Spain.

<u>IOSCO principles for hedge fund regulation</u>

In June 2009, IOSCO published a report on the hedge fund industry setting out the six principles which it believes will help national regulators to address the regulatory and systemic risk posed by hedge funds in their own jurisdiction while supporting a globally consistent approach. These principles were prepared by a working group set up by the G-20 in November last year.

Among the group's recommendations was that hedge funds and/or hedge fund managers should be subject to mandatory registration. This would involve fulfilling a series of regulatory requirements vis à vis organisational and operational standards, conflicts of interests and other conduct of business rules, disclosure to investors and prudential regulation.

Also, the prime brokers and banks that provide funding to hedge funds should be subject to mandatory registration and have in place appropriate risk management and control systems to monitor their counterparty credit risk exposures to the sector. Both hedge funds and prime brokers should provide regulators with information for the purpose of controlling systemic risks, including the identification, analysis and mitigation of the same.

IOSCO also calls on regulators to encourage and take account of the development, implementation and convergence of industry good practices, where appropriate. They should cooperate and share information in order to facilitate efficient and effective oversight of globally active managers and funds and to help identify systemic, market integrity and other risks arising from the activities or exposures of hedge funds in their cross-border operation.

All of these IOSCO-promoted principles have found their way into both the draft Directive (within its scope of application) and the relevant Spanish regulations.

4.2 Investment firms

The more settled business environment has yet to make itself felt in investment firm income statements...

The investment firms providing a range of securities investment services should expect to see some benefit from the normalisation of conditions on financial markets. Despite this, sector income statements have yet to show any sizeable improvement on the standards of preceding quarters. The only encouraging signal is a levelling-off of the decline affecting main income captions.

...though some fee items are deteriorating to a smaller extent.

The weakness of financial market turnover in the year's opening months and the downturn in collective investment continue to erode the industry's main revenue streams. In the case of broker-dealers, the increase in primary market issues, especially the government-backed issues of financial institutions, has provided some relief in placement and underwriting income though year-on-year comparison still shows negative.

Broker-dealers obtained aggregate pre-tax profits of 176.4 million euros in the first six months of 2009, 41.5% less than in the equivalent period of 2008[18]. Leading the decline was gross income (-62.8%) with fees (-21.7%) and results of financial investments[19] (see table 17) both contributing on the negative side. Operating expenses, meantime, fell with rather less intensity (-21.7%).

The aggregate pre-tax profits of broker-dealers to mid-year 2009 (176 million euros) are 42% down on the year-before figure...

Under fees and commissions, key first-half developments were the moderation of order processing and execution income, which closed the period at 274.3 million euros (-20.2% year on year) and CIS marketing income, which came to 27.5 million (50.5% down on the same period in 2008). Note that the first-above item maintains its primacy, weighing in at 70% of total investment firm fee income. Fees from distribution and underwriting stood at 21.6 million euros, a reduction of 14% versus 2008. In this case the rate of decrease has apparently slowed thanks to the recent pick-up in primary market activity. Finally, note the large inflows reported for investment advising[20], totalling 28.6 million euros in the first-half period.

...due to falling fee revenues and results of financial investments. Fees from market trades and CIS marketing dropped more steeply, but those from issue distribution and underwriting reduced their rate of decrease.

Broker income statements have suffered an even larger dent. Aggregate profits in the first six months were down to almost nothing (144,000 euros), compared to the 16 million euros obtained to mid-year 2008. Aggregate gross income closed at slightly over 65 million euros (-25.5% year on year), just covering the sector's almost 62 million euros in operating expenses. Depreciation and amortisation, provisioning and tax expenses did the rest, leaving the bottom line as stated.

Broker income statements fared even worse, with income only just sufficing to cover operating costs.

The fee income of brokerage firms amounted to 72.3 million euros, 24.0% less than in the same period in 2008. Although the aggregate income caption in table 17 below evidences a year-on-year decline of some intensity, we can point to some important differences with respect to the broker-dealer group. To start with, order processing and execution fees dropped by 11.1% in the first six months, contrasting with last year's fall of over 51%. And the story with CIS marketing fees is broadly similar (-42.7% in the first half of 2009 against -57.4% in full-year 2008). Conversely, fees associated to primary market issuance fell considerably more sharply, while portfolio management income kept up a steady decline to close the period at 9.3 million euros.

Broker fee income was 24% down on the year-ago figure, though the pattern of decline was rather different.

18 2009 statistics for investment firms are not fully comparable with the prior year, because of accounting changes introduced in December 2008. These derived from CNMV Circular 7/2008 of 26 November adapting investment firm accounts to the new framework established in the National Chart of Accounts.

19 These results are not fully comparable with the former "Results on securities transactions" caption, as their content has been modified in line with new valuation standards.

