I Securities markets and their agents: situation and outlook

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1 Executive summary

- Since the last instalment of this article, in the CNMV Bulletin for 1Q 2010, the international macro and financial environment has improved to some extent. World GDP growth reached almost 5% in the first half of the year fuelled by recovery among the developed economies and the strength of emerging markets. Inflationary pressures have remained subdued against a backdrop of high though stable unemployment.

- Some recent indicators have heaped new uncertainties on the baseline short-term scenario, which assumes a firming world recovery though with differences persisting between regions and countries. The biggest risks center on the sustainability of growth once extraordinary stimulus measures have been withdrawn, and the possible resurgence of tensions in European sovereign debt markets. On a positive note, the main emerging economies are proving both dynamic and resistant, while the upturn in world trade flows has resumed with force after the lull of the second quarter.

- The European sovereign debt crisis has taken its toll on international financial markets. This was especially true in the second quarter, with equity prices falling sharply and government yield spreads stretching wider in the most fiscally challenged countries. However, fiscal retrenchment plans in these economies, accompanied by structural reform measures, have averted a spiral of distrust with potentially grave consequences. The sovereign debt crisis has also hit hard at private debt issues, with European financial institutions among the worst affected. In currency markets, the resulting turbulence sent the euro falling sharply.

- Spanish GDP rose by 0.2% in the second quarter (-0.1% year on year) with household consumption as the main driver. In the short term, however, doubts persist about how solid this upswing really is, given that much of it may owe to consumers anticipating July's VAT hike and the expiry of government support schemes for car purchases. Inflation has inched higher since the start of the year as far as an August rate of 1.8% while unemployment continues to hover round 20% of the labour force. The public spending cuts approved last May, summing 15 billion euros over 2010 and 2011, will foreseeably steer the budget deficit back to 6% of GDP in 2011. Meantime, current forecasts for the Spanish economy point to a minor contraction in 2010 followed by moderate growth in 2011. Fiscal consolidation and other structural measures like the recent labour market reform package, allied with the results of the bank-sector stress tests conducted in Europe last July, have had a restorative effect on agent confidence. However, serious risks remain in the shape of labour market weakness and the volatile financing conditions suffered by public and private issuers alike during the last episode of the European debt crisis.

- The Spanish financial system continues to face a number of challenges, though the restructuring of the deposit-taking sector and the upkeep of sound capital adequacy means institutions are solidly equipped to negotiate the years ahead. In effect, Spanish banks' satisfactory results in the recent round of stress tests facilitated some improvement in their funding conditions during the third quarter of the year.

- Spanish non financial companies grew their aggregate profits 4% in the first half of 2010, as far as 14.7 billion euros. Profits growth extended to all sectors except construction and real estate. Listed company debt moved up 3.7% in the same period accompanied by a small upturn in financial leverage. Both debt coverage ratios and EBIT/interest expenses improved in the first-half period.

- National equity markets clawed back some of the ground lost to the start of the third quarter in a considerably less volatile trading climate. The P/E of the Ibex 35 has tended to pull into line with that of other European reference indices. Stock market turnover has been building up steadily year to date, although issuance has remained generally subdued despite the restart of some transactions.

- The Spanish government bond market has stabilised in the past two months after the turbulence of the first-half period, with yields falling moderately across all maturities. Meantime, the risk premiums of public and private borrowers have stabilised at relatively high levels. Gross fixed-income issues registered with the CNMV have receded 47% year to date, though the signs are of reactivation in certain segments such as covered mortgage bonds.

- Assets under management in Spanish investment funds dropped by 9% in the first-half period to 155 billion euros, with redemptions building up once more. In contrast, foreign UCITS marketed in Spain grew their investment volumes 28% to 32.36 billion euros. The weight of less-liquid assets in investment fund portfolios reduced from 8.7% to 7.4%. Despite a 7.5% decline in assets under management in UCITS management companies, their profits picked up slightly to mid-year 2010. The outlook for collective investment will continue to be complicated by intense competition from deposit-taking entities. The lessons for the industry are that managers must rationalise their fund offering and pursue greater efficiency in costs.

- Investment service providers continued to labour under the weight of the crisis, but with notable differences between types of firm and business lines. Broker-dealers saw their aggregate profits tumble 25% in the first-half period with non core activities as the main culprits. Conversely, the aggregate profits reported by brokers were almost three times higher than in 2009, with costs dropping faster than main revenue items. The result was that sector ROE declined once more, though less intensely than in 2009, while the number of firms in losses continued to augment. The sector remained comfortably compliant with solvency conditions to June 2010, with not one firm reporting a deficit to the statutory minimum (against more than five at the 2009 close). The prospects for the investment services industry seem a little brighter in view of the recovery under way in key business lines.

- The number of venture capital entities on the CNMV roll has continued to increase. Assets of venture capital funds moved up 16.5% in 2009, while the capital of venture capital companies was more or less unchanged. Data from industry association ASCRI point to a gathering recovery over first-half 2010. And, finally, the growth of leveraged transactions suggests that banks are starting to release more credit.

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

  - The first reviews the main novelties in U.S. securities market legislation enshrined in the Dodd-Frank Act, including new rules on OTC derivatives, hedge funds, securitisation, rating agencies and executive pay.

  - The second looks at the savings patterns of Spanish households focusing on recent changes in the mix, particularly the growing preference for bank products over investment funds and the boom in foreign savings instruments.

  - The third offers an analysis of Spanish stock market volatility, which concludes that despite the upswing experienced in early 2010 there is no evidence that the national market is structurally more volatile than other world bourses.

  - The fourth centres on the *flash crash* of 6 May last on the New York Stock Exchange, exploring the hypotheses about its causes and the mechanisms available to prevent a recurrence.

  - The fifth summarises the main features of the new disclosure regime for short selling approved by the CESR, which the CNMV has been the first to implement.

  - The last offers a brief description of the CNMV's recent published guidelines for investment firms on appropriateness and suitability testing in relation to retail clients.

2 Macro-financial setting

2.1 International economic and financial developments

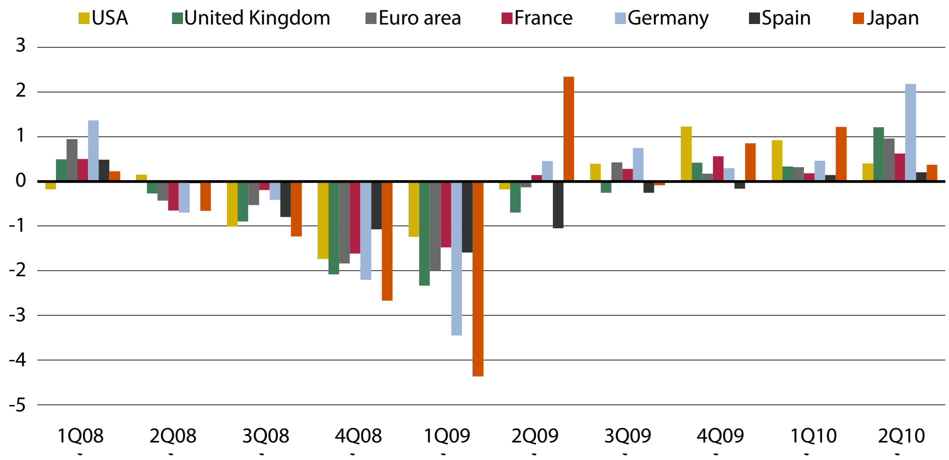
The world macro-financial setting has experienced some improvement though with differences persisting between national economies.

Since the last instalment of "Securities markets and their agents" in the CNMV Bulletin for the first quarter of 2010, the macroeconomic environment has been issuing clear improvement signals. And although differences persist between national economies, the overriding sensation has been one of a gathering recovery. Yet the surge in financial market volatility unleashed by the European sovereign debt crisis, which reached its maximum intensity in April-May, has cast a shadow of doubt over growth expectations for 2010 and 2011, especially in those economies whose fundamentals are weakest. More recently, the apparent slowdown of the U.S. economy has shaken confidence in the strength and sustainability of world recovery.

World GDP growth nears 5% in the first half of 2010.

World GDP grew near-on 5% in the first half of 2010 compared to the same period last year, according to IMF estimates. Driving this growth were output recovery among developed economies (see figure 1) and the continuing strength of the emerging economies, particularly Asia and some Latin American countries. Among the developed contingent, GDP expanded most strongly in the United States and in Germany, whose 2.2% year-on-year growth rate of the second quarter was primarily export-led, fuelled by quickening demand for German products and services in some of the world's most dynamic economies. This last group was again headed by China, whose GDP grew 10.3% in the first-half period. In Latin America, meantime, Brazil, Mexico and, lately, Chile have also been advancing strongly (with quarter-on-quarter rates in the second quarter of 1.2%, 3.2% and 4.3% respectively).

GDP: quarterly % change FIGURE 1



Source: Thomson Datastream.

Some recent output indicators have muddied the outlook for near-term growth.

The mixed nature of recent output indicators, which have at times sent out conflicting signals, adds a further dose of uncertainty to mid-term growth forecasts, for the U.S. and Japan especially. That said, the baseline scenario for leading international organisations remains one of ongoing world recovery over the next few quarters, though the pace will be moderate only and varying in intensity from one region to the next. Nor can the possibility be ruled out of temporary setbacks in the recovery of some economies. In this context, the latest IMF forecasts point to world GDP growth upwards of 4.5% in 2010 (4.3% in 2011). Leading the field will be the emerging economies, with output growth nearing 7% (see table 1). Among the developed nations, despite the uncertainties referred to earlier, the U.S. and Japan are tipped to expand in the interval of 2%-3%. Forecasts for the euro area, finally, point to more modest rates of just over 1% in 2010 and between 1.3% and 1.8% in 2011, as economies absorb the negative short-term impact of the fiscal adjustment plans in place.[1]

Gross domestic product (annual % change) TABLE 1

					IMF(*)		OECD(*)	
	2006	2007	2008	2009	2010F	2011F	2010F	2011F
World	5.1	5.2	3.0	-0.6	4.6 (+0.4)	4.3 (=)	-	-
United States	2.7	2.1	0.4	-2.4	3.3 (+0.2)	2.9 (+0.3)	3.2 (+0.7)	3.2 (+0.4)
Euro area	3.0	2.8	0.6	-4.1	1.0 (=)	1.3 (-0.2)	1.2 (+0.3)	1.8 (+0.1)
Germany	3.2	2.5	1.2	-5.0	1.2 (-0.3)	1.7 (-0.2)	1.9 (+0.5)	2.1 (+0.2)
France	2.4	2.3	0.1	-2.5	1.4 (-0.1)	1.6 (-0.2)	1.7 (+0.3)	2.1 (+0.4)
Italy	2.0	1.5	-1.3	-5.0	0.9 (+0.1)	1.1 (-0.1)	1.1 (+0.0)	1.5 (+0.0)
Spain	4.0	3.6	0.9	-3.6	-0.4 (=)	0.6 (-0.3)	-0.2 (+0.1)	0.9 (+0.0)
United Kingdom	2.9	2.6	0.5	-4.9	1.2 (-0.1)	2.1 (-0.4)	1.3 (+0.1)	2.5 (+0.3)
Japan	2.0	2.4	-1.2	-5.2	2.4 (+0.5)	1.8 (-0.2)	3.0 (+1.2)	2.0 (+0.0)
Emerging	7.9	8.3	6.1	2.5	6.8 (+0.5)	6.4 (-0.1)	-	-

Source: IMF and OECD.

(*) Figures in brackets show the change over the previous published forecasts. IMF, forecasts published in July 2010 (versus April 2010). OECD, forecasts published in June 2010 (versus November 2009).

Inflationary pressures remain muted.

The behaviour of prices suggests that inflationary pressures are generally under control. In the U.S. and euro area, concretely, year-on-year inflation stands between 1% and 2%. Where prices are rising faster is in the United Kingdom, due to one-off factors, but here too the rate stabilised at around 3% in the middle months. In Japan, deflation remains the order of the day, though the decline in prices is far less marked than in 2009. Underlying inflation rates have also stayed muted in most advanced economies, in tune with low capacity utilisation, still high unemployment rates[2] and the absence of significant pressures from the demand side. The result has been to keep official inflation rates in these economies running at historic lows.[3] Note, however, that a growing group of countries have hiked their interest rates since end-2009. First to do so were developed economies like Australia and Norway, strongly exposed to demand for specific commodities. Later other developed countries (Canada, Sweden, Switzerland and New Zealand) joined in the trend, and emerging nations like Brazil, Peru and Malaysia have begun to tighten up their monetary policy.

The sovereign debt crisis has hit hard at financial markets, especially in the second quarter…

The sovereign debt crisis in Europe had a sizeable impact on world financial markets in the first half of the year, especially the second quarter. Share prices fell heavily on main world indices accompanied by renewed jumps in volatility. The disruption was greatest on Japanese and European markets, with the German Dax the sole gainer among Europe's leading stock indices[4] (5.1%). For the rest, losses ranged from the 1.1% of Euronext to the 10% of the Ibex 35 (see table 2). U.S. markets, lastly, managed small advances in the reference period (from the 0.9% of the S&P 500 to the 1.4% of the Dow Jones and Nasdaq).

1 In light of the fiscal adjustment plans adopted in 2010, the IMF estimates that the extent of retrenchment among euro economies (estimated as the change in the structural budget balance) will stretch to almost 1 p.p. of GDP in 2011 (July 2010 estimate) against the 0.2 p.p. previously projected (in April 2010). For the G-20 countries, the 2011 adjustment will run to an estimated 1.3 p.p. of GDP against 1.1 p.p. respectively.

2 Unemployment rates in both the U.S. and euro area have stuck around the 10% mark.

3 At 0 to 0.25% in the U.S., 0.1% in Japan, 0.5% in the United Kingdom and 1% in the euro area.

4 The closing date for this report is 15 September.

Performance of main stock indices[1] (%)

TABLE 2

	2006	2007	2008	2009	3Q09	4Q09	1Q10	2Q10	3Q10 (to 15 September) % prior qt	% Dec	% y/y[2]
World											
MSCI World	18.0	7.1	-42.1	27.0	16.9	3.7	2.7	-13.3	11.3	-0.8	3.5
Euro area											
Euro Stoxx 50	15.1	6.8	-44.4	21.1	19.6	3.2	-1.1	-12.2	8.6	-5.8	-1.7
Euronext 100	18.8	3.4	-45.2	25.5	21.6	3.7	2.2	-10.5	8.2	-1.1	4.0
Dax 30	22.0	22.3	-40.4	23.8	18.0	5.0	3.3	-3.1	5.0	5.1	11.2
Cac 40	17.5	1.3	-42.7	22.3	20.9	3.7	1.0	-13.4	9.1	-4.6	0.1
Mib 30	19.0	-8.0	-48.7	20.7	19.6	-0.7	-0.4	-14.7	7.4	-8.7	-7.6
Ibex 35	*31.8*	*7.3*	*-39.4*	*29.8*	*20.1*	*1.6*	*-9.0*	*-14.8*	*16.1*	*-10.0*	*-7.3*
United Kingdom											
FT 100	10.7	3.8	-31.3	22.1	20.8	5.4	4.9	-13.4	13.0	2.6	10.2
United States											
Dow Jones	16.3	6.4	-33.8	18.8	15.0	7.4	4.1	-10.0	8.2	1.4	9.2
S&P 500	13.6	3.5	-38.5	23.5	15.0	5.5	4.9	-11.9	9.2	0.9	6.9
Nasdaq-Cpte	9.5	9.8	-40.5	43.9	15.7	6.9	5.7	-12.0	9.1	1.4	9.4
Japan											
Nikkei 225	6.9	-11.1	-42.1	19.0	1.8	4.1	5.2	-15.4	1.4	-9.8	-6.9
Topix	1.9	-12.2	-41.8	5.6	-2.1	-0.2	7.8	-14.0	0.9	-6.5	-9.0

Source: Datastream.

1 In local currency.

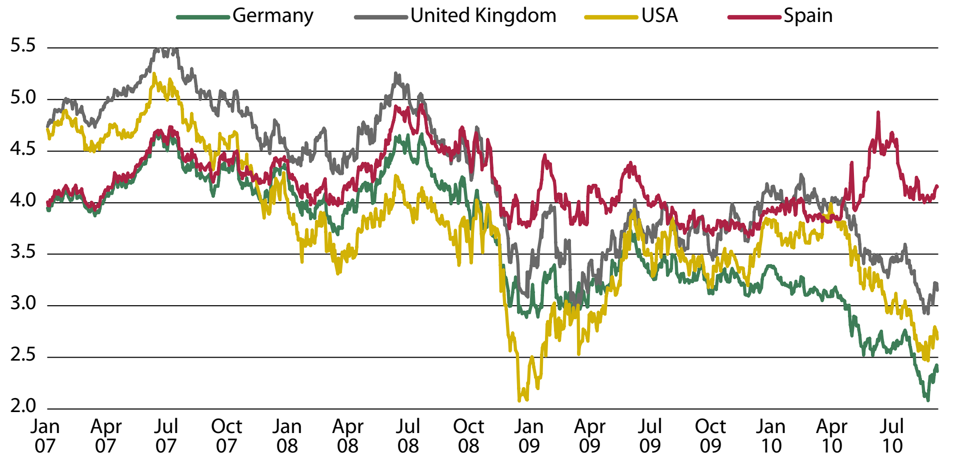
2 Year -on-year change to the reference date.

...pushing up the risk premiums of the most fiscally challenged economies.

Debt markets saw a degree of decoupling between the bonds of the economies perceived as soundest (the United States and Germany and, to a lesser extent, the United Kingdom) and those whose economic or fiscal variables have deteriorated most in recent years (especially Greece, Portugal, Spain, Ireland and Italy), although the trend has apparently softened since the end of last June. As we can se from figure 2, this latest episode of the "flight to quality" has steered the sovereign yields of the more credit-worthy borrowers down to 2.4% in the case of Germany, 2.7% in the United States and 3.2% in the United Kingdom, with rates in all instances significantly below the average of the last decade (4% in Germany, 4.2% in the United States and 4.5% in the United Kingdom).

Ten-year government bond yields (%)

FIGURE 2

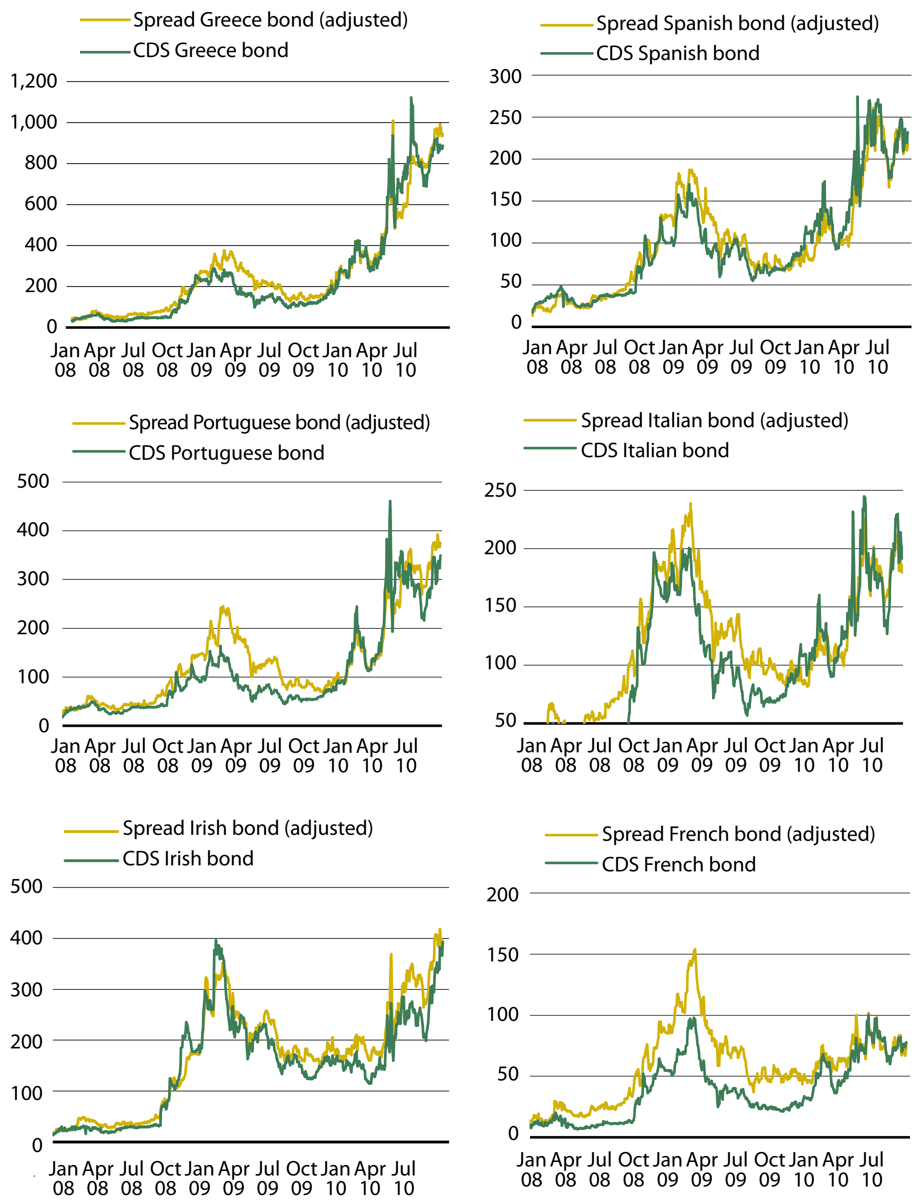


Source: Thomson Datastream. Data to 15 September.

