I Securities markets and their agents: situation and outlook

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1 Executive summary

- Since the last edition of "Securities markets and their agents: situation and outlook", published in the CNMV Bulletin for the third quarter of 2008, the financial and macroeconomic outlook has turned dramatically worse both nationally and internationally, due mainly to the mounting difficulties confronting the financial sector. These have caused a severe crisis of confidence, aggravated by the Madoff fraud, which has choked off the flow of credit and pushed most industrial countries into recession.

- Leading international forecasters expect world GDP to grow minimally or shrink in 2009, accompanied by rapidly rising unemployment and tumbling inflation rates. Monetary stances have been kept notably expansive with official interest rates down to record lows. The authorities have also launched fiscal stimulus packages in view of the faltering pace of economic growth and the reduced room for manoeuvre of monetary policy. Further, the governments of the main economic powers have taken steps to shore up the liquidity and solvency of their banking sectors in order to mitigate systemic risk and halt the credit slowdown.

- Financial markets have lived through a series of traumatic episodes, including the crises of leading banks and the fraud perpetrated by investment fund manager Madoff, which have heightened the distrust felt in the worldwide financial system. Against this backdrop, a majority of stock indices recorded falls exceeding 20% in the fourth quarter of 2008, lifting their full-year losses to record levels. In this bear setting, the financial sector was by far the most heavily chastised. Stock exchange implied volatilities have shown some signs of normalisation but are still at highly stressful levels (above 40% in many cases). And 2008 turnover was sharply down on all leading markets with the exception of the United States.

- Most European and North American supervisors have relaxed the short selling restrictions imposed last September, in view of real doubts about their effectiveness in curbing share price fluctuations and the evidence of their adverse effects on market liquidity.

- Private fixed-income credit spreads have climbed to new highs. However issuance appears to be making a timid comeback. Also, interbank tensions, as reflected in the spread between collateralised (repo) and uncollateralised (depo) transactions, have eased a little along with the downward trend in interest rates levels.

- The Spanish economy is now in recession after two quarters of negative growth, with domestic demand contracting fast and inflation at historic lows. The economic downturn is taking a heavy toll in terms of jobless numbers with construction and services worst affected. Leading forecasters augur a sharp GDP contraction in 2009 accompanied by rising unemployment, and a widening public deficit and public debt ratio in 2009 and 2010.

- Spanish deposit-taking entities continue to confront the complex international landscape from a position of relative soundness vs. foreign competitors. However, their lending activity tailed off notably in 2008, while non-performing loan ratios began showing the strain – at savings banks more than banks and especially in developer financing and home purchase loans. Liquidity conditions remained reasonably easy thanks to loans from the Eurosystem and, more recently, the funds raised at the four auctions of the Financial Asset Acquisition Fund (FAAF) and the issuance of state-backed debt. Deposit-taking entities reported earnings to September 2008 14% lower in annual terms due to asset impairment losses. Their capital adequacy ratios were a little higher than in 2007.

- The aggregate profits of non financial companies dropped 38% in the full-year period in line with the general slowdown in activity. Gross debt also levelled off appreciably among the largest borrowers, in construction and real estate. Despite this, all industries increased their leverage as a consequence of the lower equity, accompanied by a deterioration of their debt coverage ratios. Households, meantime, steered clear of all but the most conservative investments in view of the worsening economic climate. The result was that household indebtedness stabilised at 83.5% of GDP (data to September) in a break with the rising trend of the past few years.

- Leading forecasters concur that the world's top economies will experience a fall in output and employment in 2009. Some recovery should follow in 2010 though here the picture is hazier, as it is hard to predict when the financial sector will recoup some sort of normality or how effective the fiscal stimulus will prove to be in the medium to long run. Forecasts for Spain suggest GDP correction may be sharper than in the euro area, given the heavy toll the crisis is taking on the national labour market.

- Spanish share prices have continued to tumble in line with those of other world markets, in a climate of mounting uncertainty about the economy in general and financial sector income statements. Hardest hit have been small and medium cap stocks, construction and construction-related sectors, real estate companies, financial institutions and some of the more cyclical industries. Meantime, market turnover has been thinning fast in 2009 on top of the 25% decline of 2008 with falling prices as the main culprit. However, volatility and liquidity conditions have shown some signs of normalisation.

- Short-term rates have reflected the expansive stance of ECB monetary policy. The yields of long-term sovereign and corporate bonds have come down significantly since September 2008, though credit market tensions have not gone away, as is clear from the CDS spreads being offered on Spanish issuers, especially those in the financial sector.

- Fixed income issuance dried up considerably in 2008. The most popular instruments were again commercial paper and asset-backed securities, almost invariably acquired by the originating entity. The news, however, is that some kinds of issues are starting to pick up in 2009, primarily financial institution preference shares and subordinated debt. Such paper has mainly been placed among issuers' own retail client base, and the CNMV has decided to tighten its vigilance on the information being given out to prospective buyers. In particular, these issues should come with valuation reports from independent experts which are subject to regulator scrutiny in order to verify their technical quality.

- Assets under management in investment funds dropped by 30% in 2008 to a year-end total of around 180 billion euros, as investors rushed to redeem their holdings. Most to suffer were fixed income, international equity and global funds. The scale of withdrawals is proving a litmus test for funds' liquidity, though here some improvement was apparent in the closing quarter on account of lower investment volumes and the greater relative weight in sector assets of instruments quoted on less active markets. One positive note for the Spanish collective investment industry was its muted exposure to Madoff funds.

- Real estate collective investment schemes suffered the biggest problems of liquidity. Managers, in effect, have had to cope with a surge in redemption orders, motivated by the shrinkage of fund returns, at a time of sluggish activity and sharply adjusting real estate market prices. One result was that the two biggest real estate funds had to suspend withdrawals for a two-year period. Hedge funds, meantime, have been trying to work round the obstacles impeding a part of their strategies, leading some managers to amend their prospectuses (notice periods, proration, partial redemptions, etc.).