20 Inter-year comparison is ruled out by accounting changes.

Aggregate income statement (Jun 09[1])

TABLE 17

Thousand euros	Broker-dealers			Brokers		
	Jun 08	Jun 09	% change	Jun 08	Jun 09	% change
1. Net interest income	22, 373	98, 211	339.0	6, 039	1, 679	-72.2
2. Net fee income	368, 472	263, 558	-28.5	82, 530	63, 582	-23.0
2.1. Fee income	501, 817	393, 081	-21.7	95, 111	72, 250	-24.0
2.1.1. Order processing and execution	343, 910	274, 323	-20.2	33, 728	30, 001	-11.1
2.1.2. Distribution and underwriting	25, 112	21, 567	-14.1	3, 010	1, 081	-64.1
2.1.3. Securities custody and administration	11, 477	7, 911	-31.1	394	166	-57.9
2.1.4. Portfolio management	9, 893	4, 858	-50.9	11, 966	9, 284	-22.4
2.1.5. Design and advising	12, 781	28, 642	124.1	1, 550	1, 033	-33.4
2.1.6. Search and placement	9	6	-33.3	0	0	-
2.1.7. Margin trading	7	10	42.9	0	3	-
2.1.8. Fund subscriptions and redemptions	55, 621	27, 509	-50.5	17, 156	10, 010	-41.7
2.1.9. Others	43, 007	28, 256	-34.3	27, 307	20, 673	-24.3
2.2. Fee expense	133, 345	129, 523	-2.9	12, 581	8, 668	-31.1
3. Result of financial investments	973, 352	51, 163	-94.7	-926	102	-
4. Net exchange income	-252, 335	-5, 750	97.7	-230	113	149.1
5. Other operating income and expense		6, 132	-		-382	-
GROSS INCOME	1, 111, 862	413, 314	-62.8	87, 413	65, 094	-25.5
6. Operating expenses	236, 825	185, 524	-21.7	73, 205	61, 891	-15.5
7. Depreciation and other charges	23, 822	5, 143	-78.4	4, 226	1, 249	-70.4
8. Impairment losses[2]	573, 826	36, 436	-93.7	437	16	-96.3
NET OPERATING INCOME	277, 389	186, 211	-32.9	9, 545	1, 938	-79.7
9. Other profit and loss	24, 322	11, 395	-53.1	6, 374	110	-98.3
PROFITS BEFORE TAXES	301, 711	197, 606	-34.5	15, 919	2, 048	-87.1
10. Corporate income tax	0	21, 165	-	0	1, 904	-
PROFITS FROM ONGOING ACTIVITIES	301, 711	176, 441	-41.5	15, 919	144	-99.1
11. Profits from discontinued activities		0	-	-	0	-
NET PROFIT FOR THE YEAR	301, 711	176, 441	-41.5	15, 919	144	-99.1

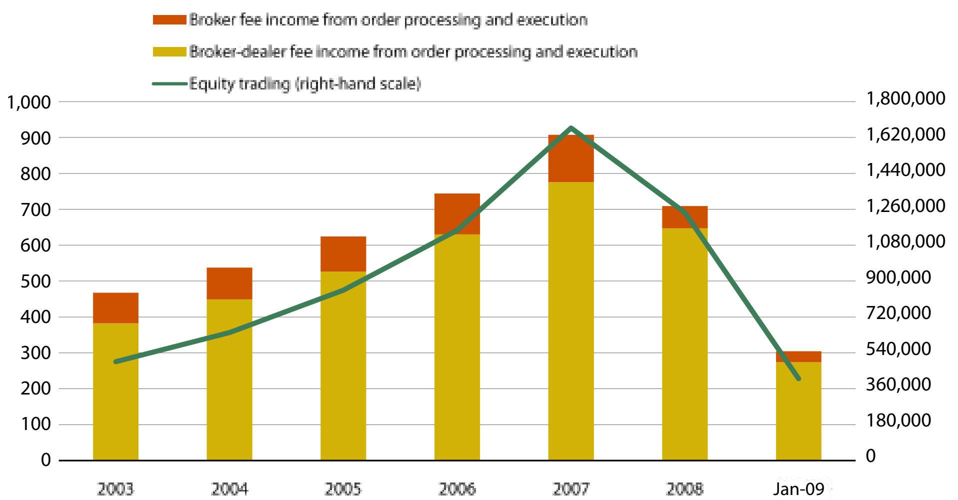
Source: CNMV.

1 Except one firm that only had data to May on the closing date for this report.

2 As of 2008, this caption includes the amount of "Net losses from capital loss provisions".

Investment firm fee income from order processing vs. trading on national equity markets (million euros)

FIGURE 11

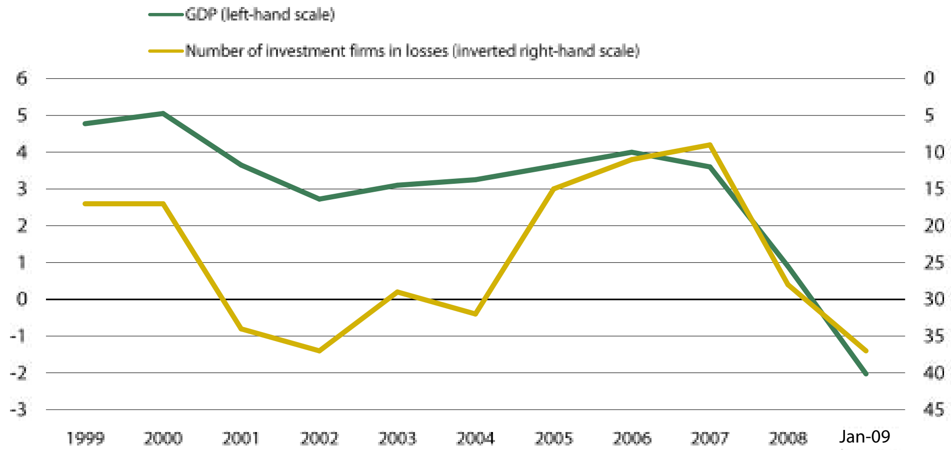


Source: CNMV. Aggregate 2009 data from January to June.