Agent confidence in the debt of the most pressured sovereign issuers improved slightly in the middle months thanks to factors like the multilateral aid package granted to Greece, the European Union's launch of a financial assistance mechanism (co-funded by the IMF), the approval of fiscal austerity plans in various European economies, the ECB's measures to support liquidity in private and public debt markets and, more recently, the July publication of the results of the stress tests conducted on European banks. All this has helped stabilise, and in some cases reduce, the sovereign risk perception hanging over more vulnerable countries with respect to the highs reached last May (see figure 3). That said, the sovereign debt market remains prone to upset and though the above measures may have averted a spiral of distrust, it would be wrong to say that tensions have dissipated.

A series of measures have helped temper perceptions of sovereign risk.

Credit spreads[1] (basis points) FIGURE 3



Source: Thomson Datastream. Data to 15 September.

1 Bond spreads expressed over the German bund equivalent. Since these spreads are an attempt to approximate yield differentials versus a risk-free asset, and this asset (the German bund) has recently experienced an increase in credit risk, as gleaned from the prices of its CDS, the spreads shown here have been adjusted to factor the risk premium of the German CDS.

Exhibit 1: "Financial reform in the United States: main novelties in securities market regulation"

The current crisis has brought to light elements of the financial market supervisory and regulatory framework where reforms are urgently needed. In mid-2009, the United States government put forward a preliminary financial reform package[1] whose main measures were written into national legislation in July 2010 as the "Dodd-Frank Wall Street Reform and Consumer Protection Act".[2] The ultimate goal of this legislation is to promote financial stability and give consumers more protection against abusive practices.

In furtherance of these objectives, the new law reorganizes the financial supervision system with the creation of two new bodies. The Financial Stability Oversight Council is responsible for monitoring the marketplace to identify firms, products and activities that might harm the stability of the U.S. financial system, as well as for promoting market discipline and responding to emerging threats to stability. The other body, a new federal agency known as the Bureau of Consumer Financial Protection, is tasked with regulating consumer financial products and services in compliance with federal law. It will also collate and monitor the enquiries and complaints submitted by investors taking over competencies in this respect from other agencies, including the Federal Reserve.

In the area of banking regulation, one of the new law's firmest aims is to challenge the notion of "too big to fail" whereby major financial institutions whose collapse might jeopardise the stability of the financial system could expect to be bailed out by the authorities. Under Dodd-Frank, these banks will proceed to orderly liquidation in the event of bankruptcy under the standard rules and procedures established for this purpose, whose operation will be streamlined. A further measure to protect depositors and taxpayers is that commercial banks will be prohibited from engaging in proprietary trading[3] and from holding or investing in hedge funds or private equity funds. The size of banks will also be capped at 10% of total financial system assets (Volcker Rule).

Regarding securities markets, the Dodd-Frank Act calls on the competent agencies to conduct studies and draw up new regulations with the following priorities:

- **OTC derivatives.** In this so far thinly regulated area, the SEC and the Commodity Futures Trading Commission (CFTC) have one year to establish new rules for swap markets. The Dodd-Frank Act also assigns more powers to the CFTC, which will take on the regulation and supervision of all swaps except security-based swaps,[4] which will be handled by the SEC. A new register will be kept of entities of systemic importance in swap markets,[5] which will henceforth come under capital and collateral requirements. Standard derivatives, finally, will be transacted on a trading platform and settled via a central counterparty, while all swap contracts, regardless of their degree of standardisation, must be disclosed to the regulator with details of the price and volumes set.

- **Hedge funds.** The financial crisis has revealed the regulatory neglect suffered by this sector, and the Dodd-Frank Act sets out to remedy this by obliging the managers of hedge funds and other private funds to register with the SEC and report regularly on the funds they advise. The SEC is now working alongside Britain's FSA to decide the exact nature of hedge fund reporting requirements.

- **Fiduciary duty of financial advisors.** The Dodd-Frank Act calls on the SEC to assess the effectiveness of the standards applying to financial advisors. The Commission is empowered, if necessary, to establish new, stricter standards of conduct (fiduciary duty) for their dealings with retail customers, which will also apply to brokers and dealers in their investment advising role.

- **Securitisation.** With the goal of reactivating securitisation and remedying the varied failures that have undermined confidence in the market, the new regulation will impose stricter disclosure requirements on issuers with regards to the nature and quality of underlying assets. Originators, meantime, will be encouraged to be more diligent by having them retain a minimum economic interest in securitised exposures. The threshold in question will be 5% in the case of residential mortgage securitisations and presumably set lower (no announcement yet) in the case of remaining asset-backed securities.

- **Credit rating agencies.** The new legislation will require these agencies to disclose procedures and methodologies used to determine each individual credit rating. They will also be urged to put internal controls in place to avoid conflicts of interest and ensure the accuracy of the ratings issued. To address the problem of incentives, the SEC will study the feasibility of starting up an entity to design an allocation system for structured finance product ratings such that issuers are assigned an agency rather than selecting it themselves. The SEC is also instructed to create a new internal department, the Office of Credit Ratings, with oversight powers and the authority to fine agencies for non compliance. Finally, regulators are urged to review and amend regulations in order to discourage references to credit ratings and have them replaced with alternative standards of creditworthiness, the idea being to tackle the problems of moral hazard that arise from too strict a reliance on credit ratings.

- **Remuneration.** Shareholder safeguards are reinforced through a series of requisites on executive compensation; chief among them, the requirement that executive pay be submitted to the non-binding vote of the company's shareholders ("say on pay") and the obligation to set up an independent remuneration committee within each organisation. Within one year of enactment, the SEC must issue rules that direct the national securities exchanges and associations to prohibit the listing of any security of an issuer that is not in compliance with these compensation requirements.

The passage of the Dodd-Frank Act marks the start of a transition period in which the relevant agencies will undertake studies and develop specific regulations conducive to its enforcement. By this means, the reform of the U.S. financial system should be rolled out in full by the end of 2011.

1 Available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

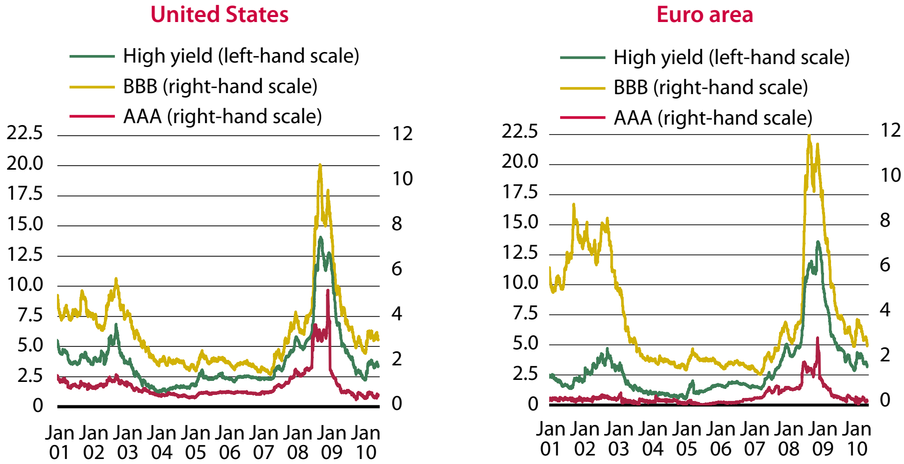
2 Available at: http://www.govtrack.us/congress/bill.xpd?bill=h111-4173.

3 The Act stipulates some exceptions, notably the purchase of instruments issued by government agencies.

4 The SEC and CFTC will shortly specify the swaps to be included in this category.

5 The so-called swap dealers and major swap participants (MSPs), pending closer definition by the CFTC and SEC.

Corporate bond risk premiums[1] (basis points) FIGURE 4



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

1 Expressed as the yield spread between bonds of the same maturity and credit quality belonging to a given index and 10-year government bonds (a synthetic bond in the case of the euro area).

Corporate risk premiums strain higher in the period.

In private debt markets, the credit risk premiums of medium- and lower-rated borrowers were pushed sizeably higher by the sovereign debt crisis, though without overtaking the levels reached before the Lehman Brothers collapse (see figure 4). Analysis by sector shows financial entities to be the worst affected. Indeed we have lately been seeing a close correlation in Europe between sovereign risk premiums and financial sector credit spreads. This is not to say that there is a clear, one-way causal relationship. Certainly the broad financial sector support measures taken by governments have meant some transfer of risk from the financial to the public sector. But it is also the case that the European government bond holdings of the region's banks mark a recent reversal of this transfer, given the impact of a sharp loss of value on financial sector income sheets.

Bond issues reduce slightly despite the scale-up in sovereign borrowing.

Total net debt issuance in international markets over the first nine months of 2010 came to 4.7 trillion dollars, 3.5% less than in the same period last year. A breakdown by instrument (see figure 5) shows the decline had its origin in the drought of investment-grade issues by financial institutions based in Europe.[5] In contrast, heavy public sector funding requirements dictated a further increase (7.2%) in sovereign debt issues, which summed 2.9 trillion dollars in the reference period or more than 62% of the worldwide total. Issues of other fixed-income instruments like asset-backed securities or high-yield bonds also rose with respect to the same period in 2009, though rather less so in volume terms[6] (from 149 billion to 217 billion dollars for ABS and from 32 to 133 billion dollars for bonds). By region, note the gap emerging between the U.S. and Japan (debt issuance up by 21% and 20% respectively) and Europe (down by 35%).

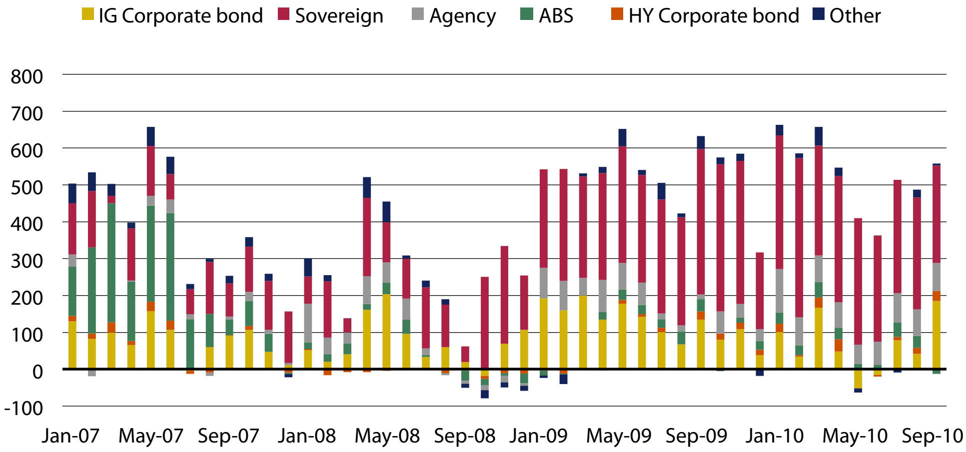
5 The latest data (September) indicate a small upturn in financial sector issuance.

6 Comparison of percentage changes yields less than satisfactory results given the low baseline values for these series.

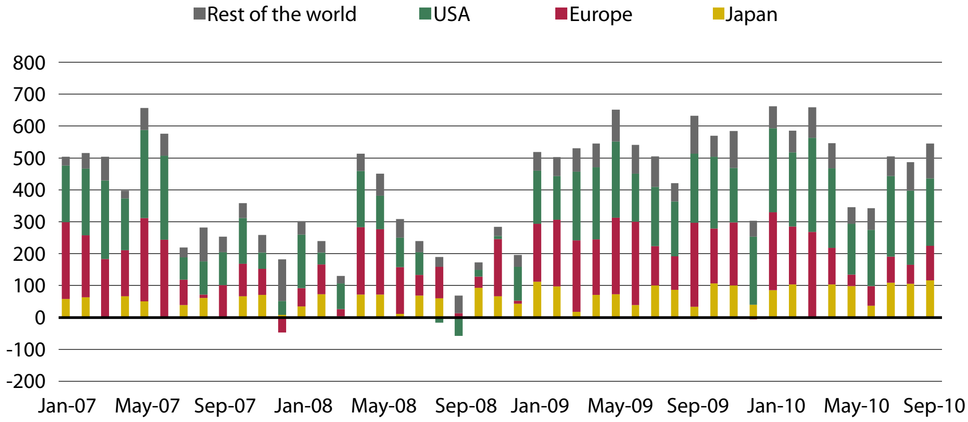
Net international debt issuance (billion dollars)

FIGURE 5

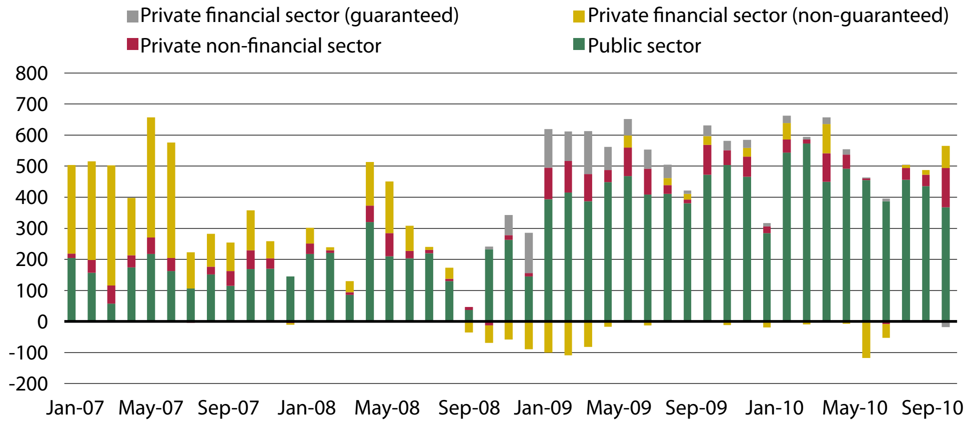
By type of financial instrument



By region



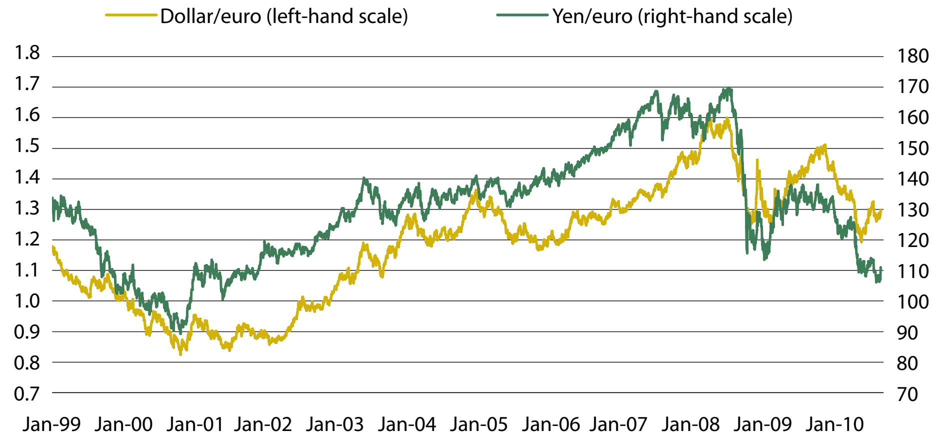
By type of borrower



Source: Dealogic. Monthly data to 15 September. September data stated on a monthly basis.

In currency markets, Europe's sovereign debt crisis sent the euro tumbling against both the dollar and the yen. In the first case, the European currency experienced a steady run-down from the 1.50 dollars of end-2009 to 1.2 dollars in June 2010. The decline, however, levelled off in the months of July and August, and by the closing date for this report the euro was again testing the 1.3 dollar mark. Against the yen, meantime, the euro sank from just below 135 yens at end-2009 to around 110 yens in mid-September (see figure 6).

Euro exchange rates vs. the dollar and yen FIGURE 6



Source: Thomson Datastream. Data to 15 September.

2.2 National economic and financial developments

Domestic output expands 0.2% in the second quarter...

The second quarter was practically a re-run of the first with modest growth of 0.2% building on the mild recovery initiated in the opening months (0.1%). In year-on-year terms, the GDP contraction of 0.1% represents the least negative outcome since end-2008. A look at the mix shows different components pulling closer into balance, with domestic demand detracting just 0.5 points against 2.5 points previously, and the positive input from net exports down to 0.4 from 1.5 points.

...thanks to recovering household consumption...

On the demand side, household consumption rose by 1.3% (0.9% in the preceding quarter) and government consumption by 0.7% (0.3% previously). Especially encouraging was the 4.6% advance of equipment investment in the second-quarter period. The recovery of quarterly rates has restored main demand variables to positive terrain in annual terms. In detail, final consumption spending, private and public, rose by 1.5% in the second quarter (the first advance since third quarter 2008), equipment investment rose by 8.7% (the first increase since second quarter 2008), and exports and imports rose by 10.5% and 8.1% respectively. Only non equipment investment, basically construction, has gone on receding at rates of over 10%.

...in response to stimulus measures that have since been deactivated, and a possible "substitution effect" ahead of the hike in VAT.

The domestic demand upturn was largely due to the aforementioned 1.3% rise in household consumption with respect to the previous quarter. However there is some concern that the recovery may be overly reliant on the support of now withdrawn stimulus measures (automobiles) and the fact that consumers may have brought forward spending, on durables especially, ahead of the July increase in VAT. There is also the threat that austerity measures announced last May with direct implications for households' disposable income (like salary cuts for government employees) could damp down private consumption going forward.

On the supply side, industry and services gain momentum.

From a supply side standpoint, the highlights were the quarterly advances of the industrial and service branches (up 0.6% and 0.3% respectively), which have lifted year-on-year rates out of the red (as far as 2.2% for industry and 0.4% for services). In contrast, construction shed a further 1.5% (-6.4% in annual terms), while overall primary sector output dropped by 2.3% in quarterly and 3.5% in annual terms.