- The financial crisis has borne down heavily on the business of investment firms. The aggregate profits of broker-dealers and brokers dropped by 53% and 77% respectively in the first eleven months of 2008 due to the thinning out of their main fee income streams (order processing and execution and CIS subscription and redemption orders). The result was to push down returns on equity and take numerous firms into annual losses. On a brighter note, the sector managed some improvement in its solvency margins thanks to the reserves accumulated in prior years. The main concern now is that a prolonged slowdown could lead to excess capacity in the investment industry, in which case firms will need to take a hard look at their cost structures and, where advised, make the opportune strategic decisions.

- Before the crisis hit, securities regulators were already scrutinising the transparency conditions of non equity financial markets – fixed income and derivatives. In 2006, a CESR report, prepared at the request of the European Commission, found no evidence of market failure associated to a lack of transparency in these markets, so considered there was no case for regulatory intervention along the lines of the MiFID in equity markets. However the financial crisis brought to light a series of information deficiencies in bond and, especially, structured product markets, which may not have caused the turmoil but probably aggravated its effects, and subsequent recommendations stressed the need to improve post-trade transparency in secondary markets. The CESR accordingly reopened its study in May 2008 (a discussion document is now out for consultation), and will publish its conclusions in summer 2009. The CNMV's opinion is that the shortcomings identified as a result of the crisis are sufficient to warrant a Europe-wide review of the existing regulations.

2 Macro-financial setting

2.1 International economic and financial developments

The deepening financial sector crisis has left its mark on the national and international financial and macro setting.

Since the last edition of the "Securities markets and their agents: situation and outlook", published in the CNMV Bulletin for the third quarter of 2008, the financial and macroeconomic outlook has turned dramatically worse both nationally and internationally, due mainly to the mounting difficulties confronting the financial sector. These have caused a severe crisis of confidence among consumers and investors which has choked off the flow of credit and tipped most industrial countries into recession.

World GDP will scrape only minimal growth in 2009 according to international organisations...

On IMF estimates, world GDP growth slowed from 5.2% in 2007 to 3.4% in 2008 with the developed economies exerting a clear drag effect (growth of a bare 1%). For 2009, the same organisation predicts worldwide growth of just 0.5%, sustained only by the output of emerging economies, especially in Asia.

Gross Domestic Product (% annual change) TABLE 1

					IMF(*)		OECD(*)	
	2005	2006	2007	2008	2009F	2010F	2009F	2010F
World	4.4	5.0	5.2	3.4	0.5 (-1.7)	3.0 (-0.8)	-	-
United States	3.1	2.9	2.0	1.1	-1.6 (-0.9)	1.6 (0.1)	-0.9 (-2.0)	1.6
Euro area	1.6	2.8	2.6	1.0	-2.0 (-1.5)	0.2 (-0.7)	-0.6 (-2.0)	1.2
Germany	0.8	2.9	2.5	1.3	-2.5 (-1.7)	0.1 (-0.4)	-0.8 (-1.9)	1.2
France	1.7	2.0	2.2	0.8	-1.9 (-1.4)	0.7 (-0.8)	-0.4 (-1.9)	1.5
Italy	0.6	1.8	1.5	-0.6	-2.1 (-1.5)	-0.1 (-0.1)	-1.0 (-1.9)	0.8
Spain	3.6	3.9	3.7	1.2	-1.7 (-1.0)	-0.1 (-0.9)	-0.9 (-2.0)	0.8
United Kingdom	1.8	2.9	3.0	0.7	-2.8 (-1.5)	0.2 (-0.9)	-1.1 (-2.5)	0.9
Japan	1.9	2.4	2.4	-0.3	-2.6 (-2.4)	0.6 (-0.5)	-0.1 (-1.6)	0.6
Emerging	7.1	7.8	8.3	6.3	3.3 (-1.8)	5.0 (-1.2)	-	-

Source: IMF and OECD.

(*) In brackets, percentage change versus the last published forecast. IMF, forecasts published January 2009 vs. November 2008. OECD, forecasts published December 2008 vs. June 2008.

...in a framework of intense employment destruction and tumbling inflation rates.

The economic downturn, characterised by sharply contracting domestic demand and a substantial reduction in world trade flows, has pushed up jobless totals the world over (though with different intensities depending on the economy). The demand stall and the decline in commodity prices, oil especially, have taken inflation rates down to the lowest levels of the past decade in some of the world's leading economies[1].

Monetary policy follows a strongly expansive course with official interest rates down to historic lows...

The authorities in main world regions have stuck to their expansive monetary and fiscal policies. Central banks have been cutting their interest rates aggressively, at times in coordinated fashion, since the date of our last quarterly report, as far as the minimum levels now prevailing. The Federal Reserve set its target band at 0-0.25% on 16 December 2008, while the latest ECB and Bank of England policy rates at the time of writing stand at 1.5% (6 March) and 0.5% (5 March) respectively.

...fiscal policy too turns laxer in response to growth weakness and the scant leeway available to monetary policy.

Fiscal policy has also turned notably laxer in response to the deterioration in economic growth and the inability of monetary policy alone to reactivate spending when its transmission mechanisms have been dynamited by the distrustful attitudes of financial market agents. National fiscal plans are in most cases a mixture of increased infrastructure spending, selected tax cuts and support to the sectors worst hit

1 In the U.S., Germany, France and Spain, for instance, though not in the United Kingdom or Japan.

by the crisis. The two approved by the U.S. government are the costliest to date (a combined 7% of GDP[2]), though some of the European countries suffering most due to the importance of their real estate sectors or the degree of leverage in their economy are also spending on a major scale. Fiscal stimulus packages are in any case a key ingredient of reactivation policies. Their success, nonetheless, will depend on how far they can stimulate private consumption, which will depend, in turn, on the concrete measures deployed and whether they are seen to square with the upkeep of fiscal stability.

The governments of leading economies have launched financial system rescue plans to bail out troubled institutions.