The continuing downturn in the investment services business pushed a growing number of firms into losses between December 2007 (with just two firms in this situation) and the first quarter of 2009 (44 firms). However this trend has halted in the second quarter, when the number of entities in losses dropped back to 37[21] (out of a total of 109), breaking down 23 brokers, 12 broker-dealers and two portfolio management companies. The aggregate losses of this group amounted to 7.3% of investment firm earnings (4.1% in December 2008 and 12.0% in March 2009).

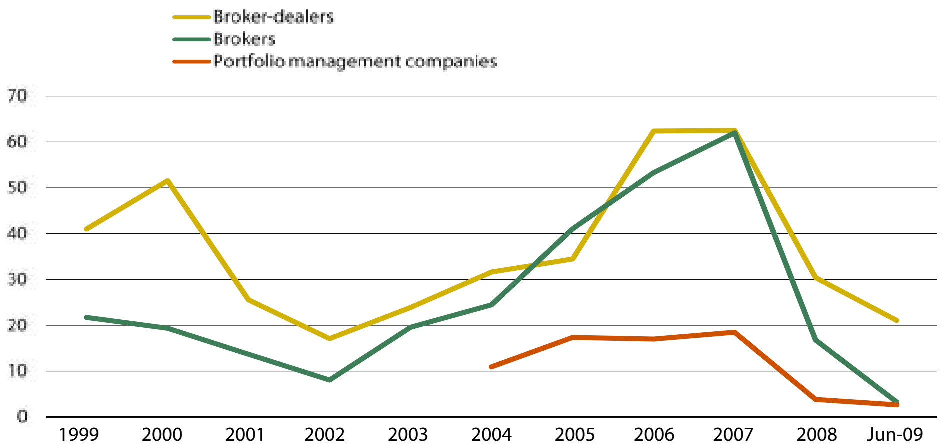
The business contraction in investment services has pushed up the number of firms reporting losses since December 2007...

Number of investment firms in losses vs. GDP (% annual change) FIGURE 12



Source: CNMV and Spanish Statistics Office (INE). The GDP rate for the second quarter corresponds to the average year-on-year rates of the past four quarters.

ROE before taxes FIGURE 13
Broker-dealers, brokers and portfolio management companies



Source: CNMV and authors. June 2009 ratios on an annual basis.

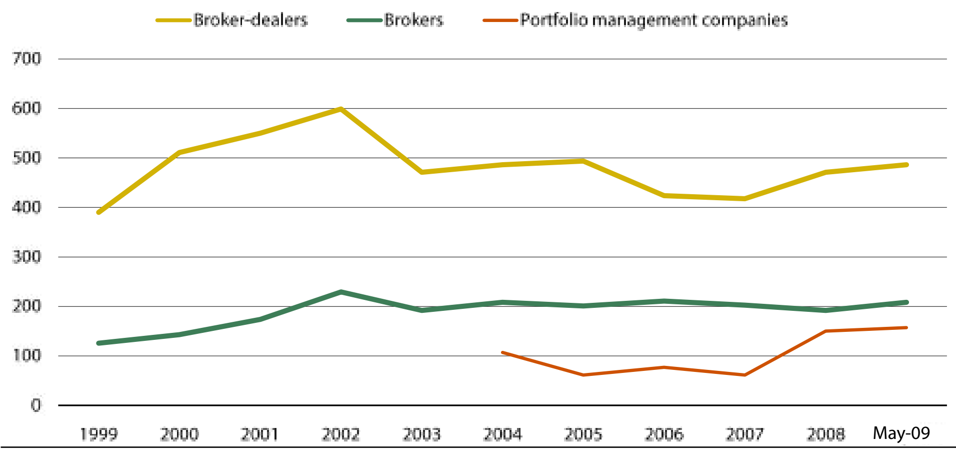
The downturn in activity made fresh inroads into the return on equity (ROE) of these financial intermediaries in the first half of 2009, with earnings decline and the strengthening of own funds both contributing on the downside (see figure 13). More specifically, the ROE of broker-dealers receded from 30.4% in December 2008 to 21.1% in June 2009. And the difference was even greater among the broker contingent, whose ROE slumped from 16.8% to 3.3%.

...and made large inroads into sector profitability ratios.

21 Data for one firm was not available at the closing date for this report.

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

FIGURE 14



Source: CNMV and authors.

In contrast, firms have strengthened their solvency to some degree by taking more earnings to reserves.

Investment firm solvency levels have improved somewhat in recent quarters, as those in profit have taken most of their surplus to reserves in order to strengthen equity. Hence the equity of broker-dealers was almost six times surplus to the mandatory requirement in May 2009 (figure 14), while that of brokers stood over three times higher. Only two firms (brokers and not market members) reported a deficit of own funds, while those running more tightly adjusted margins (below 50%) dropped from 10 in December 2008 to 7 in May 2009.