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

	2006	2007	2008	2009	European Commission* 2010F	2011F
GDP	**4.0**	**3.6**	**0.9**	**-3.7**	**-0.4 (+0.4)**	**0.8 (-0.2)**
Private consumption	3.8	3.7	-0.6	-4.2	0.2 (+0.7)	1.2 (+0.3)
Government consumption	4.6	5.5	5.8	3.2	1.0 (-0.7)	-1.2 (-3.4)
Gross fixed capital formation, of which:	7.2	4.5	-4.8	-16.0	-8.3 (+0.1)	-1.8 (-0.5)
Equipment	9.9	9.0	-1.7	-24.8	-4.3 (+1.7)	0.2 (-2.0)
Exports	6.7	6.7	-1.1	-11.6	4.4 (+3.1)	4.7 (+1.4)
Imports	10.2	8.0	-5.3	-17.8	-1.1 (+1.6)	1.8 (-0.4)
Net exports (growth contribution, pp)	-1.4	-0.8	1.5	2.7	1.3 (+0.3)	0.7 (+0.4)
Employment	3.3	2.8	-0.5	-6.6	-2.5 (-0.2)	-0.1 (+0.3)
Unemployment rate[1]	8.5	8.3	11.3	18.0	19.7 (-0.3)	19.8 (-0.7)
HICP	3.5	2.8	4.1	-0.3	1.6 (+0.8)	1.6 (-0.4)
Current account (% GDP)	-9.0	-10.0	-9.7	-5.5	-4.6 (=)	-4.5 (-0.3)
General government (% GDP)	2.0	1.9	-4.1	-11.2	-9.8 (+0.3)	-8.8 (+0.5)

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

1 Eurostat definition.

* Forecasts published in spring 2010 (vs. those of autumn 2009).

Inflation climbs higher in line with the rest of the euro area.

The annual inflation rate has crept up gradually from around 1% at the start of the year to almost 2% in August. The run-up drew equally on more volatile index components and the more stable elements making up core or underlying inflation. Spain's inflation gap vs. the euro area has held stable throughout in the interval of zero to 0.2 points. Looking ahead, scant pressure from domestic demand and squeezed business margins seem likely to cancel out the impact of the VAT increase, leaving inflation rates at more or less their current levels. Indeed the forecasts issued by main international organizations augur annual rates below 2% in 2010 and 2011.

The unemployment rate stays unchanged at around 20% of the labour force.

Labour market data for the second quarter of 2010 indicate a small drop in employment and the stabilisation of jobless rates. The number of people in work rose by almost 83,000 vs. the previous quarter to a total of 18,477,000, equating to a year-on-year decline of -2.5% against -3.6% previously. However this increase failed to offset the intervening growth in labour force numbers, leaving the unemployment rate more or less unchanged at 20.1%.

The sovereign crisis has speeded up fiscal consolidation efforts in a series of economies, Spain among them.

The European sovereign crisis has forced a series of economies to take immediate action on public spending in order to rein back public deficits.[7] In Spain's case, the fiscal austerity measures passed by the government on 20 May last brought forward a large swathe of the fiscal consolidation effort envisaged in its 2010-2013 Stability Programme, including new cuts in structural expenditure via a reduction in public investment and government worker salaries as of 1 June this year, and the freezing of public salaries and pensions starting in 2011. In all, the scale of the adjustment is reckoned at 15 billion euros (1.5% of GDP) between 2010 and 2011 with the aim of steering the public deficit down to 6% in 2011.[8] Details of national

7 A recent study published by the IMF on the public debt of 23 countries locates the Spanish economy in an intermediate bracket along with the United States, United Kingdom, Iceland and Ireland by reference to the fiscal leeway at their disposal to deal with unexpected shocks (Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Qureshi [September 2010], "Fiscal Space", IMF Staff Position Note).

8 The European Commission forecasts featuring in table 3 were issued prior to the adoption of the fiscal adjustment plan, so make no allowance for its impact.

budget implementation to June throw up a deficit balance of -2.4% of GDP, a notable improvement in year-on-year terms delivered by higher tax receipts and a moderate decline in spending.

Forecasts point to continuing growth weakness accompanied by deficit reduction in 2011.

The latest forecasts for the Spanish economy by main international organisations point to an 0.4% decrease in this year's GDP (-0.3% on government estimates) followed by a modest advance only in 2011, with extraordinary public spending cuts confining growth to the range of 0.5% to 1.3% (depending on the forecaster). Unemployment is projected to drop a little below 20%, while inflation should not stray far from 1.5%. Estimates included with the fiscal adjustment plan posit a public deficit of close to 9% of GDP in 2010 falling to 6%-7% in 2011.

Enduring tensions in wholesale debt markets have made this a complex time for Spanish financial institutions.

The Spanish financial system had a difficult first half, with economic weakness eating into credit institution turnover and asset quality, the European sovereign debt crisis in full spate, and funding conditions turning for the worse.

However, sector restructuring and the results of stress tests should help rebuild investor confidence.

However, the restructuring of the deposit-taking sector and the upkeep of sound capital adequacy conditions means institutions are solidly equipped to face the challenges ahead. In effect, Spanish banks' satisfactory results in the recent round of stress tests facilitated some improvement in their financing conditions during the third quarter.

Aggregate profits of credit institutions continue in decline...

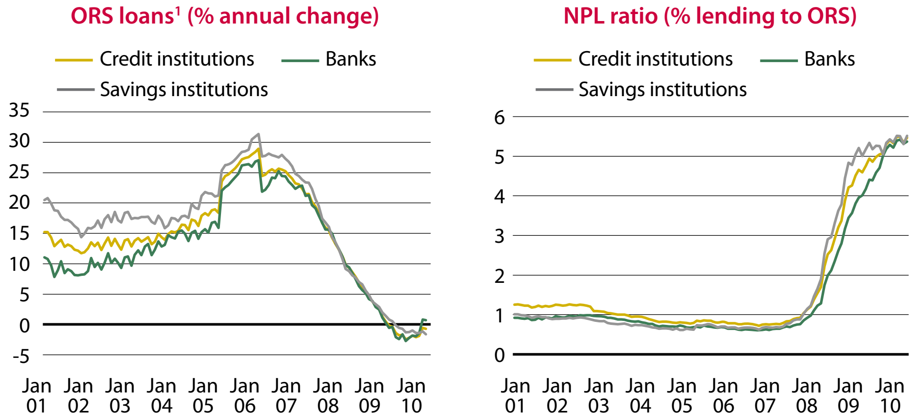
Credit institutions reported aggregate net profits of 2.84 billion euros in the first quarter compared to almost 5 billion over the same period in 2009. Factors at work included a decline in net interest income, higher financial asset impairment losses and, above all, significantly lower inflows at remaining income statement lines (from a combined 1.72 billion euros in first quarter 2009 to just 277 million one year later).

...though lending and bad debt figures seem to be stabilising.

The latest figures on credit institution loans and non-performing assets suggest both variables are now stabilising. Specifically, the annual change in the balance of outstanding loans to businesses and households was down to just -0.8% in July compared to the -2.5% low of the year's outset. This apparent stabilisation owed to a small upswing in loans to households for home purchase purposes and, to a lesser extent, for consumer credit. Among the banks, annual lending growth rates have been positive for two months running (0.8% in June, 0.7% in July), after almost one year in which decrease succeeded decrease. The non performing loans (NPL) ratio of Spanish credit institutions settled at around 5.5% in the year's middle months. The greater part of the last year's bad debt escalation can again be laid at the door of construction company borrowers and real estate development activities (see figure 7).

Deposit-taking entities: loans and NPL ratio

FIGURE 7



Source: Banco de España. Data to July.

1 Other resident sectors.

The sovereign debt crisis has persuaded credit institutions to increase their take-up of Eurosystem credits...

As remarked, sovereign debt market turmoil has had a knock-on effect on private sector funding conditions. In Spain, gross debt issuance year to date[9] by domestic credit institutions has sunk to 155 billion euros from 288 billion in 2009, with commercial paper, bonds (with and without guarantee) and, at a distance, asset-backed securities accounting for most of the downturn. Preference share issues have also dried up. Only covered mortgage bond issues were on a par with the figures for 2009. This funding source has gained most ground in both relative and straight number terms because of its use by institutions applying for Eurosystem credits. Recourse to this form of finance increased sharply in the middle months of 2010. In August, for instance, Spanish credit institutions borrowed a daily average of almost 110 billion euros from the ECB (20 billion less than in July), equivalent to 25.6% of total Eurosystem lending – a percentage disproportionate with their share of Eurosystem capital, which stands somewhere near to 12%. In parallel, Spanish institutions have also stepped up recourse to the deposit facility (see figure 8).

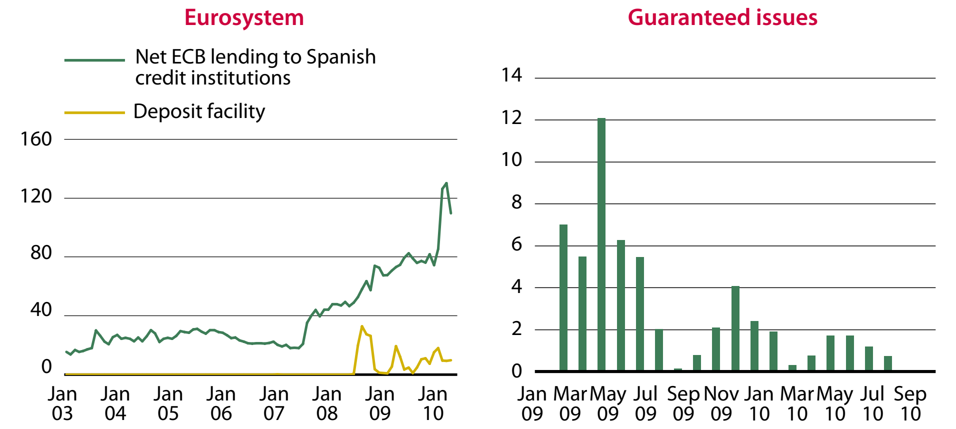
...though such recourse has lessened in recent weeks.

We should mention here the recent use by some Spanish entities of the LCH.Clearnet and Eurox Repo platforms, which channel interbank loans collateralised by government bonds and also cover default risk. This trading modality allows client entities to diversify funding streams and thereby reduce their reliance on any single source. And indeed the institutions in question have noticeably stepped up their issuance in the last weeks of August and September, with covered mortgage bonds as the main instrument of choice.

9 To 15 September.

Financing of Spanish credit institutions (billion euros)

FIGURE 8



Source: Banco de España and CNMV. Eurosystem data to August. The figures for guaranteed issues run to 15 September.

Aggregate profits of non financial listed companies grew 4% in the first half of 2010.

The aggregate first-half net profits of non financial listed companies came to 14.70 billion euros, 4% more than in the same period last year (see table 5). Growth was common to all sectors except construction and real estate. Profits of listed energy firms rose by 6.3% to over 7 billion euros and those of retail and services firms by 11.7% to 6.20 billion, while industrial sector earnings totalled 1.40 billion (compared to 450 million in 2009). Companies in construction and real estate left behind the heavy losses of previous years and staged something of a comeback at higher income statement lines, particularly gross operating profit (EBITDA) and earnings before interest and taxes (EBIT). However, year-on-year comparison remained notably adverse at the net profit line due to the large capital gains booked by some operators in the first half of 2009.[10]

Earnings by sector[1]: non financial listed companies

TABLE 5

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	1H 09	1H 10	1H 09	1H 10	1H 09	1H 10
Energy	14,745	16,827	9,954	11,224	6,663	7,083
Industry	2,162	3,320	1,082	2,169	454	1,376
Retail and services	14,590	15,005	8,782	9,077	5,585	6,236
Construction and real estate	1,987	3,579	553	1,959	1,452	7
Adjustments	-159	-107	-72	-31	-22	-1
AGGREGATE TOTAL	**33,325**	**38,624**	**20,299**	**24,398**	**14,132**	**14,701**

Source: CNMV.

1 Year-to-date earnings.

2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

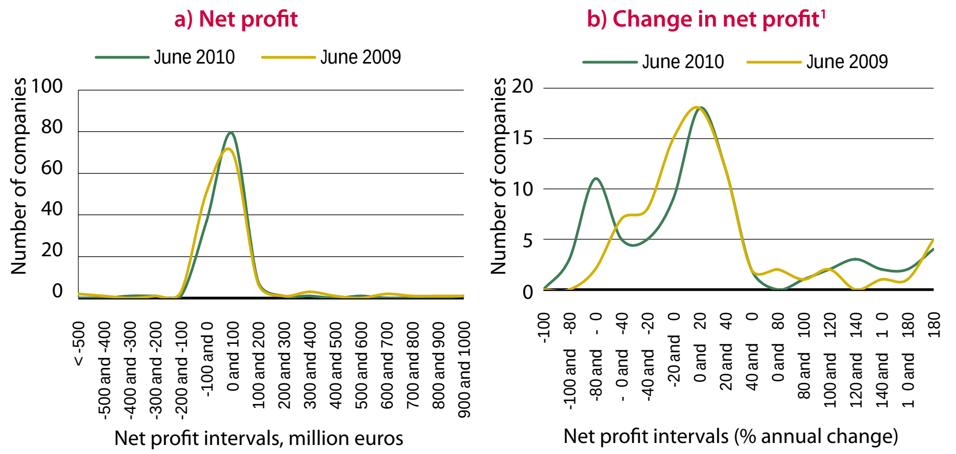
The number of companies with minor losses fell in the period, while the number slightly in profit rose.

Breaking down listed companies in terms of their net profit for the year (see figure 9, panel a), we find that the number reporting minor losses (between -100 million and zero euros) dropped significantly versus first-half 2009, while the number slightly in profit (between zero and 100 million euros) rose. Companies crossing the divide between the red and the black were primarily in industry, retail and services. Note

10 Gains from discontinued operations summed 3.03 billion euros in first half 2009, reflecting mainly the capital gains raised by certain companies from the disposal of equity interests. This same caption registered a 23 million loss in first half 2010.

also that not one firm reported losses deeper than 400 million in first-half accounts, thanks to an improved performance by real estate operators. Finally, among the companies in profit over the first-half periods of 2009 and 2010 (see figure 9, panel b), we can see an increase in both the numbers reporting a sharp earnings slide (exceeding 60%) and in those reporting growth of more than 100%.

Non financial listed companies by: FIGURE 9



Source: CNMV.

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

The debt of non financial listed companies moved up 3.7% between December 2009 and June 2010 as far as 340.23 billion euros (see table 6). The increase cut across all sectors with the exception of energy, where debt levels held more or less flat. The largest jump corresponded to retail and services companies, whose combined debt moved up 6.4% versus end-2009 to 115.6 billion euros. The debt of industrial sector companies and those in construction and real estate rose by 2.8% and 4.9%, respectively in the same period. Aggregate financial leverage – the ratio of debt to net equity – edged up in consequence from 1.63 to 1.65, with all sectors except for energy sharing in the increase.

The total debt of non financial listed companies moved up 3.7% in the first-half period.

The debt coverage ratio, measuring the years needed to repay existing debt assuming constant EBITDA, dropped from 4.8 at end-2009 to 4.4 in June 2010, with EBITDA growth driving the improvement. The largest reduction in the aggregate ratio corresponded to construction and real estate (down from 22.5 to 15.4), thanks to a strong advance in sector EBITDA (80% year on year). Meantime, interest coverage ratios moved slightly higher (EBIT/interest expenses up from 2.4 to 2.8) on the strength of the growth reported at the EBIT line (20% year on year).

Both the debt coverage ratio and interest cover (vs. EBIT) showed some improvement.

Gross debt by sector: listed companies TABLE 6

Million euros		2006	2007	2008	2009	1H 10
Energy	Debt	59,191	69,172	82,608	100,572	100,315
	Debt/ Equity	0.89	0.78	0.89	1.08	1.01
	Debt/ EBITDA[1]	2.17	2.48	2.82	3.46	2.98
	EBIT[2]/ Interest expenses	4.65	4.10	3.67	3.38	3.60
Industry	Debt	15,684	13,312	15,645	15,953	16,402
	Debt/ Equity	0.78	0.61	0.69	0.69	0.70
	Debt/ EBITDA	2.07	1.82	2.71	3.05	2.47
	EBIT/ Interest expenses	5.71	5.93	3.41	3.15	4.84
Construction and real estate	Debt	111,000	138,933	119,788	104,762	109,853
	Debt/ Equity	3.10	3.08	3.77	4.08	4.21
	Debt/ EBITDA	11.52	10.83	31.87	22.48	15.35
	EBIT/ Interest expenses	2.04	1.17	0.01	0.31	0.76
Retail and Services	Debt	91,522	96,941	112,322	108,579	115,571
	Debt/ Equity	2.52	1.70	2.14	1.78	1.96
	Debt/ EBITDA	3.58	3.01	3.58	3.70	3.85
	EBIT/ Interest expenses	2.44	3.23	2.86	3.28	3.49
Adjustments[3]	Debt	-11,199	-17,391	-20,802	-1,908	-1,909
AGGREGATE TOTAL[4]	**Debt**	**266,198**	**300,967**	**309,561**	**327,958**	**340,232**
	Debt/ Equity	1.71	1.48	1.63	1.63	1.65
	Debt/ EBITDA	3.86	3.96	4.63	4.82	4.40
	EBIT/ Interest expenses	3.29	3.03	2.01	2.42	2.81

Source: CNMV.

1 Earnings before interest, taxes, depreciation and amortisation.

2 Earnings before interest and taxes.

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

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

Household savings rates have settled at just over 18% of gross disposable income.

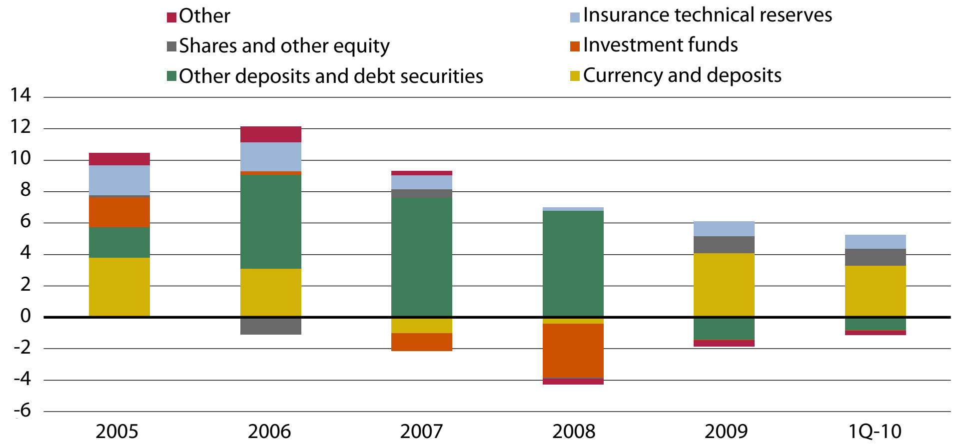
Household asset indicators for the first quarter of 2010 offered a more or less unchanged picture. The exception was the savings rate, which settled at around 18% of gross disposable income (see exhibit 2 for a more detailed analysis of recent trends in personal saving). The household indebtedness ratio held at around 125% of gross disposable income while net household wealth[11] reduced slightly in line with falling real estate values. Nor were there major changes to report in the aggregate figures for households' financial assets and liabilities, except perhaps some change in the mix. Specifically, while net financial asset purchases stood at around 4.1% of GDP in the first-quarter period[12] (4.2% in 2009), the weight of financial liabilities dropped by 1.1% (1.4% en 2009). At the same time currency and deposits reduced their share of total assets (though conserving their primacy), in contrast to the advancing weight of shares and insurance technical reserves.