Another line of support is the aid dispensed by various governments to financial institutions facing problems of solvency. Popular measures in this group include boosting deposit insurance, agreements for the public sector to purchase assets of diverse quality from finance sector entities, the recapitalization under certain conditions of struggling institutions, and government guarantees for long-term bank debt[3].

Exhibit 1: Financial sector losses and capitalisation since the onset of the crisis

Estimates of the losses taken by financial institutions in the course of the mortgage and financial crisis erupting in mid-2007 have been revised upwards on numerous occasions. In November 2008, the IMF[1] hiked its own estimates from USD 945 billion (in April 2008) to USD 1.4 trillion, factoring higher expected losses from better-quality mortgages and consumer loans and a jump in the spreads of related financial instruments. Around half of these losses would correspond to the banks and the rest would be split in roughly equal measure among insurance undertakings, pension funds, GSE (Government Sponsored Enterprises) and governments and other investors (including hedge funds, for instance).

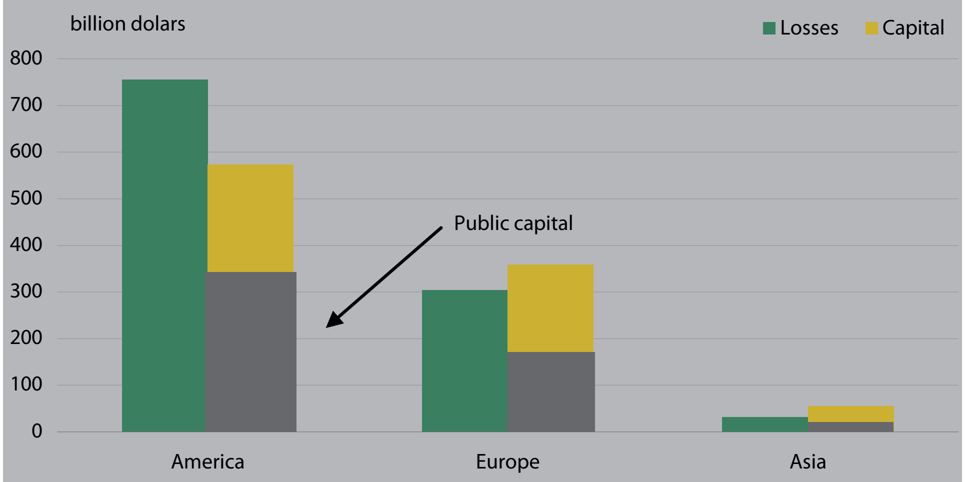
The aggregate losses posted by financial institutions (to the fourth quarter of 2008) come to USD 1.09 trillion, breaking down 69% from entities in the American continent, 28% from Europe and a bare 3% from Asia. Losses were heavily concentrated in a small number of entities, with the top eight loss-making institutions accounting for 40% of the total volume disclosed.

Over the same period, institutions have raised around USD 987 billion in capital; rather less than their reported losses. Initially most of this capital came from the private sector (basically sovereign investment funds), but the public sector has more or less taken over since end-2008 via the industry rescue packages approved by various governments. The contribution of both sectors (public and private) are fairly similar in cumulative terms, though again with notable differences from one region to another. In the U.S., financial institutions raised USD 572 billion (55% from the private sector), a sum insufficient to cover their reported losses, whereas the USD 359 billion raised by banks in Europe (46% from the public sector) was greater than their losses (see figure below). We can also observe inter-regional differences in the funding instruments of choice. In the United States, hybrid instruments predominated, primarily preference shares, while European institutions opted more for subscription warrants.

2 The public deficit is expected to reach 12.3% of GDP in 2009, the highest level since 1945.

3 In a later exhibit, we look more closely at the financial system support measures approved by the Spanish government.

Financial sector losses since the crisis and capitalisation



Source: Bloomberg. Cumulative data from 3Q07 to 4Q08.

1 IMF Global Financial Stability Report, November 2008.

The troubles of leading banks and the Madoff-managed funds scandal have dictated the market mood in recent months.

Since our last report, the financial market landscape has been marked by the crisis of leading financial institutions[4] and the shock waves of the Madoff investment fraud. These developments have simultaneously extended and sharpened agent distrust in the world financial system. Most leading stock indices shed over 20% of their value in the fourth quarter of 2008, taking full-year losses to record levels (see table 2). The banking sector suffered the worst punishment, with losses touching 72% since the crisis broke in August 2007, compared to a worldwide fall in equity prices of something over 50%. Implied volatilities on main exchanges have shown some signs of normalisation compared to the peak levels of October last (in excess of 80%), but are still at highly stressful levels (above 40% in many cases). And almost all leading markets, with the exception of the United States, saw turnover recede by more than 20%.

Performance of main stock indices (%)

TABLE 2

	2004	2005	2006	2007	2008	IV 08	1Q09 %/prior qt	(To 13 March) %/Dec	% y/y[1]
World									
MSCI World	12.8	7.6	18.0	7.1	-42.1	-22.2	-17.8	-17.8	-47.1
Euro area									
Euro Stoxx 50	6.9	21.3	15.1	6.8	-44.4	-19.4	-19.5	-19.5	-45.3
Euronext 100	8.0	23.2	18.8	3.4	-45.2	-21.1	-15.1	-15.1	-44.0
Dax 30	7.3	27.1	22.0	22.3	-40.4	-17.5	-17.8	-17.8	-39.2
Cac 40	7.4	23.4	17.5	1.3	-42.7	-20.2	-15.9	-15.9	-41.6
Mib 30	16.9	13.3	17.5	-6.5	-48.4	-22.9	-26.2	-26.2	-54.4
Ibex 35	*17.4*	*18.2*	*31.8*	*7.3*	*-39.4*	*-16.3*	*-19.2*	*-19.2*	*-43.2*
United Kingdom									
FT 100	7.5	16.7	10.7	3.8	-31.3	-9.6	-15.3	-15.3	-34.1
United States									
Dow Jones	3.1	-0.6	16.3	6.4	-33.8	-19.1	-17.7	-17.7	-40.5
S&P 500	9.0	3.0	13.6	3.5	-38.5	-22.6	-16.2	-16.2	-42.5
Nasdaq-Cpte	8.6	1.4	9.5	9.8	-40.5	-24.6	-9.2	-9.2	-36.8
Japan									
Nikkei 225	7.6	40.2	6.9	-11.1	-42.1	-21.3	-14.6	-14.6	-39.1
Topix	10.2	43.5	1.9	-12.2	-41.8	-21.0	-15.7	-15.7	-40.4

Source: Datastream.