The near-term future is looking a little brighter thanks to the rise in equity prices and financial fixed-income issuance, though some firms could still face difficulties.

The short-term outlook for investment firms is rather less discouraging than in previous quarters given the recovery of stock market prices and the tentative revival remarked on in financial fixed-income issuance. This view is also endorsed by the smaller number of operators reporting losses. Most firms, moreover, are strongly enough capitalised to ride out a longish run of losses. This is a heterogeneous industry, however, and any added deterioration in the business environment could see some firms struggling to stay ahead.

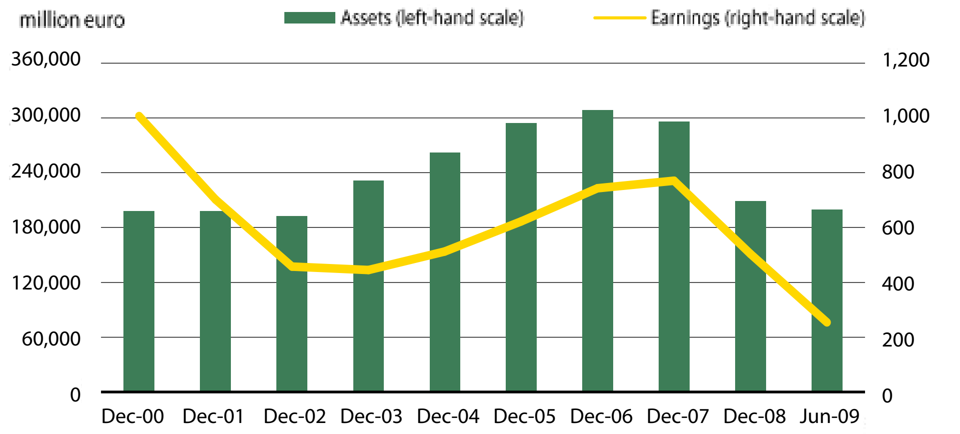
4.3 Collective investment scheme management companies

Assets under management continued to contract in the first half of the year (though the decline was less than in previous quarters)...

Aggregate figures for CIS management companies for the first half of 2009 put their assets under management[22] at just over 199 billion euros. Although this is 9.60 billion less than in December 2008, the rate of decrease has eased considerably (assets under management at these institutions fell by almost 87 billion over full-year 2008). After three years of decline, the volume of assets under management is back to the levels in place at the start of the decade (see figure 15).

22 Data for three management companies were not available at the closing date of this report.

CIS management companies: assets under management and pre-tax profits[1] FIGURE 15



Source: CNMV and authors. June 2009 ratios on an annual basis.

1 Annualised 2009 profits.

This decline in assets has eroded the fee income earned by fund management companies and taken a heavy toll on their aggregate profits. Specifically, the sector's (annualised) pre-tax profits closed the first-half period at 253 million euros, around half what they were in full-year 2008 (see table 18). The number of CIS management companies declaring losses jumped from 34 at end 2008 to 39 last June (out of a total of 120).

...taking a large slice out of management company profits...

Aggregate returns on equity dropped from 34% in 2008 to 17.3% in the first half of 2009 (in annual terms), due to the decline in sector earnings, while equity levels held flat after rising significantly over 2008.

...and, finally, a severe drop in profitability.

On current prospects for the performance of managed investment funds (with assets holding up or else falling slightly), the number of loss-making management companies is likely to stay at current levels, signalling some excess of sector capacity. This circumstance, along with the likely redrawing of the credit institution map (with almost half of all managers belonging to financial groups) and extension of the Community manager passport to foreign groups with a presence in Spain, suggests sector restructuring may be not long in coming.

The consolidation of excess capacity (given current expectations for assets under management), and the need for strategic decisions by parent companies, could herald a degree of sector restructuring.

CIS management companies: pre-tax profits and ROE TABLE 18

Million euros

	Profit before taxes	ROE before taxes (%)
2001	701.7	72.9
2002	457.1	50.1
2003	445.4	50.1
2004	512.2	57.3
2005	622.8	66.2
2006	744.0	68.9
2007	771.1	60.5
2008	503.5	34.0
June 09[1]	253.5	17.3

Source: CNMV.

1 Pre-tax profits and annualised ROE.

CIS management companies: assets under management, management fees and fee ratio

TABLE 19

Million euros

	Assets under management	CIS management fee income[1]	Average CIS management fee (%)	Fee ratio (%)[2]
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	209,020	2,302	1.10	70.8
June 09	199,397	1,675	0.84	70.2

Source: CNMV.

1 2009 data on an annual basis.

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

4.4 Other intermediaries: venture capital

The number of venture capital entities registered with the CNMV has increased anew in 2009.

The CNMV's register of venture capital entities (VCEs) recorded twelve new entries between end 2008 and 31 August 2009. Of this number, five were venture capital funds, another five were venture capital companies, and the remaining two were venture capital management companies. A further five entities left the register over this same period (see table 20), leaving the number of operators at 329.