11 Net household wealth is the sum of households' financial and non financial (real estate) assets minus their debts.

12 Cumulative four-quarter data.

Households: financial asset acquisitions (% GDP)

FIGURE 10



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

Investment fund subscriptions and redemptions (million euros)

TABLE 7

Category	Subscriptions				Redemptions			
	3Q09	4Q09	1Q10	2Q09[8]	3Q09	4Q09	1Q10	2Q09[8]
Fixed income[1]	19,696.6	20,150.3	15,240.8	13,620.5	20,089.9	21,710.4	19,940.5	22,951.2
Balanced fxd income[2]	1,081.7	3,309.0	1,243.5	1,255.4	576.6	792.3	1,106.0	1,653.8
Balanced equity[3]	541.5	366.6	292.1	556.5	554.2	264.9	225.7	601.2
Spanish equity[4]	589.2	743.2	582.5	464.0	455.6	734.9	709.6	673.9
Intern. equity[5]	775.0	1,165.3	1,259.1	1,190.3	457.5	609.5	704.9	991.1
Fixed-income guaranteed	2,544.8	2,246.8	2,359.6	3,244.1	4,046.6	4,070.5	2,135.7	1,529.0
Equity guaranteed[6]	1,683.7	1,899.6	1,607.4	1,576.3	3,100.5	2,574.1	1,818.0	1,852.4
Global funds	389.4	792.9	545.0	440.6	141.6	280.5	269.3	461.1
Passively managed[7]	204.4	269.0	242.6	271.1	164.3	235.9	396.2	682.1
Absolute return[7]	1,256.4	2,221.5	1,853.3	1,778.8	924.6	1,672.1	1,018.9	1,645.3
Hedge funds	66.4	73.8	107.9	n.a.	24.2	32.5	52.6	n.a.
Funds of hedge funds	4.6	3.7	21.4	n.a.	56.6	9.7	48.0	n.a.
TOTAL	**28,833.7**	**33,241.3**	**25,355.2**	**24,397.6**	**30,592.2**	**32,987.2**	**28,425.4**	**33,041.1**

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 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.

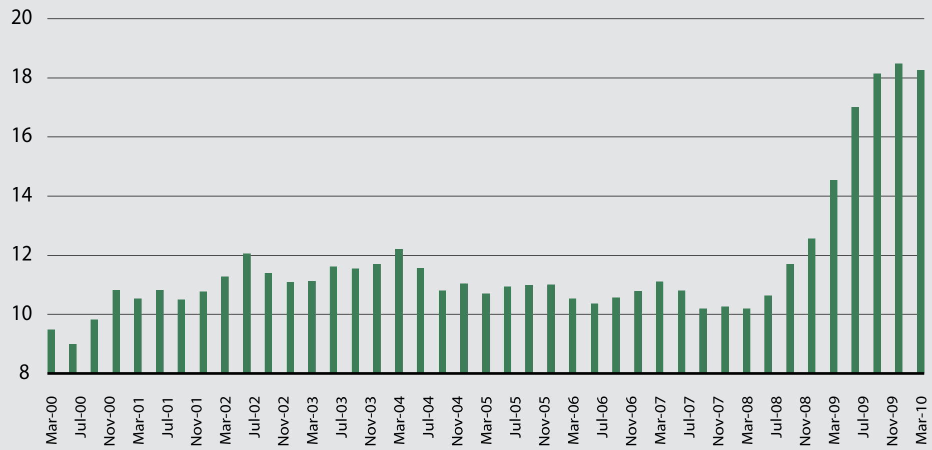
7 New categories as of 2Q09. All absolute return funds were previously classed as global funds.

8 Estimated data.

Exhibit 2: "Recent developments in Spanish household savings"

In the last decade, up to the onset of the crisis, the savings rates of Spanish households held more or less flat at around 10%-12% of gross disposable income. During this time, investments in both real and financial assets (mainly real estate in the former case) underwent an expansion that was largely funded by recourse to borrowing, in view of the newly affordable financing conditions. The result was a rise in household indebtedness ratios from 45% of disposable income midway through the 1990s to highs of nearly 130% in 2008.

Household savings rates (% gross disposable income) FIGURE E2.1

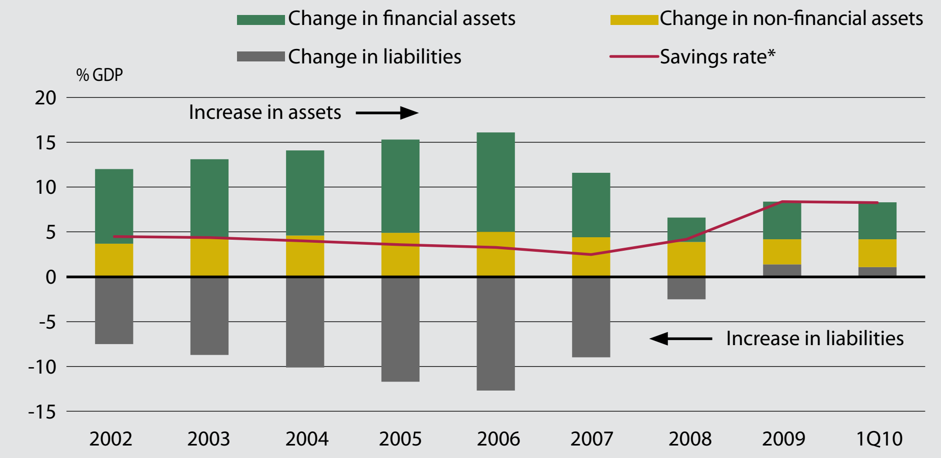


Source: Thomson Datastream.

The outbreak of the financial crisis caused mounting uncertainty over the prospects for growth and, above all, employment. The response was a historic rise in household saving to a 2009 rate upwards of 18% of gross disposable income. The form it took was a sharp run-down in the acquisition of liabilities, balancing out the simultaneous decline in asset accumulation. Specifically, the growth rate of household liabilities slowed from its pre-crisis range of 9% to 14% of GDP to just 2.5% of GDP in 2008 before turning negative in 2009 (see figure E2.2). In parallel, household investment was reined back sharply, particularly in financial assets. Real asset acquisitions, concretely, dropped from around 5% of GDP between 2003 and 2007 to values closer to 3%, while financial asset purchases slumped from around 10% to 3%-4%.

Breakdown of household savings rate (% GDP)

FIGURE E2.2



Source: Banco de España, *Cuentas Financieras*.
* Savings rate plus capital transfers.

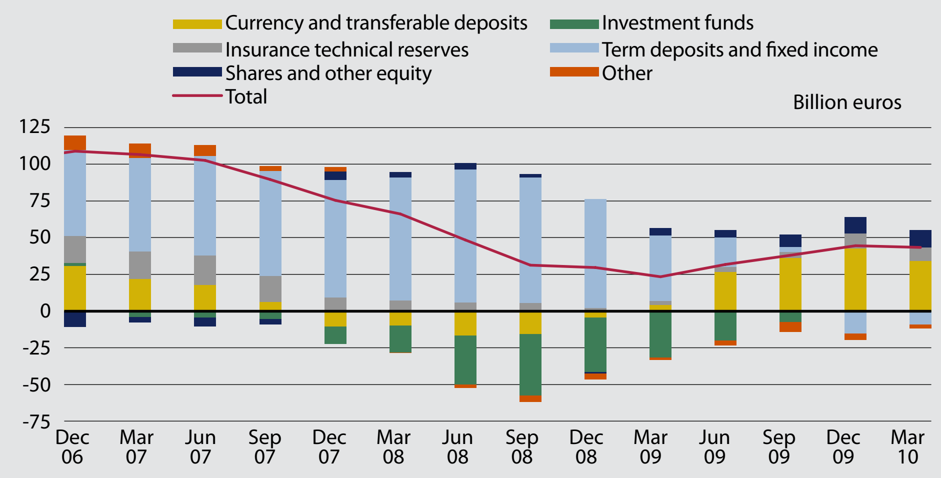
This decline in financial investment coincided with a substantial shift in the acquisition mix by instrument and issuer sector. We can distinguish two separate phases in this change in households' investment behaviour:

1) From the start of the crisis (mid-2007) to March 2009. In this period of escalating risk aversion, household preferences inclined increasingly towards deposits (mainly term deposits) to the detriment, mainly, of investment funds (see figure E2.3).

2) From March 2009 to the present. This was a time of decreasing aggregate uncertainty on financial markets, in which deposits were again the main destination of household savings but with an appreciable shift away from term to easier-to-transfer sight deposits. Investment fund outflows also eased significantly, while investment in listed shares and insurance products recovered to some extent. Demand for shares, insurance and term deposits continued robust throughout the first quarter of 2010. However investment fund redemptions picked up once more, most intensely in fixed-income schemes.

Household financial asset acquisitions[1]

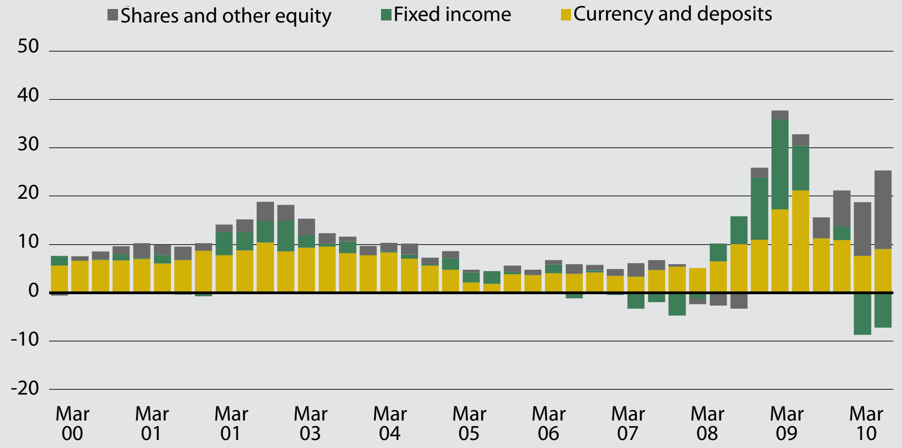
FIGURE E2.3



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

Finally, as figure E2.4 shows, Spanish households have been investing increasingly in financial instruments issued abroad, which have raised their share in the total from below 10% to ahead of 20% on a regular basis, with peak values nearing 40% at times of maximum uncertainty. Until March 2009, investment in financial instruments issued abroad was more or less evenly split between cash and deposits, on the one hand, and fixed-income instruments on the other. Conversely, in the last few quarters the lead has been taken by shares and other equity.

Household acquisitions of financial assets issued abroad[1] (%) FIGURE E2.4



Source: Banco de España, *Cuentas Financieras*.

1 % of total financial asset purchases. Cumulative four-quarter data.

2.3 Outlook

Forecasts suggest world recovery will stay on course albeit with differences between regions,...

The forecasts of both the IMF and OECD point to further recovery in the quarters ahead, with world growth rates expected to be not far off 4.5%. The recovery pace will likely be inconstant as well as varying significantly from one area to the next. Emerging economies will retain their growth lead with rates at or exceeding 6.5%, while developed economies advance at a more moderate 1%-2%.

...and accompanied by high levels of uncertainty.

These projections, however, must be handled with care in the presence of a series of downside risks. The first of these, referred to in earlier instalments of this report, has to do with the sustainability of output growth now that many of the stimulus measures adopted by the authorities have been deactivated. A second uncertainty factor concerns the possible consequences of a European sovereign debt crisis that has not yet blown over, with the risk indicators of certain economies still in the alert zone.

A particular worry is how sovereign debt market turbulence may impact the banking system.

Aside from the harmful influence of any increase in uncertainty, arising in this case from the fiscal deterioration of certain economies, we have the added worry of how the crisis might impact the European banking system. In particular, there is a real threat that further episodes of stress, like that of a few months back, in the financing conditions of credit institutions could trigger a new clampdown on bank lending to the economy to the extent of cutting short the incipient recovery. A third risk factor has to do with the latest employment and output indicators in the U.S. and Japan, which hint at weaker growth in these economies over the second half of 2010.

On a more positive note, the robust growth pace of key emerging economies is providing an added spur to the export sectors of European countries, which may at least partly counter the damping effect on output of newly enacted fiscal austerity plans.

Positive notes are provided by the dynamism of emerging economies and the expansion of world trade flows.

With recovery challenged on all these fronts, work needs doing to keep agent expectations on track. This means, on the one hand, implementing fiscal adjustment plans that are credible, solid and properly balanced, and tackling the structural reforms needed to enlarge the economy's potential growth rate, especially in those countries exhibiting fragilities. Another priority is to ensure that international financial system reform measures are swiftly rolled out. Part of this effort must be to enhance the transparency of financial markets and institutions (an example to follow would be the recent disclosure of stress test results in Europe), to advance deeper in developing new prudential regulation and to complete the restructuring of troubled institutions (see exhibit 1 on financial reform in the United States).

Measures must focus on bringing down aggregate uncertainty and a return to more settled expectations for investors and issuers.

Projections for the Spanish economy continue to suggest recovery will lag that of other advanced economies. The consensus is that average GDP will contract slightly in 2010 then resume positive growth in 2011, though not enough to permit solid inroads into Spain's high unemployment rate. Slower progress in correcting past disequilibria and the impact of the austerity package approved last May (estimated at half a point of GDP) are among the factors explaining this low-key expansion.

Prospects continue generally weak for the Spanish economy...

Despite the considerable uncertainty surrounding forecasts for the Spanish economy, we can say that fiscal consolidation and structural measures, including the recent labour market reform, the reassuring results of the stress tests run on Spanish banks, and the recovery experienced in these past months by some of the country's main trading partners are apparently doing their bit to restore agent confidence. The result has been a degree of stabilisation in credit risk indicators, albeit at still high levels vs. their recent historical average, and a resumption of public and private debt issuance under more favourable conditions. The hope now is that this trend will consolidate in the absence of new episodes of investor distrust.

...although fiscal consolidation measures and other structural reforms, plus the results of stress tests on Spanish banks, are helping to win back confidence.

Domestic demand recovery also faces certain risks, some of them referred to in earlier reports and others new to the scene. Among the known risks we have a labour-market upturn insufficiently strong to reduce unemployment rates and hasten the recovery of private consumption. Among the new risks, meantime, are the possible fallout from the withdrawal of government stimulus measures. Finally, the sovereign debt crisis may yet cause disturbances in wholesale financing markets, disrupting the normal flow of funds to the public and the private sector.

The biggest risks have to do with labour-market weakness and possible funding constraints on both the public and private sector.

3 Spanish markets

3.1 Equity markets

Spanish equity markets have recouped some of the ground lost to mid year amid an appreciable decrease in volatility...

In the third quarter,[13] Spanish equity markets made up much of the ground lost in the year's first months – with some exceptions. The share price rally was stronger than in neighbour bourses, just as the previous run-down had been steeper, and was framed by the gradual easing of investor fears about the impact of the sovereign debt crisis on Spain's economy. The result has been a normalisation of market volatility to something like historical levels, after May highs of almost 70%, and an upturn in trading that has carried liquidity indicators some way above their recent-year average. The Ibex 35, specifically, gained 16.1% between the start of July and the closing date for this report against the 9% and 14.8% declines respectively of the first and second quarters, though its year-to-date performance remains negative to the tune of 10%.

...though with performance varying markedly by company size and sector of activity.

Share prices have also performed divergently according to capitalisation and trading venue. On the size front, the Ibex Medium Cap and Ibex Small Cap indices pulled apart in the third quarter (with increases of 14% and 2.4%) after moving in line for the first six months, taking their year-to-date losses to 4.8% and 15.6% respectively. Meantime, Latin American share platforms scraped small gains in the third-quarter period, with the FTSE Latibex All-Share up by 1.1% and the index of more liquid stocks, the FTSE Latibex Top, marking an increase of 0.6%. The Top index is so far the year's best performer thanks to its less severe losses in the second quarter, although both indices are over 20% up on their year-ago levels.

The only third-quarter losers were chemicals and real estate.

By sector, chemicals and real estate were the big third-quarter losers, with falls of 47.3% and 20.8% respectively. Real estate, in particular, is now trading over 60% below the levels of twelve months back. Remaining sectors managed a third-quarter rally that fell short of recouping the losses of the year's first months, the notable exceptions being consumer goods and non banking financial services (see table 8). The sectors posting the largest third-quarter gains were discretionary consumer goods (21.1%), health (20.3%), telecommunications (18.6%), other financial services (15.2%), industrial goods and services (15%), banks (14.5%) and construction (14.3%).

The debt crisis was hardest felt in financial sector share prices.

We can see from figure 11 that the European sovereign debt crisis has weighed more heavily on financial than non financial shares. Conversely, the internationalisation of Ibex 35 companies appears not to have been a factor in share price performance. In 2009 the most internationalised firms gained 96% as of March lows, roughly doubling the rise of their more home-market oriented peers (see figure 12). In 2010, however, the shares of firms with more geographically diversified earnings have performed more or less on a par with the rest, with falls of 10% and 13% respectively.

13 To 15 September.

Performance of the Spanish stock market by index and sector (%)

TABLE 8

Index	2006	2007	2008	2009	1Q10[1]	2Q10[1]	3Q10 (to 15 September) % prior qt.	% Dec	% y/y
Ibex 35	31.8	7.3	-39.4	29.8	-9.0	-14.8	16.1	-10.0	-7.3
Madrid	34.5	5.6	-40.6	27.2	-9.6	-14.5	15.6	-10.5	-8.4
Ibex Medium Cap	42.1	-10.4	-46.5	13.8	-0.8	-15.9	14.0	-4.8	-9.4
Ibex Small Cap	54.4	-5.4	-57.3	17.6	-0.9	-16.9	2.4	-15.6	-23.6
FTSE Latibex All-Share	23.8	57.8	-51.8	97.2	6.9	-7.3	1.1	0.2	19.5
FTSE Latibex Top	18.2	33.7	-44.7	79.3	7.2	-2.5	0.6	5.1	27.0
Sector[2]									
Oil and gas	18.3	1.8	-30.8	-20.1	-6.7	-9.6	8.6	-8.4	-14.5
Chemicals	-20.4	-58.4	-67.8	3.4	-0.7	-14.4	-47.3	-55.2	-57.6
Basic materials	69.3	-17.2	-45.4	23.1	2.7	-11.2	3.9	-5.2	-11.4
Construction mat. and construction	61.6	-12.0	-51.0	25.5	-5.5	-21.2	14.3	-14.8	-16.2
Industrial goods and services	28.4	6.9	-41.9	29.3	-4.1	-11.3	15.0	-2.2	1.5
Health	40.7	19.2	-45.0	17.7	-3.7	-23.8	20.3	-11.7	-13.7
Utilities	42.0	18.5	-31.0	-7.8	-7.1	-19.1	12.5	-15.4	-12.1
Banks	27.6	-4.5	-47.9	46.3	-14.6	-13.1	14.5	-15.1	-13.2
Insurance	44.7	-13.3	-25.0	19.8	-6.6	-17.4	7.4	-17.2	-18.2
Real estate	100.4	-42.6	-58.6	-43.8	-4.1	-19.8	-20.8	-39.1	-57.4
Financial services	91.1	-35.6	-44.3	20.8	6.8	-9.8	15.2	11.1	5.2
Telecommunications and media	29.4	26.3	-31.4	23.5	-9.0	-14.6	18.6	-7.8	-3.7
Discretionary consumption	21.2	-7.7	-39.2	37.0	10.5	-9.2	21.1	21.5	32.1
Basic consumption	12.9	6.9	-22.5	-8.4	1.6	-1.2	6.8	7.2	6.6

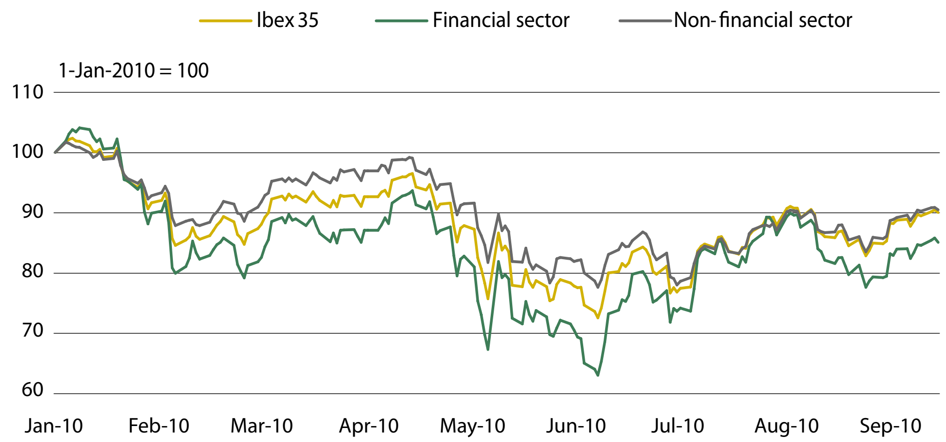
Source: Thomson Datastream.