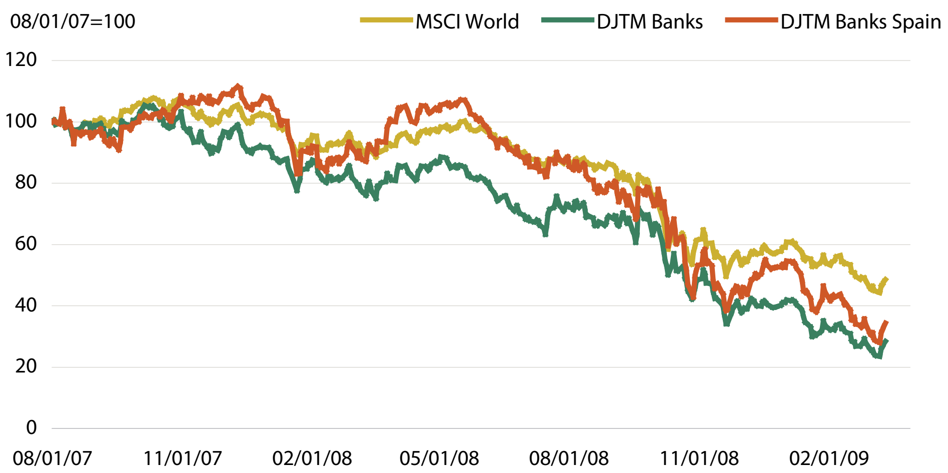
1 Year-on-year change to the reference date.

4 Prominently Washington Mutual, Fortis, B&B, Hypo Real State, Unicredit or Dexia.

In September 2008, major economies imposed a series of constraints on the practice of short selling in order to combat market instability. In the last few weeks, however, a number of European and North American securities regulators have been reviewing this decision. None have added further restrictions and some, like the SEC and FSA, have lifted them completely. As we write, only the Italian supervisor CONSOB retains its ban on both covered and naked short sales of financial instruments. Other countries like France, Germany and Spain continue to prohibit naked short sales, but allow the sale of loaned securities[5]. Also, the United Kingdom, Spain and France have retained their disclosure requirements regarding net short positions on financial instruments when these come to more than 0.25% of the issuer's outstanding capital. This relaxation of last September's measures follows a series of analyses by national supervisors and other experts which conclude that restrictions on short selling have little effect on prices even in the short term.

European and North American supervisors have eased the restrictions on short selling imposed in September 2008.

Performance of bank sector shares FIGURE 1



Source: Thomson Financial Datastream. Data to 13 March.

In private fixed-income markets, risk premiums continued at highs in both the United States and Europe, with lower rated issuers bearing the brunt. With respect to the last report published, the risk premiums of top-rated entities continued their ascent to a mid December peak of around 300 bp in the U.S. and just over 200 bp in Europe, then softened slightly to mid-February before returning to highs in the weeks that followed. Among cross-over entities, risk premiums refused to budge by more than the smallest margin. In primary markets, especially in Europe, the opening weeks of 2009 brought a mild upswing in sales of senior corporate debt.

Corporate bond spreads reach new highs, but the issuance market begins to stir.

In interbank markets, leading interest rates came down sharply across the full range of maturities, in line with (or even surpassing) the official rate run-down on both sides of the Atlantic. The spreads between collateralised (repo) and uncollateralised (depo) transactions have eased significantly to under 100 bp after marking new highs in October last year (topping 350 bp in the United States).

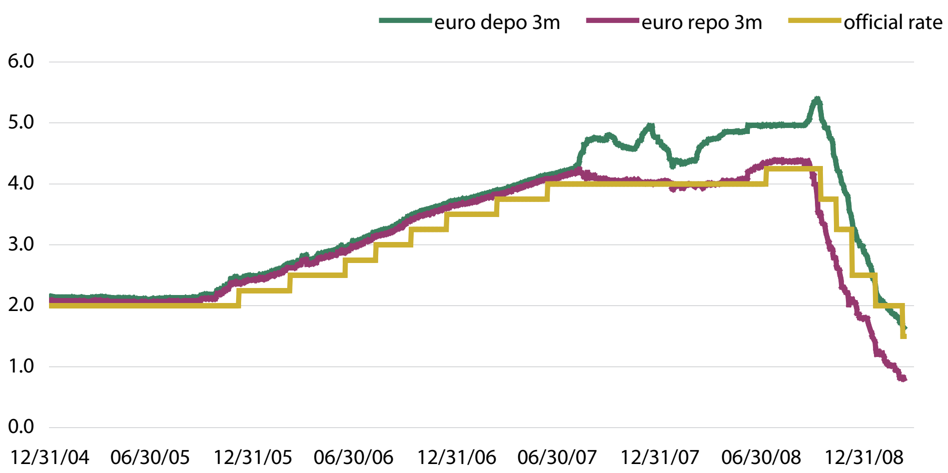
Interbank tensions abate thanks to lower interbank-interest rates and a narrowing of the depo-repo spread.

5 Spanish regulations also forbid naked short sales of non financial securities.

Currency markets experience intense volatility. The dollar gains ground against main rival currencies.