Movements in the VCE register in 2009

TABLE 20

	Situation at 31/12/2008	Entries	Retirals	Situation at 31/08/2009
Entities	**322**	**12**	**5**	**329**
Venture capital funds	95	5	1	99
Venture capital companies	154	5	3	156
Venture capital fund managers	73	2	1	74

Source: CNMV.

Venture capital fund assets dropped by 6.9% between 2007 and 2008...

Annual statistics on the entities registered with the CNMV put the total 2008 assets of venture capital funds at 2.58 billion euros, representing a 6.9% reduction on the total for 2007 (see table 21). The distribution of assets across investor groups is not entirely comparable between 2007 and 2008 due to accounting changes in the information entities supply to the CNMV[23]. Confining ourselves to items that admit inter-year comparison, we find that credit institutions (particularly savings banks) are again the largest corporate owners of fund assets, with a share of 23% just slightly down on the 26.6% of 2007. Next come the public authorities, holding 11.2%, while natural persons again account for a minority share of 7.0%.

...while the capital of venture capital companies contracted by something close to 30%.

Venture capital companies, meantime, closed the year 2008 with share capital of 3.65 billion euros, 30% down on the level of one year before. Non financial companies remain the largest subscribers, although their relative weight has dropped from 48% to 41%, while credit institutions (banks plus savings banks) conserve a similar share of around 25%.

23 CNMV Circular 11/2008 of 30 December on accounting standards, annual accounts and confidential disclosures of venture capital entities.

VCEs grew their total assets 3.5% in 2008 as far as 11.94 billion euros, breaking down 80% companies and 20% funds. Note however that this increase owed exclusively to new entities entering the register (otherwise total assets would have fallen by around 300 million euros). Around 6.82 billion of the 2008 total was invested in venture capital activities, 9.5% less than in 2007, of which amount 82% came from venture capital companies and the remainder from funds. Among the year's new-start entities, the same investment breakdown was 69% from companies and 31% from funds. Sector leverage (calculated as long-term payables to total liabilities) jumped from 0.7% in 2007 to as far as 2.2% in 2008. Most of this difference traced to venture capital companies which increased their leverage from 0.9% to 2.7%, while fund leverage remained unchanged at a negligible 0.1%. The leverage of new-start entities was zero in the case of funds and 5.4% in the case of companies.

The assets of venture capital entities rose 3.5% in 2008 to 11.94 billion euros, due exclusively to new firms entering the register. The sector's overall leverage increased from 0.7% in 2007 to 2.2% in 2008.

Venture capital entities: assets by type of investor

TABLE 21

Million euros

	Venture capital funds		Venture capital companies	
	2007	**2008**	**2007**	**2008**
Natural persons				
Residents	237.79	181.45	182.56	46.90
Non residents	0.18	1.15	1.05	0.26
Legal persons				
Banks	134.22	191.17	1,026.03	466.35
Savings banks	603.30	398.70	307.17	422.05
Pension funds	266.85	266.43	26.62	24.20
Insurance undertakings	61.97	55.67	17.53	15.73
Broker-dealers and brokers	0.03	0.00	3.22	0.88
CIS	58.86	31.93	40.44	9.70
National venture capital entities		27.63		39.49
Foreign venture capital entities		123.65		7.98
Public authorities	331.46	289.10	134.48	120.41
Sovereign funds		20.27		
Other financial companies	512.83	252.19	684.06	679.63
Non financial companies	280.47	367.00	2,512.33	1,500.38
Foreign entities		286.04		32.69
Others		85.58		282.91
Academic institutions[1]			1.22	
Stock exchanges[1]			0.62	
Others[1]	264.92		289.92	
Available realised gains[1]	16.92		0.26	
TOTAL	**2,769.81**	**2,577.96**	**5,227.51**	**3,649.56**

Source: CNMV.

1 Items belonging to the old chart of accounts existing until 2007.

Data furnished by the Spanish industry association (ASCRI) for the first half of 2009 show a significant downturn in sector investment to 678 million, 49% less than in the year-ago period and back to the levels of 2004. Problems of access to bank finance tended to rule out any major takeovers (not one deal went through at over 100 million euros compared to two in 2008), and medium-size transactions were also fewer in number (14 transactions involving over 10 million euros capital versus 25 in the first half of 2008). Leveraged buy-outs, finally, numbered 12 in the period against 16 and 28 in first-half 2008 and 2007 respectively.

ASCRI data for the first half of 2009 show a large reduction in sector investment. Borrowing constraints are a dissuasory factor for large-scale operations...

Once more, borrowing constraints meant firms turned increasingly to expansion capital operations, which accounted for 47% of first-half investment and 59% of

...but are encouraging expansion capital deals and, generally, transactions requiring less leverage.

transaction numbers. Divestments in the period summed 269 million euros (316 million in the first half of 2008).

Credit constraints will go on dictating the amount and nature of sector investments in coming months, though liquidity, it appears, is not a problem.

Everything suggests that credit rationing will continue to dampen sector investment over the next few months, so the focus will stay on small and medium-size transactions placing fewer demands on funds. However, although finding cash is not easy in the current climate, venture capital entities have kept clear of liquidity problems and have the money on hand to go on investing substantially in the next few months.

5 Recent regulatory initiatives on short selling

5.1 Introduction

Regulator vigilance of speculative practices and their potentially destabilising impact prompted a widespread review of short selling regulations in the closing months of 2008...