1 Change on previous quarter.

2 Classification obtained from Thomson Datastream.

Ibex 35: financials vs. non financials[1]

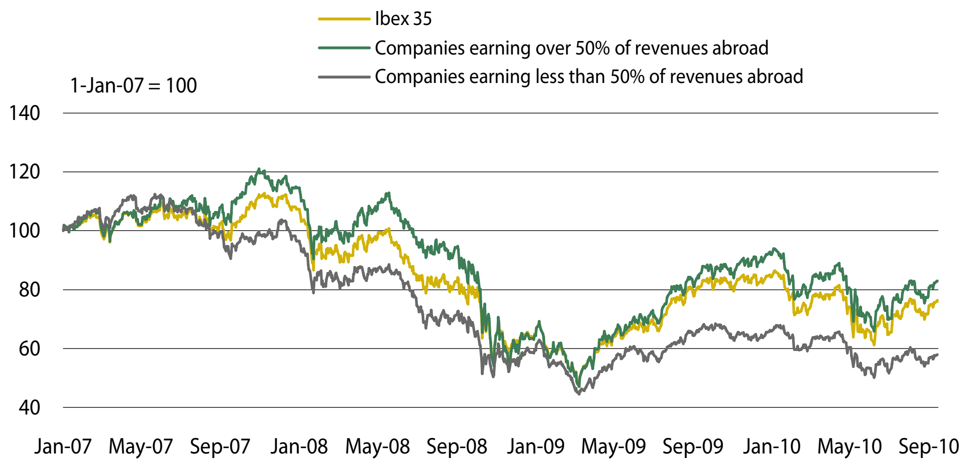
FIGURE 11



Source: Thomson Datastream. Data to 15 September.

1 Each company is weighted according to the share of its market cap. in the market capitalisation of the Ibex 35 at the close of the preceding year.

Performance of Ibex 35 companies by degree of internationalisation[1] FIGURE 12



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

1 Each company is weighted according to its share in the market capitalisation of the Ibex 35 at the close of the preceding year. The yardstick used for internationalisation is 2009 operating profits, in the case of credit institutions, and 2009 revenues for all other firms.

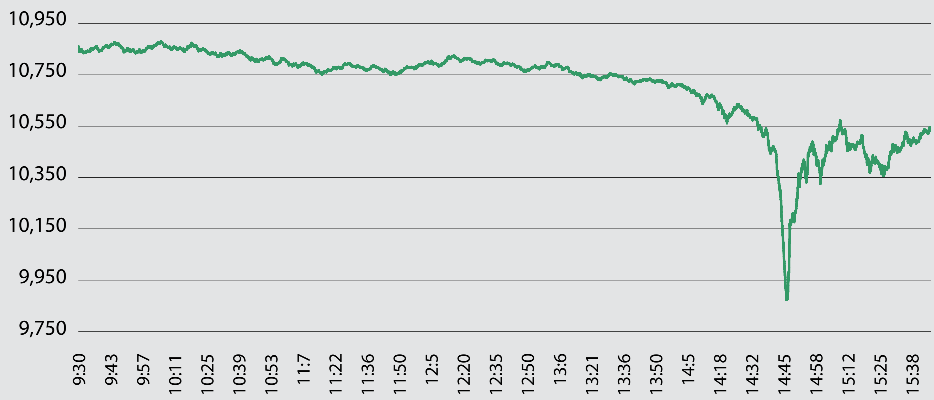
Exhibit 3: "The flash crash of 6 May: hypotheses and prevention mechanisms"

On May 6 last, the Dow Jones Industrial Average (DJIA) dropped around 1,000 points (9.16% of the previous day's closing level) in a few traumatic minutes. Just a short time later, the market had made up almost all the ground lost (see figure E4.1). During this episode, of the type known as a flash crash, two hundred companies saw their share prices briefly plummet to a handful of dollar cents.

Even after a joint probe by the Commodity Futures Trading Commission (CFTC) and the SEC, the ultimate cause of one of the greatest intraday shocks in stock market history is still far from clear. Initially suspicions centred on a human error in entering a sell order, triggering a sudden fall in the price of the share with an instantaneous knock-on effect on remaining stocks. However, the latest findings suggest that the shock owed to a combination of various factors, among them the complex organisation of United States equity markets, with liquidity at times thinly spread between regulated markets and multilateral trading facilities, the increasingly intensive use of high-frequency trading strategies and a heterogeneous regulatory environment such that any one incident can be dealt with in different ways.

Another factor at work is the complex interrelation of U.S. trading platforms, all of which operate under a National Market System (NMS), such that orders must be routed to the market with the best current price, to support price consolidation and offer participants the best execution. However this rule has exceptions and, as Magerman[1] (2010) points out, may be impractical in certain circumstances due to technical problems of interconnection or in the presence of trading peaks. The result can be unexpected shifts in liquidity from one market to another. In light of this latest incident, debate has resumed about the fragmentation of liquidity across diverse trading platforms, with 30% of volumes transacted on non public platforms (dark pools and internalisers) and high-frequency trading strategies[2] gaining in popularity.

DJIA prices on 6 May 2006 FIGURE E3.1



Source: Bloomberg

The latest line of investigation being followed by the SEC points the finger at a manipulative practice called "quote stuffing" where traders flood the market with buy or sell orders that they immediately cancel, the goal being to slow down the system and deceive other investors into following a movement that then disappears.

Other flash crash analysts have mentioned regulatory disparity in the volatility controls of different trading platforms as a possible exacerbating factor in share price fluctuations, though without pinpointing any one norm. During the twenty minutes the flash crash lasted, there was a shift in orders from the NYSE towards multilateral trading facilities with no volatility buffers in place. On the NYSE, the trading system switched to "manual" mode ("go slow"), slowing order execution by a considerable margin. But in the absence of blanket regulations, trading on other platforms proceeded unhindered. The result was to accelerate the price fall by diverting part of NYSE's normal activity to thinner, less deep venues. Also, some participants contend that a large number of high-frequency traders pulled out of the market, with damaging effects on liquidity and depth.

The NYSE operates two types of volatility controls, triggered by a pre-set variation in price:

1. Liquidity replenishment points (LPRs) are activated individually for each share. They slow down trading by removing the quote from automatic execution and transferring it to the traditional open outcry mode.

2. Circuit breakers, when activated, pause trading in some or all of the securities on a given market. The idea is to reduce volatility and improve investor confidence by taking a long enough break for incoming information to be calmly assessed, and thus mitigate the risk of trading failures. The NYSE first introduced circuit breakers in 1989 in response to the volatility episodes of October 1987 and that same year. In its initial formulation, this was an asymmetric measure in that trading was only halted in the event of a steeply falling DJIA index, but never with a rise. Every quarter, the exchange would calculate and disclose the DJIA thresholds for a 10%, 20% and 30% variation and set out the measures to be taken depending on the time slot when the

incident occurred. In the case of a 10% drop, for instance, the measure could be one of three according to the timing. If the price fell before 14:00, trading would be called off for an hour; between 14:00 and 14:30 and the exchange would close for half an hour; later than 14:30 and trading would continue. In the case of 20% falls, the market would be suspended for two hours before 13:00, and for one hour if the fall came between 13:00 and 14:00. Any later than that and the trading session would be brought to a close. Finally, a 30% fall at any time of day would cause the market to close for the rest of that session.

The SEC's first measure after the events of May 6 was to set up a system of individualised "short circuits" for each share jointly with the Financial Industry Regulatory Authority (FINRA), to apply to all equity trading platforms operative in the United States. The new system came on stream on 11 June this year and will be run on a pilot basis until 10 December next. In this initial try-out period, it will be confined to the 500 stocks making up the S&P 500, but after the results have been analyzed the idea is to roll it out to all listed shares, including exchange-traded funds (ETFs).

Under the new rules, trading of a given share will be suspended for five minutes when the price change in the previous five minutes has exceeded 10%. Among the novelties incorporated are the following: i) this is a homogeneous system applicable to all trading platforms; ii) it applies to individual shares; iii) it is more responsive because it factors immediately preceding movements in price; and, lastly, iv) it operates symmetrically, covering both upward and downward movements.

Since 2001, Spain's regulated stock markets have had mechanisms in place fulfilling this same function, known as "volatility auctions". Auctions last five minutes and come into play when a share price varies by a given percentage over the preceding trading price (*dynamic range*) or the last auction where it was sold (*static range*). The goal is to facilitate the spread and assimilation of new information on listed shares or on the exceptional circumstances prevailing at a given time.

1 *The Flash Crash*, David M. Magerman, 14 May 2010, Mill Creek Capital Advisors, LLC.

2 In a recent speech, SEC Chairman Mary L. Schapiro called for new obligations for high-frequency traders so their activity serves to support market stability and integrity (the speech "Strengthening Our Equity Market Structure", delivered in September 2010 before the Economic Club of New York, is available on http://www.sec.gov/news/speech/2010/spch090710mls.htm).

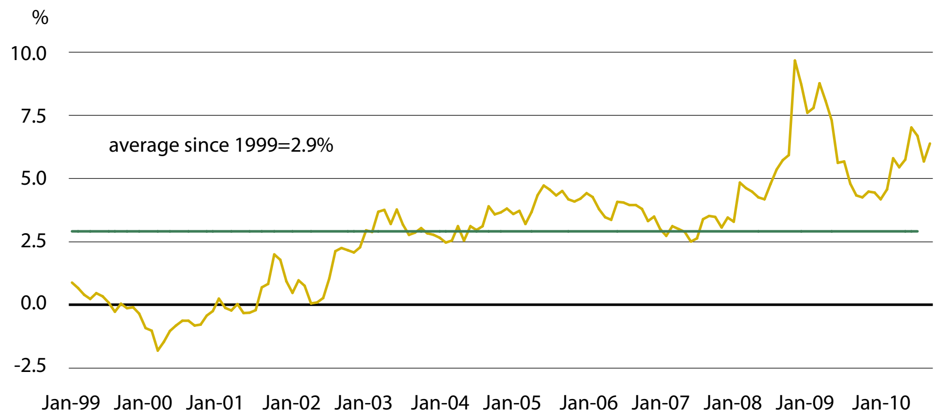
The price/earnings ratio of the Ibex 35 has pulled into line with those of main European indices, after trailing behind since the start of the year.

The P/E of the Ibex 35 has tended to align with those of main European indices...

Also in the third quarter, the earnings yield gap which expresses the risk premium of Spanish equities (in comparison to government bonds) broke free of the ascent traced since the year's outset after the easing experienced in March-December 2009. Movements in this indicator, which tend to be led by share prices rather than bonds, have lately been conditioned more by sovereign yields in a climate of heightened debt market volatility. This indicator, concretely, settled at 6.4% in the month of September compared to the 2.9% average recorded since 1999 (see figure 13).

...while the earnings yield gap approximating the risk premium of Spanish equities has reversed its upward trend.

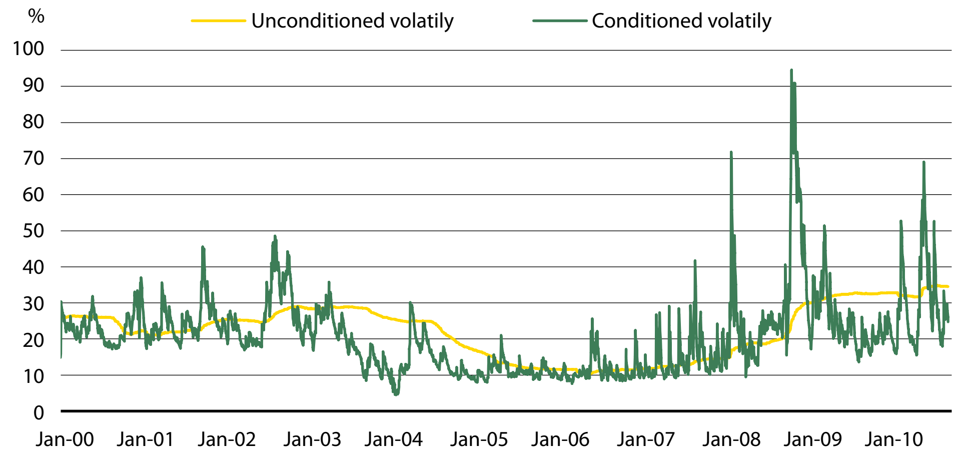
Earnings yield gap[1] of the Ibex 35 FIGURE 13



Source: Thomson Datastream y elaboración propia.

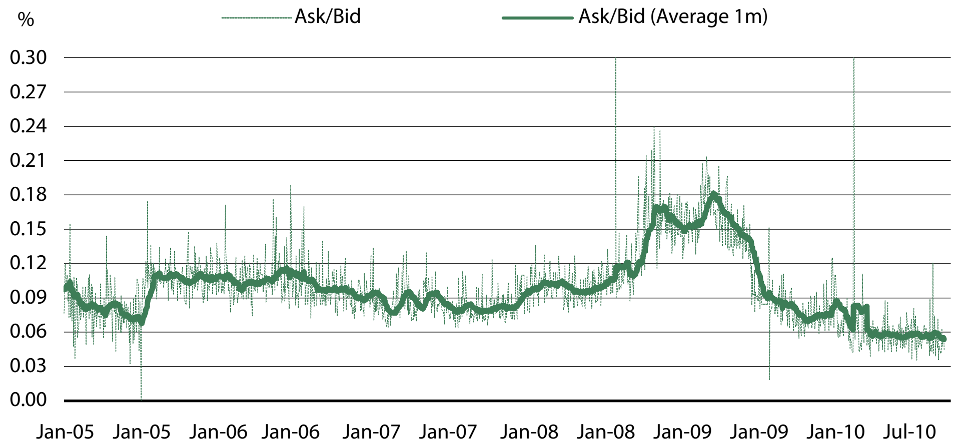
1 Difference between stock market yield, taken as earnings/price, and ten-year Spanish government yields. Monthly data to September 2010.

Historical volatility. Ibex 35 FIGURE 14



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

Ibex 35 liquidity. Bid/ask spread (%) FIGURE 15



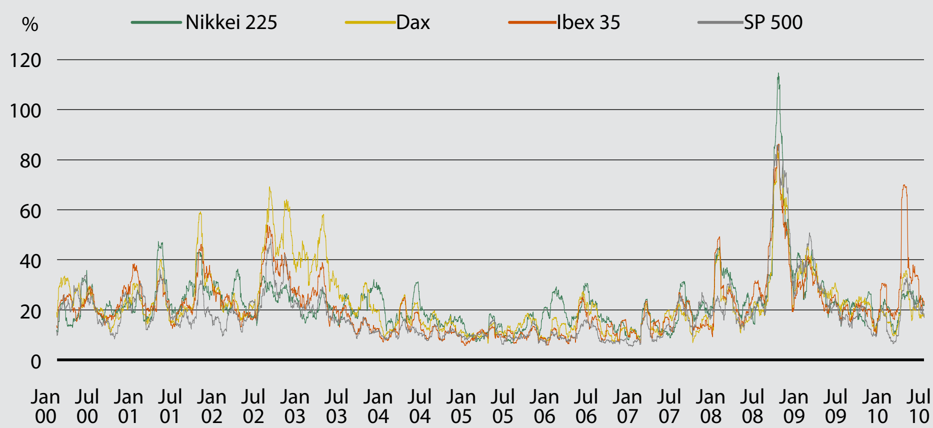
Source: Thomson Datastream and CNMV. Data to 15 September.

Exhibit 4: "Spanish stock market volatility: an international comparison"

Volatility measures the degree of fluctuation of financial asset prices and is accordingly tied in strongly with their market risk. There are various ways to estimate the volatility of a given asset, among the most frequent being the *historical* and *implied* methods. Among the first, the simplest procedure is to take the volatility of an asset or index as the standard deviation of its daily returns over a specified time period. Some models assume that volatility is not constant over time, so divide it into two components, variable and fixed.[1] The historical approach can also be used to measure intraday volatilities, taking, for instance, the time variation between the asset's price highs and lows on each day of the reference period. Implied volatility, meantime, is derived backwards from the market price of options on the underlying asset.

In the second quarter of 2010, available measurements of Spanish stock market volatility (with the Ibex 35 as proxy) showed a marked upswing tracing to the European sovereign debt crisis. The historical volatility of the Ibex 35 (taken as the standard deviation of daily returns) clearly exceeded the levels of reference markets (see figure E4.1) to the extent of testing 70% in the first fortnight in May, though it later eased back to the region of 20%.

Historical volatility of international stock indices (%) FIGURE E4.1



Thomson Datastream and CNMV. Data to 15 September.

Table E.4.1 sets out the average historical volatilities of selected indices in distinct time periods, with a grouping by region (core European economies, United States and Japan and peripheral European economies). For each index, we have compared average volatility with that of the Ibex 35 in periods of normality or absence of turbulence (between 2005 and June 2007) and in the tumult of the recent crisis (since June 2007).

In general, statistical analysis shows that Ibex 35 volatility: (i) is in line with that of main European reference indices in both calm and turbulent periods; (ii) is significantly higher than that of U.S. indices and lower than those of Japan; and (iii) lies around the middle of the volatility range of peripheral European economies (below Greece and Ireland but above Italy and Portugal)[2]. The results of these tests have proved largely robust for different time periods and other volatility measures (see figure E.4.2 for average measurements of intraday historical volatility).

Historical volatilities[1] of selected stock indices (%) TABLE E4.1

	Index\Period	From 2005	2005-Jun 07 (normality)	From Jun 07 (crisis)	Latest reading[2]
	Ibex 35	20.6	11.5	27.2	20.6
Core European	Euro stoxx 50 (Euro)	20.4	12.3	26.4	19.6
	Euronext 100	18.9	11.1	24.6	18.1
	Dax 30 (Germany)	19.9	13.1	24.9	15.4
	Cac 40 (France)	20.7	12.3	26.8	21.0
	FT 100 (United Kingdom)	18.0	10.2	23.7	16.0
U.S. and Japan	Dow Jones (U.S.)	17.2	9.5	22.8	16.1
	S&P 500 (U.S.)	18.6	9.8	25.1	18.3
	Nasdaq-Cpte (U.S.)	20.5	12.7	26.2	20.3
	Nikkei 225 (Japan)	22.3	15.4	27.4	25.8
	Topix (Japan)	20.8	14.8	25.3	20.1
Peripheral European	Athens Exchange (Greece)	23.7	14.8	30.3	30.2
	Portugal	15.2	7.4	20.9	11.0
	Ireland	23.9	12.2	32.4	27.4
	Mib-30 (Italy)	15.9	8.9	21.0	17.5

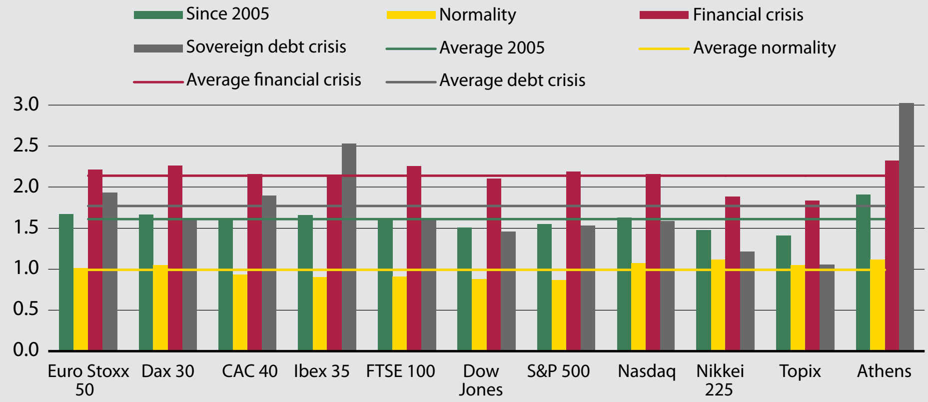
1 Calculated as the standard deviation of daily returns over the past twenty days.