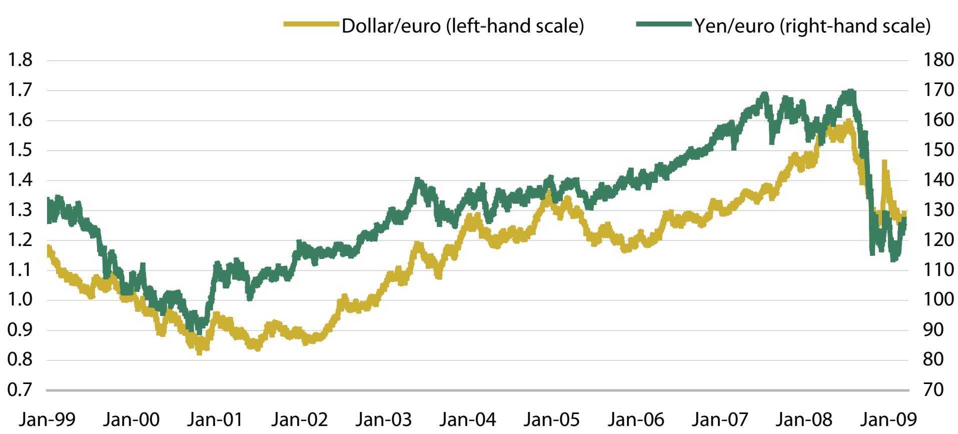
Currency markets have experienced heightened volatility in the last few months reflecting investor concerns about the length and severity of the crisis. The dollar gained ground against almost all leading currencies, while the euro depreciated sharply at times in tune with the ECB's rate-cutting cycle. But the most dramatic development has been the punishment taken by the pound sterling vs. the euro since November 2008.

Interbank market in euros and official ECB rates (%) FIGURE 2



Source: Thomson Financial Datastream. Data to 13 March.

Euro exchange rates vs. the dollar and yen FIGURE 3



Source: Thomson Financial Datastream. Data to 13 de March.

2.2 National economic and financial developments

The Spanish economy officially enters recession after two quarters of negative growth, as domestic demand shrinks.

Since our last report the Spanish economy has suffered a considerable correction. Quarterly GDP growth was in negative territory for two consecutive quarters (the third and fourth of 2008), meaning the Spanish economy has officially entered recession. The growth stall owes to the rapid contraction of domestic demand, which detracted three percentage points from fourth-quarter growth, with all components, except government consumption, contributing on the downside. Household consumption has sagged in response to the prevailing climate of distrust, the intense destruction of employment and tougher financing conditions, which are countering the positive income effects of wage increases, lower inflation and the fiscal stimulus provided by personal income tax cuts. Rather, these last two factors are contributing to a sizeable increase in the savings rate.

All domestic demand components have fallen sharply, with the exception of public spending,...

Another highlight on the domestic demand side was the slump in housing investment (-10.9% year on year in the fourth quarter). Demand weakness and the decline in prices are driving a profound restructuring in Spanish real estate after the enormous expansion of the past few years. The prevailing uncertainties and constraints on credit also explain the decline in business investment over the closing months of 2008 (-9.7% in equipment investment in the last quarter alone).

...contrasting with the positive growth contribution from the net exports side.

Net exports, meantime, input positively to growth (for the first time since 1997), with imports falling faster than exports despite the deceleration of external markets.

The economic downturn is exacting a heavy cost in terms of employment...

The deterioration of the Spanish economy has pushed jobless totals to well above the three million mark. The unemployment rate, which by mid 2007 had achieved an unprecedented low of 8%, ended the year 2008 closer to 14%. This labour-market downturn, which started in construction, is now spreading to other industrial sectors and some branches of services.

...while inflation is down to historic lows.

Inflation entered a downward course in the year's second half, which took it from mid-year rates of over 5% to 1.4% at the December close. The decline in energy prices was the main force at work. One outcome was that Spain's inflation differential vs. the euro area turned negative (-0.1 p.p.) for the first time ever.

Leading forecasters expect Spanish GDP to contract sharply in 2009 and augur higher unemployment, deficits and debt for 2009 and 2010.

Leading institutional forecasters predict that the Spanish economy will contract further in 2009, with GDP dropping by some 2.0% and unemployment rates exceeding 16% of the labour force. Public-sector accounts will also feel the effect of the activation of automatic stabilisers (manifest basically in rising unemployment benefit costs and declining tax receipts) and the reactivation measures approved by the Government, whose economic impact is reckoned at around 2% of GDP. Specifically, European Commission forecasts put the 2009 public deficit at over 6% of GDP. Public debt will work up from around 40% of GDP in 2008 to 47% in 2009 and 51.6% in 2010[6]. The step-up in debt issuance will go to cover the increased public deficit and financial system support measures (the Financial Asset Acquisition Fund, FAAF, the increased allocation to the Official Credit Institute [ICO], and a special loan to this last entity earmarked for SME financing).

6 Tesoro Público. Treasury Securities Issuance Strategy.

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

	2005	2006	2007	2008	European Commission* 2009F	European Commission* 2010F
GDP	**3.6**	**3.9**	**3.7**	**1.2**	**-2.0 (-1.8)**	**-0.2 (-0.7)**
Private consumption	4.2	3.9	3.5	0.1	-2.6 (-2.2)	0.0 (-0.5)
Government consumption	5.5	4.6	4.9	5.3	2.3 (+1.0)	0.2 (-0.5)
Gross Fixed Capital Formation, of which:	7.0	7.1	5.3	-3.0	-6.0 (-0.2)	-3.7 (-2.0)
Equipment	9.2	10.2	10.0	-1.1	-12.7 (-7.5)	-4.5 (-3.6)
Exports	2.5	6.7	4.9	0.7	-2.7 (-5.0)	0.6 (-2.2)
Imports	7.7	10.3	6.2	-2.5	-4.6 (-2.1)	-2.1 (-2.9)
Net exports (growth contribution, pp)	-1.6	-1.5	-0.8	1.1	0.8 (-0.7)	0.8 (+0.3)
Employment	3.2	3.2	3.0	-0.7	-3.9 (-1.9)	-2.0 (-1.1)
Unemployment rate[1]	9.2	8.5	8.3	11.3	16.1 (+2.3)	18.7 (+3.2)
HICP	3.4	3.6	2.8	4.1	0.6 (-1.5)	2.4 (-0.4)
Current account (% GDP)	-7.5	-9.0	-10.1	-9.4	-7.1 (+1.5)	-6.6 (+1.6)
General government (% GDP)	1.0	2.0	2.2	-3.4	-6.2 (-3.3)	-5.7 (-2.5)

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

1 Eurostat definition.

* Forecasts published in January 2009 (with respect to November 2008).