World securities markets have been labouring since the start of the crisis under intense volatility. At times, this has been accompanied by price slumps in bank shares that have sown doubts in investors' minds about the viability of certain institutions.

In this context, some securities regulators identified speculative practices that could be the agent of destabilising spirals. The result was a review extending to all main markets on the rules governing short sales.

In most cases, supervisors' first reaction was an outright ban on naked short selling, when the seller does not actually own the securities being transferred. This was the case of the United States, France and Italy. Other countries opted for more restrictive measures. This was the case of the United Kingdom, which temporarily prohibited the building or expansion of short positions through any transaction modality. Most jurisdictions added new transparency requirements regarding significant short positions.

...concluding in outright bans (in some or all modalities) and/or the introduction of enhanced transparency requirements.

In Spain, naked short sales are prohibited by law. For this reason, the CNMV decided to reinforce its oversight by making it incumbent on market participants to disclose any short positions exceeding 0.25% in the stock of listed financial sector companies.

Recent months have brought new agreements under the auspices of IOSCO and CESR.

In general, the measures taken in different jurisdictions have lacked any common or consistent direction. However, recent agreements under the auspices of IOSCO and, above all, CESR have sought to achieve closer harmonisation of the rules governing short sales. In the following section we examine some recent advances in this regard.

5.2 IOSCO-sponsored initiatives

IOSCO calls for concerted regulatory action and a global approach, and puts forward the following principles and recommendations:

IOSCO set up a special task force to draw up guidelines or principles for the effective regulation of short selling. The organisation has called for concerted regulatory action to eliminate differences and develop a global approach to the short selling issue. The result is a document setting out four principles and a list of accompanying recommendations. These principles and recommendations are as follows:

a) Short selling should be subject to controls to reduce or minimise potential risks that could affect the stability of markets. To this end it recommends a strict settlement system, including the compulsory buy-in of failed trades that could disrupt the settlement process.

- short selling should be subject to controls,...

b) Short selling should be subject to a reporting regime that provides timely information to the market and market authorities. The recommendation here is adopt a specific disclosure regime for short positions and/or sales.

- communicated to the market and supervisors in a timely manner,...

c) Short selling should be subject to an effective compliance and enforcement system. To this end, supervisors should be empowered to proceed as follows: introduce regular monitoring and inspection of settlement incidents, require appropriate parties to maintain books and records of short sales (in jurisdictions with flagging systems in operation), require information from all market participants on their short selling activities, establish mechanisms to analyse the information obtained on short selling to detect potential abusive trading practices or systemic risk, and establish cooperation mechanisms with other regulators to facilitate investigation of cross-border cases.

- and come under an effective compliance and enforcement system,...

d) Regulations should allow appropriate exceptions for certain types of practice that facilitate efficient market functioning and development. In this respect it is important that market authorities clearly define the exempted activities.

- with exceptions for certain practices.

5.3 CESR-sponsored initiatives

Europe's supervisors slapped a series of (mainly temporary) restrictions on short selling at the height of market turmoil in late September 2008. These ran from simple disclosure requirements up to outright bans (in some cases, only of naked selling, and in other of all short sales). On September 22, the Executive Committee of CESR issued a resolution requiring the disclosure of all short positions of over 0.25% in the capital of listed financial sector companies and reiterating the prohibition on naked short sales of any exchange-traded shares.

European supervisors followed their emergency measures to restrict short selling, ...

5.3.1 Disclosure regime proposed by CESR

After months of deliberations, in late May 2009 CESR sent out a consultation document (in circulation till September 30) on the transparency standards to apply in a pan-European regime. Its proposal was, firstly, to prioritise disclosure measures in the regulation of short selling and, secondly, to provide the market with a harmonised reporting system that relieves participants of the cost of complying with different models. The text upholds each regulator's right to maintain or impose restrictive or limiting measures without closing the door to future agreements of a wider scope on the regulation of short sales activity.

...with a May 2009 agreement drawn up by the CESR on the transparency standards applicable to a Pan-European regime.

The model adopted by the CESR for the reporting and disclosure of short positions takes in the following elements:

The CESR proposal for the reporting and disclosure of short positions has the following main features:

1) **Disclosure thresholds.** The supervisor should be notified, without public disclosure, of any short positions between 0.1% and 0.5% of an issuer's share capital. Positions exceeding this upper threshold of 0.5% should be reported to the supervisor and will be communicated to the market, with disclosure of the

- Different disclosure triggers for short positions depending on the recipient (supervisor or market),

holder's identity. The supervisor will likewise be notified of any 0.1% step up or down after the initial disclosure requirement is triggered before and after reaching the second threshold of 0.5%, though only steps upward of 0.5% will trigger the public disclosure requirement. Thought went to the possibility that supervisors could regularly publish the aggregate sum of individual positions below 0.5%, without disclosure of identity, so the market could be apprised of the level of short positions in a given share, though this was finally ruled out for reasons of practical difficulty.

- though these may be modified in future if so desired.