2 15 September.

Focusing on the instability peaks in financial markets over the last decade, it appears that the largest relative increases in volatility occur in the indices of the economies under closest scrutiny. Hence indices in Europe, and Germany particularly, were the most volatile of all during the accounting scandals that rocked various European companies in 2002/2003. Conversely in late 2008, it was U.S. indices whose volatility hit record highs (above 100%) in the wake of the collapse of several large American financial institutions. Finally, during the recent turmoil surrounding the European sovereign debt crisis, the economies seen as most challenged, Spain among them, tended to show equity market volatility readings in excess of the average.

Intraday historical volatility[1]

FIGURE E4.2



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

1 Calculated as the % difference between maximum and minimum price. Averages are provided for each index in differing time periods.

It is interesting in this light that fiscal adjustment measures by some of these countries in tandem with pan-European initiatives (financial assistance mechanisms, ECB liquidity support, etc.) have succeeded in reducing volatility readings in their markets to near levels of "normality", as we can see from the final column in figure E4.1.

1 Figure 14 shows a breakdown of this type for Ibex 35 volatility, based on a GARCH model.

2 The fact that Spanish market volatility exceeds that of the Portuguese or Italian markets may reflect the latters' specific characteristics of liquidity or depth.

Market turnover has picked up significantly…

Turnover on Spanish stock markets summed over 776 billion euros in the first nine months of 2010 (to 15 September), 32% up versus the same period last year. Average daily trading reached 4.52 billion euros in the third quarter, in line with the figure for the preceding six months (4.19 billion). This is sizeably ahead of the 3.49 million of full-year 2009 but remains well short of the 4.89 billion of 2008 and the record 6.59 billion of 2007.

...but issuance remains low-key, despite the renewal of certain transactions.

Equity issuance revived somewhat in the second quarter of 2010 after the lethargy of preceding years, although transaction volumes (a total of 534 million) pale in comparison to the pre-crisis years (see table 10). Capital increases filed to 15 September amounted to just over 7 billion euros, some way down on the 9.08 billion of one year back and far removed from pre-crisis levels.

Turnover on the Spanish stock market

TABLE 9

Million euros	2006	2007	2008	2009	1Q 10	2Q 10	3Q 10[1]
All exchanges	**1,154,294**	**1,667,219**	**1,243,387**	**886,135**	**229,120**	**298,811**	**248,611**
Electronic market	1,146,390	1,658,019	1,235,330	880,544	227,866	297,495	247,251
Open outcry	5,318	1,154	207	73	17	13	25
of which SICAVs[2]	4,581	362	25	20	3	4	7
MAB[3]	1,814	6,985	7,060	5,080	1,089	1,141	1,231
Second Market	49	193	32	3	0	1	0
Latibex	723	868	758	435	147	162	103
Pro-memoria: non resident trading (% of all exchanges)							
	58.4	61.6	65.5	64.2	64.8	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.

Equity issues and public offerings[1]

TABLE 10

					2010		
	2006	2007	2008	2009	1Q10	2Q10	3Q10[2]
CASH AMOUNTS[3] (million euros)	29,436	69,955	16,349	11,391	241	5,115	2,323
Capital increases	26,977	67,887	16,340	11,389	241	4,581	2,323
Of which, rights offerings	645	8,503	292	17	15	924	6
National tranche	303	4,821	292	17	15	924	6
International tranche	342	3,681	0	0	0	0	0
Public offerings	2,459	2,068	10	2	0	534	0
National tranche	1,568	1,517	10	2	0	534	0
International tranche	891	551	0	0	0	0	0
NUMBER OF FILINGS[4]	86	100	54	53	10	18	12
Capital increases	77	91	53	53	10	17	12
Of which, rights offerings	8	8	2	2	2	4	2
Of which, bonus issues	20	19	18	11	1	4	3
Public offerings	14	12	2	1	0	2	0

Source: CNMV.

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

2 Data to 15 September 2010.

3 Excluding amounts recorded in respect of cancelled transactions.

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

Exhibit 5: "The new CESR disclosure regime on short selling and its implementation by the CNMV"

In the third quarter of 2008, faced with a deepening financial crisis, financial supervisors began imposing new rules for the disclosure of short positions in equity markets.[1] This was the case of numerous European jurisdictions, which activated reporting requirements for this type of position with the regulator (private disclosure) and, at times, remaining market participants (public disclosure).[2]

Despite an ample consensus around the need to have transparency requirements in place, Europe's national authorities have not always coincided on how they should be enforced. Initially, most countries opted to have investors disclose all positions above 0.25%. There were exceptions, however, including Greece, which set the same threshold at 0.1%. Another point of difference was whether disclosure should be to the regulator alone or also to the market. Finally, a majority decided that both should be informed, though countries like Portugal and Austria have stuck with the first option.

Against this backdrop, the Committee of European Securities Regulators (CESR) launched a public consultation on the transparency standards to apply as part of a pan-European regime. The resulting document, published in March 2010 with the title "Model for Pan-European Short Selling Disclosure Regime",[3] set out a common disclosure regime for net short positions, while calling on the European Commission to begin work on writing its requirements into EU securities market legislation.

The regime envisions a two-tier disclosure system:

- Disclosure to the competent supervisor when the short position exceeds 0.2% of the company's issued share capital. Once this requirement is triggered, investors must renew disclosure after any change (up or down) of more than 0.1%.

- Disclosure to the market when the short position crosses the threshold of 0.5% of the company's issued share capital. Once this requirement is triggered, investors must likewise renew disclosure after any change (up or down) of more than 0.1%.

Regarding how the net position is to be calculated, CESR lays down that investors should take into account transactions in all financial instruments that create an economic exposure to the issuer's share price. Calculating the net short position should therefore not be confined to positions held in cash equity markets, but should also extend to those in linked derivative contracts (futures, equity swaps, contracts for differences, options, baskets, indices, etc.).[4]

The new regime will apply to shares admitted to trading in any regulated market within the European Economic Area or in any multilateral trading facility when the issuer's primary market is located outside the EEA. Liquidity providers are considered to be exempt, whereas market makers must ask the CNMV for exemption

Spain was the first country to implement the terms of the agreement. Specifically on 27 May 2010, the CNMV Executive Committee took the necessary steps to enforce the CESR measures with immediate application. As of 10 June, investors are obliged to disclose their net short positions to the regulator and the market when they exceed 0.2% and 0.5% respectively of the company's issued share capital. On 11 June 2010, the CNMV made the first ever posting on its website[5] of data on investors holding net short positions above 0.5%.

A few weeks before the closing date for this report, in September 2010, the European Commission published a draft regulation making it incumbent on all EU member countries to implement the CESR short-selling disclosure regime.

1 Readers of this Bulletin will find an article titled "The effects of short selling restrictions in equity markets: some early results" by A. Ispierto Maté and R. Losada López, on how this kind of disclosure requirement affects stock market operation.
2 The article "Short selling" by Rodrigo Buenaventura, published in the CNMV Bulletin for the fourth quarter of 2008, describes the main measures in force at that point.
3 Available at http://www.cesr.eu/data/document/10_088.pdf.
4 Preferential subscription rights, convertible bonds and equity warrants issued by the company will not compute towards calculating the net short position until the underlying shares are admitted to trading. The execution of rights converting these instruments into shares entails the creation of a number of new shares equal to their delta.
5 http://www.cnmv.es/Portal/Consultas/Busqueda.aspx?id=29.

3.2 Fixed-income markets

A relative calm returns to the Spanish public debt market...

Spanish fixed-income markets have settled down after the turbulence experienced in the first months of 2010. Government bond yields reduced slightly in the year's middle months and new issues have been relatively stress free. Also, September figures show that financial institutions have stepped up their debt financing.

...with moderate falls in yield at all maturities…

Short-term government yields have tended to ease after the run-up of the second quarter. At the closing date for this report, the interest rates of Letras del Tesoro stood around 67 bp for tenors up to three months, with six-month bills at 118 bp and twelve-month bills hovering just above the 160 bp mark. Private fixed-income instruments have told a rather different story, with short rates rising less than their public debt equivalents in the second-quarter period, but then rising further in the third while short-term treasuries fell.

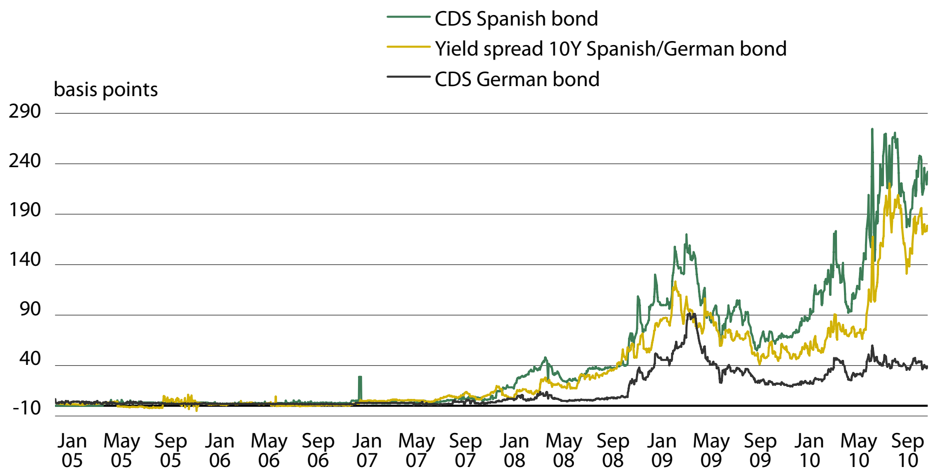
...particularly shorter-dated instruments.

Long-term sovereign bonds performed similarly to shorter-dated instruments, that is, with a run-up in the second quarter giving way to a degree of easing in the third which, nevertheless, did not suffice to compensate the earlier increase. More specifically, three- and five-year yields moved up 140 bp and 104 bp in the second quarter and then dropped back by around 70 bp to mid-September levels of 2.6% and 3.1% respectively. Meantime yields on ten-year bonds followed a similar but smoother course.

The premium demanded of Spanish debt remains at high but manageable levels.

The risk premium of Spanish debt, taken as the spread vs. the German ten-year benchmark, has climbed by over 45 bp since end-August to upwards of 175 bp. This came on the heels of a roughly 80 bp drop from the peak reached in early July (around 210 bp) following the escalation of the second quarter. The recent progress of this indicator suggests that public debt market tensions may have abated but they have not gone away. And the sovereign risk premiums implied by CDS tell basically the same story with more fluctuations (see figure 16).

Risk premium of Spanish government debt[1] FIGURE 16



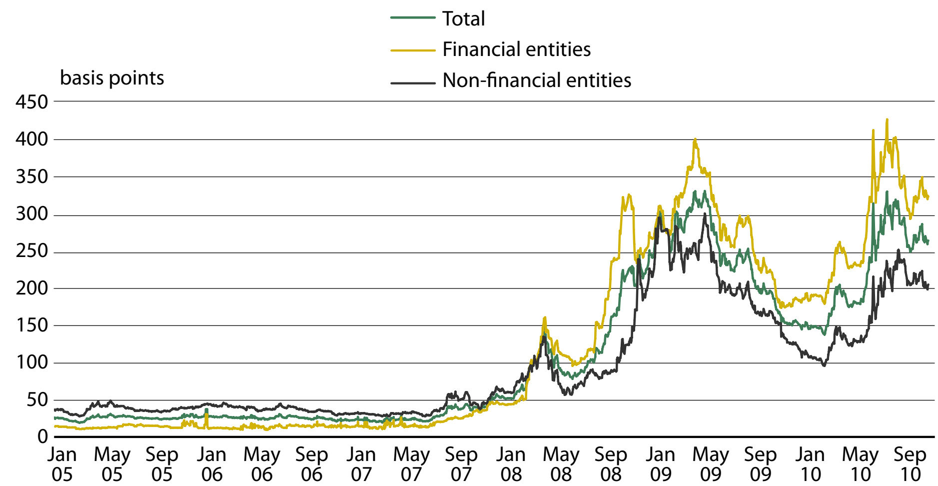
Source: Thomson Datastream.

1 Data to 15 September.

Corporate debt spreads too hold at manageable levels after the highs reached last May.

Meantime, corporate debt spreads strained higher in August after a mid-year dip, among financial issuers especially, following on from the sharp run-up of the second quarter (see figure 17). The stress tests conducted on European credit institutions, whose results were published in July, initially steered spreads back to lower levels. However fears of a weak recovery, the busy debt redemption schedules faced by credit institutions over coming years, and concern about the impact of upcoming changes in financial regulation all tended to support the view that sector funding conditions may take time to normalise.

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



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

1 Simple average.

The volume of fixed-income issues registered with the CNMV was 158 billion euros to 15 September, 47% less than in the same period last year (see table 11). Of this gross amount, financial institutions accounted for rather more than 155 billion (98% of the total), a decrease of 46% with respect to the equivalent 2009 figure. Non financial companies issued 2.95 million euros in the same period, 64% less than in 2009. Changes in the instrument mix are described below:

Gross fixed-income issues registered with the CNMV drop by 47% year on year, though some segments are showing renewed signs of vitality.

- Commercial paper was again the single most popular funding instrument. Issue volumes however dropped 53% year on year to 69 billion euros, taking their relative weight down to 44% (49% in 2009).

- Issues of asset-backed securities, the next most popular, rekindled in the second and third quarters (to 15 September) with rises of 16 and 27 billion euros respectively after their first-quarter slump to less than 3 billion euros. Although this gives them 29% of year-to-date issuance, gross issue volumes are still 31% lower year on year. One factor that may influence this market going forward is the ECB's end-July announcement of new control measures in its collateral framework, namely an increase in the valuation haircuts (discounts on market value) applied to liquidity operations[14] based on lower-rated instruments.

- Mortgage bonds more or less kept up the pace of last year, with some 21 billion issued to 15 September (a year-on-year decline of 6%), while general issuance lassitude boosted their weight in the total by six points to 13%. Also noteworthy was the increased issuance of covered bonds, as far as 5.40 billion euros between January and September against just 500 million in full-year 2009.

- Issuance of non convertible bonds was confined to financial institutions, which placed some 17 billion over the first three quarters, 65% less than the year before. Around half this financing was government backed, with savings banks particularly continuing to draw on this facility.

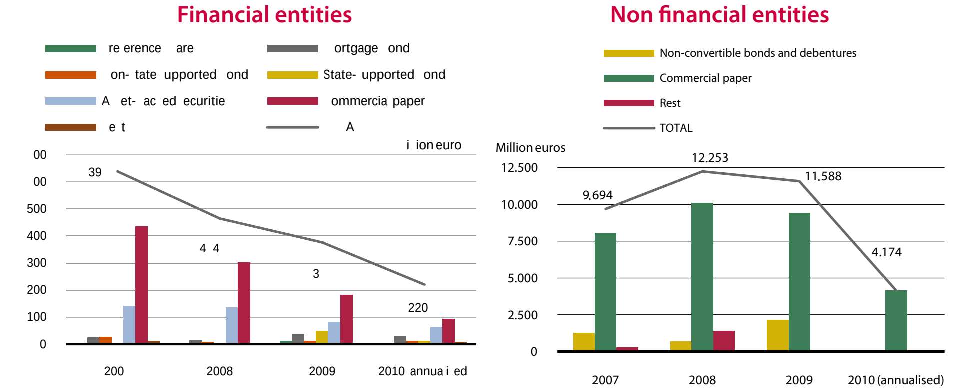
- Preference share issues have dried up altogether. This is true not just of Spain but also other European countries, where their use has dwindled ahead of the regulatory changes envisaged in Basel II, such that they will no longer compute as high-quality regulatory capital.

Foreign debt financing by Spanish issuers dropped back to 73 billion euros between January and July 2010 (see table 11), though here a gap has opened between short-term issues (basically commercial paper) which fell by 38%, and bonds and debentures, up by more than 14%.

14 The new framework will come into force in January 2011 and marks another step in the unwinding of the extraordinary lending conditions currently in place. What the ECB is pursuing with this measure is to dissuade banks from using lower-rated assets. Thus it will continue to accept assets rated down to BBB- in 2011 (vs. a pre-crisis threshold of A-), but it will do so at a price via the application of a higher valuation haircut. For more details on this program see: http://www.ecb.int/press/pr/date/2010/html/sp090728_1annex.en.pdf?2e693e1817cc1b3276a5f9d012cfee82.

Gross debt issuance by type of entity and instrument[1]

FIGURE 18



Source: CNMV.

1 Data to 15 September. 2010 data are annualised for the purpose of comparison.

Gross fixed-income issues

TABLE 11

a) filed[1] with the CNMV	2006	2007	2008	2009	2010 1Q10	2010 2Q10	2010 3Q10[2]
NUMBER OF ISSUES	**335**	**334**	**337**	**512**	**70**	**121**	**52**
Mortgage bonds	37	32	47	75	11	32	18
Territorial bonds	6	8	8	1	2	4	1
Non convertible bonds and debentures	115	79	76	244	39	58	19
Convertible/exchangeable bonds and debentures	1	0	1	6	0	0	0
Asset-backed securities	82	101	108	76	5	9	6
Commercial paper facilities	83	106	88	73	13	18	8
Asset-backed	3	3	2	2	0	1	0
Other commercial paper	80	103	86	71	13	17	8
Other fixed-income issues	0	3	0	0	0	0	0
Preference shares	11	5	9	37	0	0	0
FACE VALUE (million euros)	**523,131**	**648,757**	**476,276**	**387,476**	**51,667**	**57,410**	**48,929**
Mortgage bonds	44,250	24,696	14,300	35,574	4,650	10,892	5,667
Territorial bonds	5,150	5,060	1,820	500	400	4,700	300
Non convertible bonds and debentures	46,688	27,416	10,490	62,249	8,733	6,811	1,287
Convertible/exchangeable bonds and debentures	68	0	1,429	3,200	0	0	0
Asset-backed securities	91,608	141,627	135,253	81,651	2,875	15,699	27,190
Domestic tranche	30,886	94,049	132,730	77,289	2,875	15,205	27,190
International tranche	60,722	47,578	2,522	4,362	0	494	0
Commercial paper[3]	334,457	442,433	311,738	191,342	35,010	19,307	14,485
Asset-backed	1,993	465	2,843	4,758	995	930	1,433
Other commercial paper	332,464	441,969	308,895	186,583	34,015	18,377	13,052
Other fixed-income issues	0	7,300	0	0	0	0	0
Preference shares	911	225	1,246	12,960	0	0	0
Pro memoria:							
Subordinated issues	27,361	47,158	12,950	20,989	3,284	1,984	833
Covered issues	92,213	86,161	9,170	4,794	299	0	0

b) placed abroad by Spanish issuers	2006	2007	2008	2009	2010 1Q10	2010 2Q10	2010 3Q10[4]
FACE VALUE (million euros)	**98,975**	**103,631**	**112,366**	**149,686**	**36,792**	**23,862**	**12,450**
Long term	76,257	65,629	39,894	47,230	15,671	8,990	6,585
Preference shares	1,504	2,581	0	3,765	0	0	0
Subordinated debt	5,758	8,984	70	2,061	0	0	0
Bonds and debentures	64,292	53,327	39,360	41,404	15,671	8,990	6,585
Asset-backed securities	1,703	736	464	0	0	0	0
Short term	25,718	38,003	72,472	102,456	21,121	14,871	5,865
Commercial paper	25,718	38,003	72,472	102,456	21,121	14,871	5,865
asset-backed	16,517	12,119	425	108	95	67	3

Source: CNMV and Banco de España

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

2 Available data to 15 September 2010.

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

4 Available data to 31 July.

4 Market agents

4.1 Investment vehicles

Financial UCITS[15]

Investment fund assets drop 9% in the first half as redemptions gather pace.