Spanish deposit-taking entities struggle with funding difficulties and the impact of the economic downturn. New lending tailed off considerably in 2008, while NPL ratios began to creep up steadily, at savings banks particularly...

Spanish deposit-taking entities are having to operate in an increasingly complex landscape dominated by the funding difficulties brought on by the financial crisis and now the downturn in national output. Their lending to households and businesses[7] exhibits a clear procyclical pattern, in that it expanded steadily over the prolonged upcycle (at rates from 10% to 30%), then began slowing gradually from the opening months of 2007 as far as a year-on-year rate of 5.4% in January 2009 on a combination of tougher borrowing conditions and lower credit demand. Meantime, the non-performance ratio of loans to other resident sectors[8] had been shrinking steadily up to the start of the subprime crisis. From this point on, and most notably since the early months of 2008, the gathering deterioration of economic activity, the persistence of high interest rates for most of the year and a series of regulatory changes[9] have sent NPL ratios moving sharply higher, as far as an aggregate 3.87% according to the latest data, for January 2009. Compare this to the 0.76% of June 2007, one month before the rebound started. As we can see from figure 4, the bad debt problem has affected the savings banks more than the banks (4.45% and 3.17% respectively), though both groups started from near identical levels in June 2007 (0.68% and 0.65% respectively).

...and with special incidence in real estate financing and home purchase loans to households.

The segment contributing most to the bad debt upswing has been real estate financing, followed by home purchase and refurbishment loans to household borrowers and, to a lesser extent, loans to companies engaging primarily in construction activities. A look at the other resident loan mix of banks and savings banks reveals that the latter's NPL exposure is more heavily concentrated in household mortgage loans.

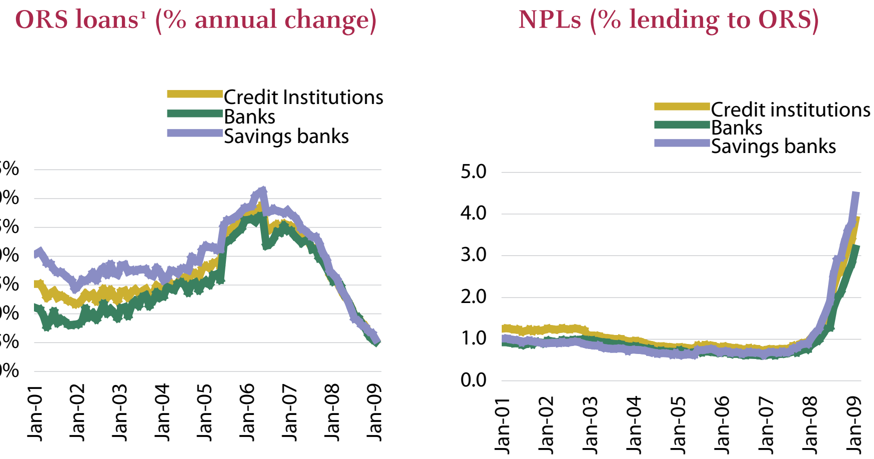
7 In official statistics, loans to other resident sectors.

8 Measured as the ratio of doubtful loans according to the new Banco de España Circular 4/2004 to total gross loans.

9 This change has a dual origin. Circular 4/2004 of the Banco de España requires the prompter and fuller recording of doubtful loans than the previous circular 4/1991 in the interests of maximum prudence. Likewise, new bankruptcy legislation encourages company managers to apply earlier for insolvency proceedings, so the impact of their arrears is also recorded earlier in bank sector income statements. See Banco de España Financial Stability Reports for November 2008 and May 2007.

Banks, in turn, are registering more arrears in consumer loans and among retail and catering industry borrowers, who occupy a larger proportion of their total loan books.

Deposit-taking entities: loans and NPLs FIGURE 4



Source: Banco de España. Data to January 2009.

1 ORS: Other resident sectors.

Deposit-taking entities enjoy reasonably sound liquidity thanks to loans obtained from the Eurosystem and, more recently, funds raised at the four FAAF auctions.

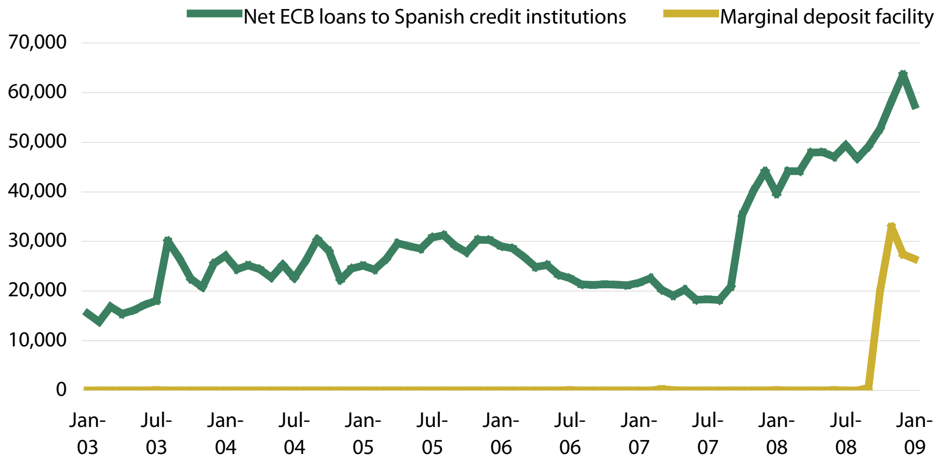
The liquidity conditions of deposit-taking entities are relatively sound, despite their recent funding problems in wholesale and interbank markets. In this respect, entities have had various resources to draw on, including Eurosystem loans to financial institutions[10] (see figure 5), FAAF auctions (instrumented through both repo and outright purchases) and, in recent weeks, government-guaranteed debt financing[11]. The volume of Eurosystem loans has been moving steadily higher from around 20 billion euros when the mortgage crisis broke in summer 2008 to almost 60 billion in January 2009, while the four FAAF auctions held have provided finance entities with a further 20 billion in funds. Since October 2008, moreover, we can talk about a change in sector practices, with banks parking about half their borrowings from the ECB in the same institution's deposit facility (see figure 5). This decision not to touch a large part of the liquidity drawn from the Eurosystem may be motivated by caution. However this could temper with the ECB's new rules on eligible collateral, introduced on 1 February 2009[12]. Also, in the last few weeks, Spanish institutions have issued government-guaranteed debt securities for a global value of over 11 billion euros.