CESR acknowledges that setting thresholds that are a perfect fit with all markets and jurisdictions is a complicated proposition (given the disparity of trading volumes, capitalisation and free float of listed stock) and that the percentages put forward might vary in future. However it chose these thresholds by reference to the experience of the regulators receiving the largest number of notifications (in the United Kingdom, Spain and France). In Spain, for instance, the average and median of initial holder disclosures were 0.43% and 0.32% respectively. It was also felt that thresholds should consist of an easy-to-remember figure; hence the choice of 0.5% for the public disclosure of short positions. In setting the 0.1% level the main consideration was to give the regulator an overview of those parties whose individual holdings were on too small a scale to merit disclosure to the market.

A flagging system was also considered, but was found to have two major drawbacks.

An alternative to this system would have been the flagging of short sales, whereby a flag is put on each short sale order a broker sends to the market for execution, and all such flags are aggregated by the regulator for eventual publication to the market. This system undoubtedly has its benefits as a way of tracking share price trends and providing the market and supervisors with real-time data on short selling, but it was also felt to have two major drawbacks. Firstly, the infrastructure required is extremely expensive (of all CESR members, only Greece currently operates a flagging system) and the extracost required would fall directly on market intermediaries. Secondly, the system does not provide information about outstanding short positions on a given share, nor does it factor shorting positions on OTC derivatives markets. Finally, the anonymity of the short seller that the flagging system confers would mean it is less effective as a constraint on aggressive short selling.

- Disclosure obligations apply to short positions on all listed companies in the European Economic Area.

2) **Notification and disclosure requirements apply to short positions in the stock of all listed companies in the European Economic Area (EEA)**. The above transparency regime extends to all issuers whose shares are quoted or have been admitted to trading on regulated markets or multilateral trading facilities (MTFs) within the EEA. There are no objective reasons to confine it solely to the financial sector (in effect, if we believe the mandatory reporting of short positions is a good thing for the market, it makes no sense to limit it to any given sector, even though the initial focus was on the financial sector due to the systemic importance of its component entities). The inclusion of MTFs is in order to prevent "regulatory arbitrage" and the competitive disadvantage posed to regulated markets if companies trading solely on MTFs were relieved of reporting requirements.

- Positions should be formulated in net terms (including cash and derivate products).

3) **The positions reported will invariably be calculated on a net basis and take in both cash positions and those in derivative products.** Although the document does not go into technical details, it is understood that positions in derivative instruments should factor the adjusted delta of each.

4) **Disclosure obligations will apply at the level of the legal entity**. The definition of "legal entity" for disclosure purposes will be decided after receiving the industry's feedback to the consultation paper. One option would be for disclosure to apply at the level of individual funds. It is likely, for instance, that various legal entities holding net short positions (funds, companies, etc.) will co-exist within an investor group. Another alternative would be to impose the disclosure requirement on the natural or legal person with decision power in respect of one or several legal entities (funds).

- Disclosure obligations to apply at the level of the legal entity.

5) **Short positions should be disclosed by the end of the trading day following the day on which the disclosure obligation is triggered**. Information on short positions must be notified to the regulator and conveyed to the market at the earliest opportunity. Delaying disclosures would lessen the value of the information and hinder investor decision-making and, where needed, the timely adoption of measures by the supervisory authority. The CNMV's experience to date regarding this timeframe (T+1) is fairly satisfactory, though it is necessary to keep an eye on compliance in cases where the holders of short positions begin to unwind them on dropping below the trigger level for disclosure. It bears mention that the proposed disclosure regime neither can nor aspires to offer information on intraday short positions. A real-time reporting system capturing intraday positions (similar to the flagging system) would be costly and difficult to implement without any assurance that the data provided offer an accurate picture of the level of short positions in a given share.

- Positions should be disclosed, at the latest, during the trading day after the day on which disclosure is triggered.

6) **Only market makers and similar entities are exempt from disclosing short positions when engaged in market making functions.** The functions of a market maker are set out in the consultation paper (although solely for illustrative purposes). Some countries contend that exemption should be extended to other forms of liquidity provision comparable to market making, while the CNMV's instinct is that the definition should not be made too all-embracing. CESR believes that market makers acting as such should be afforded a certain degree of flexibility in holding long and short positions. However, the consultation paper suggests that no exemption should apply to those found to be continually and systematically holding short positions at the close of the trading day.

- Only market makers and comparable entities may be exempt from reporting requirements.

7) **Disclosures should be made to the supervisor of the most relevant market in terms of liquidity**, in line with article 25.3 of the MiFID but contrary to the provisions of the Transparency Directive (article 21.1, home state authority criterion) vis à vis the reporting of voting rights. The argument here is that it would not be logical to have one competent authority for market supervision and investigative purposes and another for the reception of short position disclosures. The consultation paper also stresses the need for effective cooperation between supervisors.

- Disclosures should be sent to the supervisor of the most relevant market in liquidity terms.

8) **Finally, the public disclosure threshold is lowered to 0.25% when companies are raising capital**, on the grounds that such issuers require enhanced protection and on the evidence that attempts have been made in other jurisdictions to manipulate prices in this situation. The lower threshold of 0.1% is maintained for disclosure to the supervisor. These triggers may be subject to adjustment depending on the results of the consultation, particularly in the case of small rights issues which may be deemed not to require this added protection.

- The disclosure threshold is lowered to 0.25% on the occasion of rights issues.