Assets held in investment funds dropped by 8.9% in the first six months of 2010 to just over 155 billion euros, close to the level recorded at end-1997. Redemptions were the main motor of this substantial decline, with fixed-income funds[16] back to the volumes suffered at the start of the crisis after the considerable respite of late 2009. It is precisely the conservative, contained-risk nature of bond funds that has made them a prime victim in the scramble for savings launched by national deposit-taking institutions, with high-interest term deposits as the prize lure. Note, however, that not all categories registered cash outflows in the first half of the year. Guaranteed fixed-income funds and absolute return funds achieved combined net subscriptions of around 3 billion euros, while net withdrawals from euro equity funds stood in contrast to the inflows recorded by international equity products.

Portfolio depreciation was less of an issue.

The rest of the overall decline in funds assets owed to the depreciation of portfolio instruments, with equities leading the downside in line with the bear markets of the first-half period. In all, investment fund returns re-entered negative territory in the second quarter (-1.8%) after scraping a 0.6% gain in the first three months. All fund categories experienced some degree of decrease, most notably euro equity (-10.7%), passively managed funds (-7.3%) and international equity (-5%).

Fund mergers remain the order of the day.

Mergers were again a common feature of the investment fund landscape (57 in the first quarter and 98 in the second)[17] taking the number of funds in operation down to 2,436 by mid-year. Unitholder number fell by almost 53,000 in the same period to just under five and a half million. This was accompanied by a shift in the mix such that fixed-income guaranteed and international equity funds gained 120,000 and 30,000 investors respectively while fixed-income funds lost as many as 176,000.

15 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.

16 Cumulative net redemptions in this fund category exceeded 11.70 billion euros in the first six months.

17 One management company was the source of almost all mergers in the period.

Main investment fund variables*

TABLE 12

	2008	2009	2009			2010	
Number			**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Total investment funds	2,912	2,536	2,735	2,628	2,536	2,500	2,436
Fixed income[1]	629	582	612	598	582	567	547
Balanced fixed income[2]	195	169	190	171	169	171	168
Balanced equity[3]	202	165	181	174	165	161	143
Euro equity[4]	237	182	193	185	182	179	179
International equity[5]	330	242	271	252	242	239	233
Fixed income guaranteed	260	233	253	241	233	239	251
Equity guaranteed[6]	590	561	610	593	561	549	530
Global funds	469	187	208	193	187	182	181
Passively managed[7]		69	69	69	69	66	64
Absolute return[7]		146	148	152	146	147	140
Assets (million euros)							
Total investment funds	175,865.3	170,547.7	167,161.0	169,458.4	170,547.7	167,524.3	155,295.5
Fixed income[1]	92,813.1	84,657.2	86,711.3	85,913.9	84,657.2	79,655.6	69,654.5
Balanced fixed income[2]	5,803.0	8,695.5	5,421.8	6,322.4	8,695.5	8,867.1	8,264.2
Balanced equity[3]	3,958.8	3,879.6	3,480.1	3,812.4	3,879.6	3,930.7	3,441.5
Euro equity[4]	5,938.9	6,321.6	4,946.0	6,094.1	6,321.6	6,017.6	5,181.2
International equity[5]	4,254,7	5,902.4	4,108.3	5,020.9	5,902.4	6,869.4	6,682.5
Fixed income guaranteed	21,150.3	21,033.4	21,664.1	21,322.7	21,033.4	22,047.8	23,520.3
Equity guaranteed[6]	30,873.7	25,665.8	29,120.6	27,857.4	25,665.8	24,814.2	23,981.7
Global funds	11,072.8	3,872.5	3,350.7	3,400.4	3,872.5	4,130.3	3,991.1
Passively managed[7]		3,216.6	2,714.5	3,066.3	3,216.6	2,971.9	2,350.2
Absolute return[7]		7,303.0	5,643.6	6,647.7	7,303.0	8,219.9	8,228.4
Unitholders							
Total investment funds inversión	5,923,346	5,475,403	5,498,325	5,461,473	5,475,403	5,489,598	5,422,414
Fixed income[1]	2,204,652	2,041,487	2,067,091	2,042,556	2,041,487	1,994,558	1,864,776
Balanced fixed income[2]	277,629	290,151	241,097	254,599	290,151	298,542	295,325
Balanced equity[3]	209,782	182,542	187,244	184,985	182,542	180,722	185,118
Euro equity[4]	377,545	299,353	270,079	277,093	299,353	290,734	280,529
International equity[5]	467,691	458,097	419,928	434,299	458,097	478,952	487,813
Fixed income guaranteed	538,799	570,963	540,428	550,041	570,963	617,901	690,600
Equity guaranteed[6]	1,402,948	1,188,304	1,339,321	1,272,792	1,188,304	1,153,385	1,142,072
Global funds	444,300	88,337	96,581	79,288	88,337	94,630	99,163
Passively managed[7]		85,403	91,738	97,399	85,403	92,352	97,949
Absolute return[7]		270,766	244,818	268,421	270,766	287,822	279,069
Return[8] (%)							
Total investment funds inversión	-4.21	5.73	2.43	2.80	0.73	0.61	-1.83
Fixed income[1]	2.06	1.91	0.55	0.88	0.24	0.46	-0.62
Balanced fixed income[2]	-7.14	6.85	3.48	4.18	0.63	0.42	-2.18
Balanced equity[3]	-22.21	16.47	9.86	10.18	1.99	-0.14	-6.00
Euro equity[4]	-39.78	32.41	23.34	19.76	3.06	-2.57	-10.67
International equity[5]	-41.71	37.28	20.08	15.15	6.30	5.63	-4.97
Fixed income guaranteed	3.29	3.81	0.94	1.31	0.37	0.98	-1.24
Equity guaranteed[6]	-2.61	3.56	0.85	1.40	0.16	0.39	-1.91
Global funds	-8.64	10.90	4.90	5.18	1.87	1.43	-2.82
Passively managed[7]		-	16.50	12.09	4.61	-1.26	-7.28
Absolute return[7]		-	1.54	1.90	0.70	0.98	-1.19

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:

* Funds filing reserved statements (i.e., not including funds in the process of winding-up or liquidation).

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 2T09: 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: Intenational 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 2008 and 2009, and non annualised quarterly return for each quarter shown.

The latest estimates of liquidity conditions among private fixed-income funds suggest that the volume of less-liquid assets reduced considerably in the first half of 2010, from a start-out level of 14.87 billion to 11.42 billion at end-June (see table 13). This equated to a decline in their share of total investment fund assets from 8.7% in December 2009 to 7.4% in June 2010, the largest drop since this indicator first came under scrutiny (third quarter of 2007). Lower exposure to less-liquid assets extended to both fixed-income and asset-backed securities, with a sharp contraction in the former case among assets rated below AA (down by 1.9 billion in the six-month period).

Less-liquid assets take a lower share of investment fund portfolios.

Estimated liquidity of investment fund assets TABLE 13

Type of asset	Less-liquid investments					
	Million euros			% total portfolio		
	Dec 09	Mar 10	Jun 10	Dec 09	Mar 10	Jun 10
Financial fixed income rated AAA/AA	4,637	3,977	3,724	20.7	17.9	18.3
Financial fixed income rated below AA	4,619	4,231	2,740	31.4	26.0	19.6
Non financial fixed income	190	304	246	3.9	3.9	3.5
Securitisations	5,423	5,318	4,711	73.4	72.4	79.9
AAA-rated securitisations	3,179	2,806	2,346	81.7	77.8	79.6
Other securitisations	2,244	2,512	2,366	64.1	67.1	80.2
TOTAL	**14,870**	**13,832**	**11,421**	**30.1**	**25.8**	**24.2**
% of investment fund assets	**8.7**	**8.3**	**7.4**			

Source: CNMV.

The outlook for the collective investment industry will continue to be complicated by heightened competition from deposit-taking entities, joined lately by foreign UCITS marketed in Spain, which grew their assets 28.5% to a mid-year total of 32.36 billion euros. And the surge in fixed-income fund redemptions in the first six months suggests this trend may persist in coming months. The lesson for the industry, if it is to resume the incipient recovery of late 2009, is that management companies must persevere in rationalising their fund offering so it is sufficiently attractive in terms of costs and returns. The merger wave should help to boost funds' efficiency, while the normalisation of financial markets, and bond markets particularly, should offer a leg-up in profitability.

Industry prospects are clouded by the intense competitive pressure from deposit-taking entities.

Real estate investment funds

Real estate UCITS continued to operate in a troubled environment. The long redemption queues forming at the height of the crisis have triggered early asset sales, property reappraisals and, in some cases, the spreading-out of redemption dates. As described in previous instalments of this report, the CNMV has authorised various funds at their own request to suspend redemptions for a two-year period, so managers have time to put an orderly disposal plan in place.

Real estate funds continue to struggle.

The latest data show real estate fund numbers to be unchanged with respect to end-2009. However of the eight funds on the register, one is in liquidation and a further three have suspended or postponed redemptions. That leaves just four funds as going concerns, of whom three are majority owned by investors belonging to the financial group of the management company.[18] But while these active funds have still had to cope with a regular stream of redemption orders, the last few months have

Of the eight funds on the register, only four are active and coping comfortably with redemption orders.

18 With interests amounting to 80%, 78% and 41% in the three funds with this characteristic.

brought some respite, and all have attended their liquidity commitments without major difficulty.

Assets under management in real estate funds dropped 3.1% from January to July, with unitholder numbers down by just under 8%.

Against this backdrop, assets under management in real estate investment funds fell by 3.1% in the first seven months of 2010 as far as 6.26 billion euros at end-July, while unitholder numbers dropped 7.9% to 76,966. The sector's mean returns remained in the red albeit with some improvement on the losses taken since the closing quarter of 2008.

By contrast, real estate investment companies enjoyed a mini expansion.

Real estate investment companies represented the reverse side of the coin, with year-to-date increases in both assets (up 5.2% in the first seven months to 324.6 million euros) and unitholder numbers (up from 928 at end-2009 to 937 in July 2010).

Main real estate fund variables TABLE 14

					2009	2010		
	2006	2007	2008	2009	Q4	Q1	Q2	Q3 [1]
FUNDS								
Number	9	9	9	8	8	8	8	8
Unitholders	150,304	145,510	97,390	83,583	83,583	81,647	76,772	76,966
Assets (million euros)	8,595.9	8,608.5	7,406.9	6,465.1	6,465.1	6,363.7	6,279.6	6,262.8
Return (%)	6.12	1.27	0.69	-8.32	-1.45	-1.63	-0.99	-0.30
COMPANIES								
Number	8	9	9	8	8	8	8	8
Unitholders	749	843	937	928	928	927	942	937
Assets (million euros)	456.1	512.9	371.9	308.6	308.6	304.6	327.0	324.6

Source: CNMV.

1 Available data to July 2010, with return stated on a monthly basis.

The weakness of the real estate market remains a clear obstacle in the way of recovery.

It is far to assume then that real estate UCITS have more hard times ahead, with fundamentals unlikely to pick up until the Spanish real estate sector is back on an even footing and the pressure of redemption orders starts to ease.

Hedge funds

Performance divergences between funds of hedge funds and hedge funds per se...

A performance gap has opened up of late between hedge funds per se and funds of hedge funds. Funds of hedge funds, we should recall, faced a series of liquidity and valuation problems following the outbreak of the crisis, due to restrictions imposed by foreign hedge funds in which they were invested. They also experienced difficulties coping with the upsurge in redemption orders. And these factors have continued to hold back recovery in this UCITS segment despite the more upbeat figures of fourth quarter 2009.

...with contraction in the first group contrasting with mild expansion in the second.

Specifically, the fund of fund industry shrank further in the first half of 2010, with three retirals taking the number of undertakings down to 35. Sector assets meantime dropped by 8% versus end-2009 to 763.9 million euros, while unitholder numbers fell by a more subdued 3.1%. Conversely, the hedge fund sector experienced encouraging growth across all main variables. The number of undertakings held at 30, one more than in 2009, while assets rose by 25% to 767.2 million euros, and unitholder numbers by 14% to 2,192. That said, aggregate returns have performed negatively year to date with the 2.2% gain of the first quarter wiped out by 3.5% losses in the second.

Main hedge fund variables TABLE 15

	2007	2008	2009	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2[1]
FUNDS OF HEDGE FUNDS								
Number	31	40	40	40	40	38	37	35
Unitholders	3,950	8,151	5,321	5,577	5,303	5,321	5,311	5,241
Assets (million euros)	1,000.6	1,021.3	810.2	709.5	846.8	810.2	793.9	763.9
Return[1] (%)	-0.43	-17.80	7.85	2.59	2.88	0.83	1.72	0.13
HEDGE FUNDS								
Number	21	24	29	26	27	29	31	30
Unitholders	1,127	1,589	1,917	1,768	1,778	1,917	2,137	2,192
Assets (million euros)	445.8	539.4	652	536.9	602.6	652.0	722.4	767.2
Return[2] (%)	0.84	-4.82	14.94	8.12	5.21	1.45	2.23	-3.47

Source: CNMV.

1 Available data to May 2010. Returns stated refer to April-May.

In the near term, the numerous undertakings in liquidation could make a dent in industry assets.

The hedge fund industry faces the same adverse scenario as remaining UCITS modalities. Many undertakings are in liquidation, and we cannot rule out more negative newsflow on their asset volumes, with shrinkage most pronounced in the funds of funds segment. On the upside, hedge funds *per se* have managed to expand at a time when almost the whole UCITS industry is in retreat, and we can hope that the progressive normalisation of financial markets and thinning redemption volumes will play in favour of a stronger recovery.

4.2 Investment firms

Investment firms faced another tough period, though some segments fared better than others.

Investment firm business is still struggling under the weight of the crisis, though with visible differences now emerging by type of firm and business line. So although broker-dealer profits continued in decline, the fault this time has lain mainly with proprietary trading, while their core business (provision of investment services) has apparently been picking up in recent months. Among the brokers, conversely, profit recovery has been led by operating cost containment while revenues have continued to languish. The most positive note is provided by portfolio management companies in the shape of higher ordinary revenues allied with ongoing cost constraint. The result, as we will see, has been to keep solvency indicators safely in the comfort zone.

The aggregate pre-tax profits of broker-dealers fell by 25% to mid-year 2010…

In the case of **broker-dealers**, aggregate pre-tax profits closed the first-half period at 148 million euros, 24.8% less than in the same period of 2009 (see table 16). Behind this negative outcome was a 12% fall in gross income hand in hand with a 13% jump in operating expenses. Other items such as impairment losses and extraordinaries also contributed negatively to first-half income statements.

...however, the decline traced mainly to non ordinary activities while net fee income advanced in the period.

Analysis of the main revenue streams of broker-dealers (gross income) shows grounds for some cautious optimism, in that the aggregate decline has been entirely driven by factors alien to their ordinary activity – in this case the intervening fall in net interest income and steep exchange losses occasioned by a weakening euro – whereas net fee income climbed by over 6% in a clear break with the downtrend of preceding years. Under fee income, the largest advances referred to the biggest revenue item, fees from order processing and execution (up 12%), and fees from the marketing of mutual funds (up 17%). Fees from investment advice contracted 11% in the first-half period, though the biggest fall was reserved for issue placement and underwriting, reflecting the stall in primary market activity.

Aggregate income statement (Jun 10)

TABLE 16

Thousand euros	Broker-dealers			Brokers			Portfolio managers		
	Jun 09	Jun 10	% var.	Jun 09	Jun 10	% var.	Jun 09	Jun 10	% var.
1. Net interest income	98,211	43,915	-55.3	1,679	732	-56.4	247	165	-33.2
2. Net fee income	263,559	279,871	6.2	63,582	56,876	-10.6	5,175	5,967	15.3
2.1. Fee income	393,081	423,657	7.8	72,250	65,412	-9.5	10,653	11,440	7.4
2.1.1. Order processing and execution	274,323	306,583	11.8	30,001	21,791	-27.4	-	-	-
2.1.2. Distribution and underwriting	21,567	2,906	-86.5	1,081	610	-43.5	-	-	-
2.1.3. Securities custody and administration	7,911	11,218	41.8	166	186	12.3	-	-	-
2.1.4. Portfolio management	4,858	6,366	31.0	9,284	8,808	-5.1	8,995	9,218	2.5
2.1.5. Design and advising	27,581	24,477	-11.3	890	1,291	45.0	1,316	1,921	46.0
2.1.6. Search and placement	6	7	8.7	0	115	-	-	-	-
2.1.7. Margin trading	10	5	-50.5	3	10	286.2	-	-	-
2.1.8. Fund subscriptions and redemptions	27,509	32,261	17.3	10,010	12,004	19.9	7	26	245.7
2.1.9. Others	29,317	39,834	35.9	20,816	20,596	-1.1	335	275	-17.9
2.2. Fee expense	129,523	143,785	11.0	8,668	8,536	-1.5	5,479	5,473	-0.1
3. Result of financial investments	51,163	76,990	50.5	102	-104	-	25	65	156.9
4. Net exchange income	-5,749	-38,210	-564.6	113	278	145.8	13	16	17.7
5. Other operating income and expense	6,132	1,437	-76.6	-402	-654	-62.7	-261	-173	33.8
GROSS INCOME	**413,316**	**364,004**	**-11.9**	**65,074**	**57,128**	**-12.2**	**5,200**	**6,040**	**16.2**
6. Operating expenses	185,780	209,760	12.9	61,891	50,836	-17.9	4,597	4,543	-1.2
7. Depreciation and other charges	5,143	1,776	-65.5	1,249	1,430	14.5	95	86	-9.1
8. Impairment losses	36,436	3,159	-91.3	16	-32	-	0	0	-
NET OPERATING INCOME	**185,957**	**149,310**	**-19.7**	**1,919**	**4,894**	**155.1**	**508**	**1,411**	**177.9**
9. Other profit and loss	11,395	-929	-	110	551	403.0	-15	-6	56.8
PROFITS BEFORE TAXES	**197,353**	**148,381**	**-24.8**	**2,028**	**5,445**	**168.5**	**493**	**1,405**	**184.9**
10. Corporate income tax	24,057	16,200	-32.7	1,904	1,003	-47.3	202	234	16.2
PROFITS FROM ONGOING ACTIVITIES	**173,296**	**132,181**	**-23.7**	**125**	**4,443**	**3,458.4**	**291**	**1,170**	**301.5**
11. Profits from discontinued activities	0	0	-	0	0	-	0	0	-
NET PROFIT FOR THE YEAR	**173,296**	**132,181**	**-23.7**	**125**	**4,443**	**3,458,4**	**291**	**1.170**	**301.5**

Source: CNMV.

Brokers, in contrast, grew their profits in the first-half period...

Brokers, meantime, obtained a combined pre-tax profit of 5.4 million euros in the first six months of 2010 (see table 16). This is well ahead of the two million reported in the same period in 2009, though still far short of the 16 million of June 2008.

...with expenses falling faster than revenues,...

As table 16 shows, profit recovery drew on a reduction in operating costs outstripping the fall in main revenue lines. Net fee income, to go no further, sank by almost 11%, due to lower inflows under all main captions excepting UCTIS redemptions and subscriptions.

...especially under personnel heads.

The near-on 18% reduction in brokers' operating expenses was secured through personnel cost savings in the wake of workforce reductions. Earnings from provision writebacks and other extraordinary items also contributed positively at the pre-tax profits line.

Profits growth at portfolio management companies drew on both revenue and cost items.

Finally, **portfolio management companies** posted pre-tax profits of 1.4 million between January and June 2010, almost three times more than in 2009. Growth here drew on a strong performance from net fee income, up 15% in the first-half period, as well as a 1.2% reduction in operating expenses. The salient development under fees was the 2.5% increase in what is the main revenue source for this kind of firm, portfolio management fees and, particularly, fees from the provision of financial advice (up 46%).