10 Since 15 October 2008, the ECB has been meeting entities' liquidity demands at auction at the corresponding fixed rate.

11 See exhibit on "Support measures for the Spanish financial system".

12 The measure with most bearing on Spanish institutions is the reclassing of asset-backed securities (ABS) to category 5, such that the haircut jumps from 2% to 12% regardless of the issue format and maturity (this means that if an institution puts up collateral worth 100 million euros, the ECB will deliver 88 million in cash). This discount is set 5% higher when the ABS have no market price, lifting the global haircut to 16.4%. This category includes the multiseller bonds so popular in Spain (bonds issued by a group of savings banks, with each one providing collateral).

Net ECB lending to Spanish credit entities and balance of the deposit facility (million euros) FIGURE 5



Source: Banco de España. Data to January 2009.

Exhibit 2: Support measures for the Spanish financial sector

Starting in August 2007, a series of events originating in the United States plunged leading world economies into a severe and lasting financial crisis. One of its consequences has been to impair the ability of financial institutions to raise funds on capital markets, causing a dearth of liquidity whose ultimate consequences are paid by business and household borrowers.

In these extraordinary circumstances, the Spanish government launched a battery of measures to restore confidence in the financial system and get loans flowing once more towards companies and families.

The amount guaranteed by the Deposit Guarantee Fund was raised from 20,000 to 100,000 euros, followed by two measures aimed at boosting the liquidity in the financial system and preserving its stability.

The first of these was Royal Decree-Law 6/2008 creating the Financial Asset Acquisition Fund (FAAF), and allocating it 30 billion euros from the National Budget, extendable to a ceiling amount of 50 billion euros. Asset acquisitions – in the form of repos or outright purchases – are instrumented through a system of auctions. Four of these have been held to date, with results as shown in the following table. In all, the FAAF has acquired assets summing 19.34 billion from 54 institutions for terms of 2 or 3 years.

	1st auction 11/20/08	2nd auction 12/11/08	3rd auction 01/20/09		4th auction 01/30/09	
			Competitive tranche	Non competitive tranche	Competitive tranche	Non competitive tranche
Amount bid (mill. euros)	4,562	9,479	4,399	3,373	7,127	4,865
Amount allotted (mill. euros)	2,115	7,224	3,024	976	4,732	1,270
No. of bids	70	96	117	44	100	36
No. of bidding entities	28	37	49	44	40	36
No. of bids covered	51	62	88	42	60	36
No. of awardees	23	31	45	42	32	36
Stop-out rate	3.150%	3.750%	2.450%		3.330%	
Weighted average rate	3.339%	3.934%	2.697%		3.492%	

The second measure was enacted through Royal Decree-Law 7/2008 on extending state guarantees to new financing transactions undertaken by credit institutions resident in Spain, up to a maximum amount of 100 billion euros. To date[1], eight institutions have conducted eight issues of guaranteed debt for a global amount of 11.105 billion euros.

Institution	Amount (million euros)	Term
Caja de Ahorros y Pensiones de Barcelona	2,000	3 years
Caja de Ahorros y Monte de Piedad de Madrid	2,000	3 years
Banco Popular Español, S.A.	1,500	3 years
Bankinter, S.A.	1,500	3 years
Banco Pastor, S.A.	1,000	3 years
Caja de Ahorros y Monte de Piedad de Navarra	105	2 years
Caixa d´Estalvis de Cataluña	1,500	3 years
Caja de Ahorros y Monte de Piedad de Valencia, Castellón y Alicante (Bancaja)	1,500	3 years

Finally, Royal Decree-Law 7/2008 authorises the Ministry of Economy and Finance, exceptionally and up to 31 December 2009, to acquire securities on request from credit institution issuers resident in Spain, including preference shares and *cuotas participativas* (savings bank marketable securities), for the purpose of reinforcing their equity. To date no institutions have taken up this facility.

The CNMV is assigned a dual role in the implementation of these measures. On the one hand, it will advise the Directorate-General of the Treasury and Financial Policy and issuing institutions in order to secure the rapid verification of issues – in which the FAAF will act as purchaser or guarantor – and their subsequent admission to trading. Further, the Ministerial Order implementing Royal Decree-Law 6/2008, creating the Financial Asset Acquisition Fund, regulates the composition of the Technical Committee advising the Fund's Executive Committee, which will comprise nine members, two of them representatives of the CNMV.

(1) On information to 12 March 2009.

Deposit entity profits fall an annual 14% to September 2008 with impairment losses doing most of the damage...

Credit institutions reported aggregate net profits of over 16.40 billion euros in their third-quarter income statements, a decrease of 14% versus the equivalent period in 2007. The three key income captions (net interest income and gross and net operating income) all increased their balance in year-on-year terms so the earnings dip is basically ascribable to asset impairment losses (9.85 billion euros between January and September 2008 compared to 4.87 billion in the year-before period). Return on equity (ROE) receded from 23.6% in September 2007 to 16.0% in September 2008.

... while their capital adequacy ratios improve on the previous year's.