The formal mechanics of disclosure will be decided once industry comments are in.

The paper also discusses the mechanics of disclosure, which will be finally decided once industry comments are in. The idea is to base the procedure on existing models so the reporting parties are spared any additional expenses, with main features as described below:

a) Responsibility for making the disclosure should rest with the position holder, although it would also be acceptable for an agent or broker to handle the procedure.

b) The disclosure should contain at minimum the identity of the short position holder, the identity of the issuer, the size or amount of the position held and the date on which the disclosure obligation came into being.

5.3.2 Other aspects: naked short sales, settlement incidents and emergency measures

CESR is concurrently working on another two aspects of short selling:

1) The design of contingency measures for supervisors in the event of an emergency, and

2) Analysis of naked short selling and its relationship with failures in transaction settlement.

CESR will go on looking into other aspects of short selling practices, in particular:

a) The design of contingency measures for supervisors to act on in the event of an emergency. These measures should at least allow the introduction of temporary disclosure requirements (over and above those stated in the proposal for a pan-European regime) and the possibility of imposing selective trading halts or other restrictions on naked or covered short sales. The triggers for activating these emergency measures would be, among others, evidence of "abusive" short selling, aggressive price falls in a given sector, a situation of severe losses in an issuer's shares which could pose a threat to financial stability or the existence of excessive volatility in a sector or share that could undermine confidence in the investment.

b) Analysis of the relationship between settlement incidents and short selling. In the CNMV's opinion, there are sufficient data to posit a direct relationship. Moreover, the settlement system employed by the Spanish market is especially conducive to this analysis, as opposed to other systems where the supervisor has to conduct an ad hoc study in every case.

5.4 Latest decisions by securities regulators

In summer 2009, rules on short selling were modified or extended in a number of major jurisdictions: SEC (United States), FSA (United Kingdom), CONSOB (Italy). SFC (Hong Kong) and AMF (France).

In summer 2009, rules on short selling were modified or extended in a number of jurisdictions. The most significant of these changes are discussed below.

In the United States, the SEC resolved on 27 July to make its temporary regulations permanent (Rule 204T, expiring 31 July). The rule in question attempts to limit any damage from naked short sales by obliging intermediaries to promptly borrow or arrange access to the securities deliverable in a flagged short sale. The idea is to dissuade agents from naked short selling. On the question of transparency, the SEC has announced that it is in talks with a number of market operators with self-regulation powers (Self Regulatory Organisations) to get them to post short sale figures on their websites.

The UK's FSA will shortly publish the opinions received in response to its consultation paper on short selling.

In Italy, the CONSOB retracted its view that securities from a securities loan could not serve as a deliverable in respect of short sale authorisation (de facto prohibition of naked sales), with effect as of 31 July. This interpretation is now only retained for sales taking place during a rights issue.

Hong Kong's SFC published a public consultation document on 31 July 31 on the subject of a disclosure regime for short positions (Hong Kong markets already operate a flagging system).

France's AMF has extended its September 2008 measures for 6 more months (to 31 January 2010), and has said that it will await the outcome of the CESR consultation before proposing a permanent regime. However, it has publicly stated its position on the contents of the future regulation, in particular its concern about the correlation between short selling and settlement failure. It also favours imposing the same settlement obligations on MTFs and regulated markets, and the conclusion of securities loan agreements between the short seller and lending entities prior to execution (naked short selling).

5.5 Conclusions: the future of short selling regulations

The consensus reached within CESR is a welcome first step towards a fully harmonised regime for the activity of short selling.

The consensus reached within CESR on a common pan-European transparency regime based on the private and public disclosure of short positions is an important step forward for future agreements. The tasks now must be to implement the proposed transparency regime and, at the same time, develop a scheme to harmonise remaining rules on short selling practices.

But although there is broad agreement over the benefits of short selling and the need for regulators to be able to restrict it in certain cases...

There are two common starting points that should aid progress towards this future regulation. Firstly, it is agreed that, under normal conditions, short selling is a beneficial activity[24], which contributes to efficiency and may help mitigate speculative bubbles. Secondly, it is accepted that supervisors should be empowered, in exceptional circumstances, to restrict or even ban short selling if it is deemed to pose a threat to financial stability or market integrity.

..there is still no clear view on how far to tolerate naked short sales.

At the core of the debate is how tolerantly to treat short selling in its naked modality. Many observers feel that this kind of trading may contribute to downward price spirals or failures in the settlement process. They also feel that the modality brings few benefits that could not be obtained through covered sales. Some take the opposite view, arguing that the stabilising effect of short sales is largely lost if principals have to pre-borrow the securities they are selling, and that we have ample mechanisms to ensure settlement discipline even in the presence of naked short sales. Spain's experience is that prohibiting naked short sales does not impair market efficiency, while it certainly limits the risk of settlement failure. Note, however, that the peculiarities of the Spanish settlement system, whereby transactions become firm at the point of trade, prevents us from drawing definitive conclusions about the effectiveness of naked short selling restrictions in mitigating settlement risk in the post-trade process.

24 For a fuller discussion about the benefits and drawbacks of short selling, see Rodrigo Buenaventura's article of the same name in the CNMV Bulletin for the fourth quarter of 2008.