Exhibit 6: "Guide on appropriateness and suitability testing"

As anticipated in its Activities Plan for 2010,[1] the CNMV has included among its priority objectives to foster greater transparency and better communication among the diversity of market agents. Part of this effort would be to establish good practice standards for testing the appropriateness and suitability of financial instruments with regard to a given service user.

Accordingly, on 17 June, the CNMV published its guidance on appropriateness and suitability testing in the case of services rendered to retail clients.[2] The goal is to help sector firms comply with current legislation by ensuring that they know what is expected of them and how best they can deliver it. The main points covered are as summarised below.

1. Appropriateness testing

Special attention goes to the "initiative" concept which determines when it is necessary to test for appropriateness in the case of non complex products. The Guide points out that an investment service is provided at the initiative of the firm when a customer requests it after a personalised approach from the company, which has contacted him/her directly by whatever means. The communication in question will either have invited the customer or attempted to persuade him/her to acquire a particular financial instrument or to engage in a particular transaction.

In appropriateness tests, the client may only be deemed to have sufficient prior experience when outstanding positions or earlier transactions involve the exact financial instrument being proposed or others of similar characteristics, and when such experience is based on more than one transaction and not too long a time has elapsed since his or her previous exposure.

The Guide offers a series of tips on how to weigh up clients' level of education, professional experience, and familiarity with different kinds of financial instruments. For instance, a non complex product could be a good option for a client without investment experience if he or she has a sound educational level and professional experience or understands the nature of the instrument and the risks involved.

It also deals with practical matters like the standards to follow in drawing up questionnaires and how to issue clients with the relevant warnings. The firm must in any case be able to provide evidence that an appropriateness test has been conducted. When it uses questionnaires to compile customer data, it could, for instance, keep paper copies signed by the client or use some other medium that constitutes a formal record. Firms should take special care with the design and evaluation of questionnaires to ensure there are no inconsistencies or biases that might invalidate the test results.

It is important that firms can prove that they have given the client the opportune warnings, whose content will vary when the transaction is "execution only", when the product is considered inappropriate and when the test cannot be run for lack of details. Their wording in any case must be concise and clearly understandable, so the client will have no doubt about the message being transmitted.

Finally, the Guide reminds firms that they are obliged to act in customers' best interests with regard to appropriateness. In particular, if a company approaches a client to interest him/her in a complex financial instrument, despite having up-to-date information in its power from which one could reasonably presume that the investment is inappropriate, that company will be found to have acted without the required diligence and transparency, even if it has issued a warning.

2. Suitability testing

The Guide offers a series of pointers to help distinguish between investment advice scenarios, each with its own legal requirements and its own implications with respect to the duty to act in the client's interest. These include for instance the frequency with which advice is delivered and whether or not the firm's recommendations are subject to subsequent monitoring.

It points out that portfolio management or investment recommendations must be consistent with the analysis conducted, so recommendations or investment decisions are properly aligned with the client's investment objectives. That said, even if a client is willing to take on a high degree of risk, there will be times when he or she cannot afford to do so, or else appears to have an insufficient grasp of the nature and risk of the proposed investment. And these are factors that a firm must reckon with when making recommendations or managing a portfolio.

Providers are also advised on how to define a client's investment objectives. Considerations here include the need to establish parameters or variables that the client can understand, the advisability of controlling the portfolio's global risk as opposed to the individual risks of component instruments, and the option of graduating assessments of investor knowledge and experience as a function of the service being rendered, on the grounds that these factors are of less relevance in the case of portfolio management.

As with appropriateness testing, the Guide urges firms to properly document all tests run and offers guidance on constructing questionnaires.

Finally, firms must have procedures in place to procure the client information required for suitability testing. Such information must be kept updated with any changes in inputs duly documented and acted on.

1 Available on http://www.cnmv.es/DocPortal/Publicaciones/PlanActividad/PlanofActivities2010en.pdf

2 Available on http://www.cnmv.es/portal/verDoc.axd?t={1b7ee817-3cab-432d-bd71-e2d4a1d5a463}

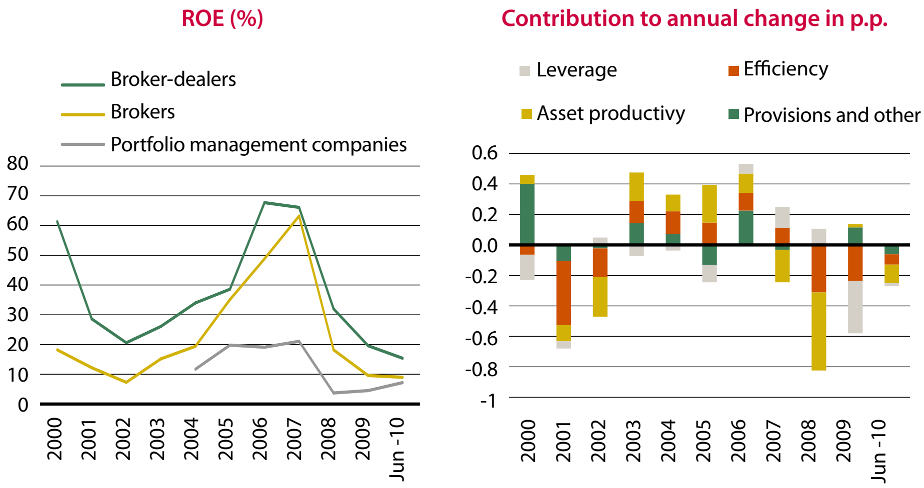
In line with main earnings trends, the **return on equity**[19] (ROE) of the investment firm industry headed lower in the second quarter, albeit less so that in 2009 (see figure 19). Behind this decline was the waning profitability of broker-dealers, down from 21.4% in June 2009 to 15.5% one year later, contrasting with the gains made by brokers and portfolio management companies (from 5.7% to 9% and 3.2% to 7.2% respectively).

Investment firm ROE descends anew, though less so than in 2009,...

A breakdown of the change in investment firm ROE reveals some interesting differences with respect to 2009. As we can see from figure 19 (right-hand panel), last year's slide in profitability was mainly about falling leverage and efficiency losses[20]. In contrast, the more moderate decline to mid-year 2010 was attributable to lower asset productivity, some loss of efficiency and the negative impact of provisions and other extraordinaries.

...due to a degree of erosion in companies' efficiency and asset productivity.

Pre-tax ROE of investment firms FIGURE 19



Source: CNMV.

The number of firms in (pre-tax) losses continued to climb, from 26 at end-2009 to 34 in June 2010 (32 in June 2009, see figure 20). Of these 34 loss-making firms, 15 were broker-dealers, 16 brokers and three portfolio management companies (against a year-before distribution of eleven broker-dealers, 23 brokers and two portfolio managers). Aggregate losses stood at 12.4 million euros, equating to around 8% of the sector's pre-tax profits.

The number of firms in losses continues to climb.

19 ROE is calculated as:

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

in which:

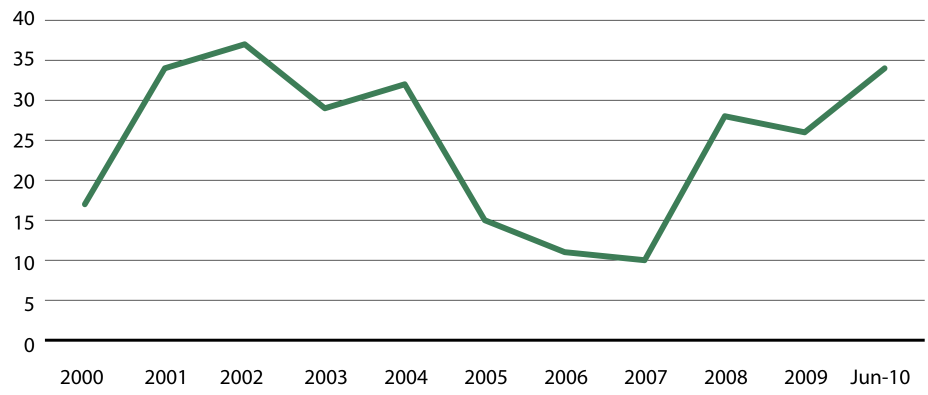
Equity = Capital + Share premium + Reserves – Treasury shares + Retained earnings and profit/loss from previous years – Dividends and other entitlements.

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

$$ROE = \frac{PBT}{Equity} = \frac{PBT}{Netoperatinginc.}(1) \times \frac{Netoperatinginc.}{Gros\sin come}(2) \times \frac{Gros\sin come}{Assets}(3) \times \frac{Assets}{Equity}(4)$$

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

Number of investment firms in losses FIGURE 20



Source: CNMV.

Firms remain comfortably compliant with capital standards...

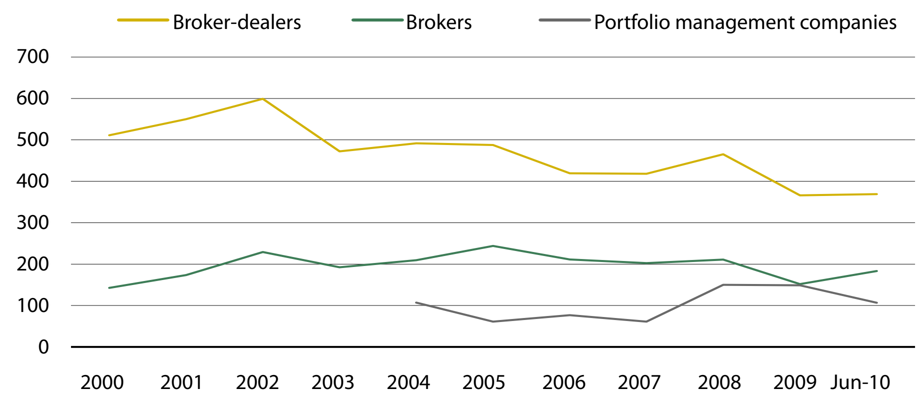
The sector's capital adequacy remains within the comfort zone, and has stayed largely unchanged in this first year since the entry of the latest standards (Circular 12/2008 on investment firm solvency). That said, margins have narrowed in comparison to prior years due to the higher allocation required for operational risk.

...especially the broker-dealers.

At the end of first half 2010, broker-dealers had equity levels 3.7 times higher than the minimum requirement (equalling the 2009 close and improving on the 3.5 times of June 2009), while brokers had a surplus of 1.8 times (against the 1.9 of one year before and 1.5 in December 2009). Meantime, portfolio management companies saw their surplus contract from the 1.9 times of June 2009 to 1.1 times one year later (see figure 21). It bears mention that on June 30, 2010, not one investment firm reported a deficit vs. the minimum standard. Of the five below the minimum in December 2009, four have since ceased trading, while the remaining firm has fought back to compliance via a properly structured viability plan.

Investment firm capital adequacy FIGURE 21

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



Source: CNMV.

A tentative recovery in key business lines augurs better times for investment firms.

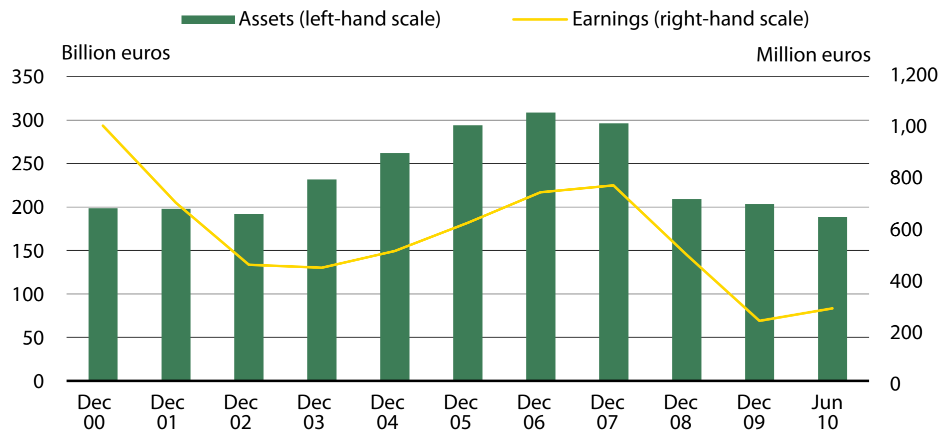
The outlook for the investment firm sector is a little brighter than in previous quarters, to judge by the tentative recovery in revenues from key business lines – including those tied in with market trading – and the success of cost contention efforts, especially among brokers and portfolio managers. In the case of broker-dealers, the negative contributions of net interest income and exchange differences will likely dissipate in coming quarters, helping to attenuate the profits slide. The situation of the broker contingent is rather more complex, with no clear recovery in sight for their core service provision. Again the best news for sector earnings would be a firm upturn in financial market turnover. Finally, although recent months have seen a number of closures, the sector is still carrying excess capacity.

4.3 UCITS management companies

Assets under management contract 7.5% in the year's first half,...

Aggregate figures for UCITS management companies for the first half of 2010 show a 7.5% decline in assets under management as far as 188 billion euros. The scale of the fall, some 15 billion euros, is considerably greater than the 5 billion of full-year 2009, but a long way from the bleak times of 2008, when assets under management slumped by 87 billion euros (see figure 22 and table 18).

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



Source: CNMV. To June 2010. Data for June 2010 are stated on an annual basis.

…but profits edge higher.

Despite this drain in assets, the industry's first-half pre-tax profits came to 285 million euros (in annual terms) compared to the 236 million of full-year 2009. Management fee income held relatively steady at around 0.85% of assets, while the number of companies in losses rose from 31 in 2009 to 37 in June 2010 (excluding one loss-making concern that went out of business). Aggregate (annualised) return on equity rose from 16.7% in December 2009 to 19.4% in June, in line with the increase in sector earnings.

UCITS management companies: pre-tax profits and ROE		TABLE 17
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	497.8	36.8
2009	235.9	16.7
2010 (June[1])	285.4	19.4

Source: CNMV.

1 Data for June are stated on an annual basis.

The woes of the collective investment industry add further uncertainty to management company prospects, compounded by an excess of sector capacity.

The first-half woes of the collective investment industry obviously cast a pall over the outlook for management companies. And the modest profits advance of the first six months may soon lose steam, in view of its close tie-in with shifting investment fund objectives (in favor of equity funds which traditionally carry higher management fees). The truth is that over 30% of these institutions remain stuck in losses, and we cannot rule out a process of industry restructuring to trim the excess capacity. Finally, managers must get down to the twin tasks of rationalising their fund offerings and gaining efficiency via lower costs.

UCITS management companies: assets under management, management fees and fee ratio TABLE 18

Million euros	Assets under management	CIS management fee income[2]	Average UCITS management fee (%)	Fee ratio (%)[1]
2000	198,280	2,869	1.45	63.5
2001	198,115	2,465	1.24	65.8
2002	192,099	2,259	1.18	72.7
2003	231,458	2,304	1.00	73.8
2004	262,132	2,670	1.02	73.6
2005	293,973	2,976	1.01	72.2
2006	308,476	3,281	1.06	71.5
2007	295,922	3,194	1.08	70.5
2008	209,014	2,302	1.10	70.8
2009	203,379	1,702	0.84	68.6
2010 (June[2])	188,159	1,636	0.86	68.5

Source: CNMV

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

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

4.4 Other intermediaries: venture capital

The register of venture capital entities welcomed 19 entrants in 2009 against 13 retirals.

The CNMV's register of venture capital entities (VCEs) recorded ten new entrants between end-2009 and 31 August 2010 (four funds and six companies) against the retiral of one venture capital company. This left the total of 337 entities in operation, of which 105 were venture capital funds (VCFs), 158 venture capital companies (VCCs) and 74 venture capital management companies (VCMCs).

Movements in the VCE register in 2010 TABLE 19

	Situation at 31/12/2009	Entries	Retirals	Situation at 15/09/2010
Entities	**328**	**10**	**1**	**337**
Venture capital funds	101	4	0	105
Venture capital companies	153	6	1	158
Venture capital fund managers	74	0	0	74

Source: CNMV.

Annual statistics on the entities registered with the CNMV put the total 2009 assets of venture capital funds at 3.18 billion euros, an increase of 16.5% versus 2008 (see table 20). A breakdown by investor type puts institutional investors once more at the head after growing their share in the past year. In all, the percentage of VCF assets owned by legal persons rose from 93.2% in 2008 to 95.6% in 2009, while the percentage held by natural persons dropped from 6.8% to 4.4%. Of legal persons, credit institutions, mainly savings banks, were the biggest owners with a stable share of 22%, followed by non financial companies (14.4%), public authorities (12,2%), pension funds (11.2%) and, finally, foreign entities (10%).

Assets of venture capital funds, held mainly by institutional investors, moved up 16.5% in 2009.

Venture capital companies, meantime, closed last year with share capital of 4.17 billion euros. This is roughly the same figure as in 2008, indicating some degree of respite from the decline of preceding years. The largest capital subscribers in this group were again non financial companies, though their relative weight receded from 46% to 36% at end-2009. Conversely, credit instituions, and savings banks in particular, raised their ownership interest from 23% to 33%.

The share capital of venture capital companies stabilised in 2009.

VCEs grew their assets by 1.1% to an end-2009 total of 9.90 billion euros, with 74% corresponded to VCCs and 26% to VCFs. Of the total, 6.19 billion were invested in venture capital activities, 8% more than in 2008, with 76% corresponding to VCC holdings and the rest to investments by VCFs. Sector leverage (calculated as long-term debt to total equity and liabilities) climbed from 4.7% to 5.8%, though here a clear split emerges, with funds' leverage still at minimum levels (0.2%) and companies' up from 6.1% to 7.7%.

Venture capital entities grew their total assets 1.1% in 2009, and raised their investments by 8%.

Venture capital entities: assets by investor group TABLE 20

Million euros	VCFs		VCCs	
	2008	**2009**	**2008**	**2009**
Natural persons				
Residents	185.47	138.00	68.76	66.54
Non residents	1.15	1.65	0.55	0.57
Legal persons				
Banks	202.49	207.70	530.25	551.92
Savings banks	413.18	488.37	438.10	819.37
Pension funds	295.84	356.91	24.20	27.19
Insurance undertakings	59.06	77.09	15.85	15.83
Brokers and broker-dealers	-	-	0.88	0.89
UCITS	32.58	22.39	10.31	8.20
National venture capital entities	31.26	49.46	39.55	85.41
Foreign venture capital entities	123.65	247.67	7.98	50.53
Public authorities	310.66	386.46	120.43	132.44
Sovereign funds	20.27	26.02	-	-
Other financial companies	281.85	263.84	680.06	717.56
Non financial companies	391.87	455.92	1,914.95	1,500.53
Foreign entities	286.04	347.26	32.69	36.34
Others	91.41	108.15	290.94	156.43
TOTAL	**2,726.78**	**3,176.89**	**4,175.49**	**4,169.74**

Source: CNMV.

ASCRI data point to some reactivation in the first half of 2010.

Data furnished by the Spanish industry association (ASCRI) for the first half of 2010 show a sector pulling free of the trough experienced in 2009. Investment in the period totalled 1.09 billion eutos, equivalent to a year-on-year increase of 43%. Transaction numbers were down 10% with respect to 2009, but with something of a surge in new operations. As regards preferred life cycle stages, 45% of investments were targeted on expansion enterprises. Leveraged buy-outs accounted for a further 25% of investment, in what was a clear break with the pattern of previous years. The sectors attracting most funds were communications (32%), transport (19%), energy and natural resources (12%) and consumer goods (10%).

Growth in leveraged buyouts and large transactions hint at a revival of credit flows to venture capital activities.

In sum, all main inputs to industry analysis suggest a degree of recovery is under way, coinciding with the upturn registered in other European countries. This follows on from a series of years in which borrowing constraints placed a tight lid on sector investment, with large transactions most affected. The outlook now can be seen as moderately favourable considering that liquidity is not a major problem and that quickening growth in leveraged and large-scale transactions suggests financial institutions are renewing the flow of credit to what are seen as worthwhile projects.