In June 2008, Spanish deposit-taking entities disclosed their capital levels for the first time in accordance with the New Capital Framework (Basle II). The aggregate capital adequacy ratio was 11.3%, while the core capital ratio (tier 1) stood at 7.7%. These readings are not only higher than the previous year's (10.6% and 6.9% respectively), but also stand comfortably clear of the minimum requirement.

Exhibit 3: Financial institution issues marketed to retail customers

One effect of the international financial market crisis has been to waken banking institutions to the need to reinforce their equity. Hence injections of public money all over the world have been supplemented at times by capital increases (especially among the most international institutions with the largest balance sheets). In Spain, where there has so far been no call on public funds to recapitalise ailing banks, recent months have seen the return to favour of subordinated debt and preference share issues which, under certain conditions, can count towards minimum capital requirements.

Spanish institutions began turning to these instruments in the last quarter of 2008, with half a dozen issues conducted in November and December, mostly of 10-year subordinated debt. In some cases, these were small-scale issues (less then 150 million euros) placed with institutional investors, mainly funds and insurance undertakings. Others, however, were targeted exclusively on retail investors, with no institutional tranche, and marketed through the issuer's own branch network.

The CNMV verified the prospectuses of 10 such exclusively retail issues in 2008 and the opening months of 2009, for a combined face value of 6.72 billion euros.

Financial institution issues aimed exclusively at retail investors between January 2008 and 6 March 2009

INSTITUTION	TYPE	FACE VALUE (million euros)	DATE
Caja General de Ahorros de Granada	12th subordinated debt issue	120	12-23-2008
Caixa D´Estalvis de Catalunya	8th subordinated debt issue	500	10-23-2008
Caja de Ahorros de Salamanca y Soria	Caja Duero V mortgage bonds	150	10-28-2008
Caja España de Inversiones, Caja de Ahorros y Monte de Piedad	7th subordinated debt issue	200	7-17-2008
Caja de Ahorros y Pensiones de Barcelona	Subordinated debt issue	2,500	1-20-2009
Caja de Ahorros y Pensiones de Barcelona	Mortgage bonds	1,000	4-17-2008
Popular Capital, S.A.	Series D preference shares	600	2-3-2009
BBVA Capital Finance, S.A.	Series D preference shares	1,000	12-10-2008
Banco de Sabadell, S.A.	Series I/2009 preference shares	500	1-29-2009
Caixa Galicia Preferentes, S.A., Sociedad Unipersonal	Series D preference shares	150	3-5-2009

This kind of placement involves a conflict of interest in that the issuer is also the marketing agent. The supervisor has accordingly taken steps to ensure that clients are properly informed about and able to judge the risk and return of the financial instruments their bank is offering them. Specifically, the CNMV sent a letter last February to all credit institution associations setting out a series of basic rules that this kind of issue must comply with. Some of these rules refer to the valuation reports that must accompany the sale prospectus, and which should assess the reasonableness of the return offered against the conditions available on wholesale markets. The CNMV understands that this information is vital for investors to critically asses the attractiveness of these debt instruments, and will accordingly strive to ensure that valuation reports meet the relevant standards of independence and technical quality.

Non financial listed companies reported a large decline in 2008 earnings as a result of the economic slowdown, although not all sectors suffered to the same extent. Aggregate profits closed the year at over 22 billion euros, 38% less than in 2007 (see table 4). The worst performers were companies in the construction and real estate sectors, which saw their earnings plummet from over 7.50 billion profits in 2007 to around 6.60 billon losses in 2008. Remaining sectors managed to close the year in gains though by a smaller margin than in 2007. The sole exception were the energy companies, which grew their profits by 34% to more than 17.55 billion euros. Industrial companies' profits fell by 41% (from 2.33 to 1.37 billion) and those of service sector companies by 21% (from 14.50 to 11.43 billion euros).

Non financial companies see their profits drop by 38% as the economy slips deeper into slowdown...

Earnings by sector[1]: listed companies TABLE 4

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	**2H07**	**2H08**	**2H07**	**2H08**	**2H07**	**2H08**
Energy	28,258	29,341	19,572	20,035	13,087	17,557
Industry	4,811	3,779	3,426	2,269	2,335	1,367
Retail and Services	31,290	30,861	19,415	19,216	14,498	11,430
Construction and Real estate	12,442	4,194	9,477	517	7,543	-6,595
Adjustments	-3,230	-3,431	-2,331	-2,467	-1,296	-1,415
AGGREGATE TOTAL	73,570	64,744	49,559	39,570	36,168	22,344

Source: CNMV.

1 Year-to-date earnings.

2 Gross operating income.

3 Earnings before interest and taxes.

The combined debt of non financial listed companies varied by a bare 1.0% in 2008 to just over 304 billion euros (see table 5), representing 1.65 times their equity compared to 1.48 times in 2007. Again inter-sectoral differences were striking. This levelling-off of aggregate debt traces almost entirely to the debt reduction of construction and real estate companies[13] (over 14%), despite which their leverage was pushed even higher[14] (from 3.1 in 2007 to 3.7 in 2008) by the drain in their equity over the same period.

... and debt levels tend to stabilise with construction and real estate leading the way.

In remaining sectors, debt volumes rose at a rate of over 11% en 2008, prompting a moderate rise in leverage aggravated by the decline in their aggregate equity (in all sectors but energy) following valuation adjustments.

But leverage still climbs due to the decline in companies' equity...

Debt coverage indicators have worsened across the board reflecting the more modest growth of corporate earnings. In construction and real estate, earnings before interest and taxes (EBIT) have fallen so far that they barely serve to cover interest expenses. Other sectors too have seen their coverage deteriorate, industry especially, though not to a worrying extent. Specifically, aggregate EBIT was double interest expense in the sample as a whole, compared to three times in 2007.

...while coverage ratios deteriorate.

13 The most heavily indebted sector despite the decline in the relative weight of its borrowings from 46% of the total in 2007 to 39% in 2008.

14 Defined as debt to equity.

Gross debt by sector: listed companies

TABLE 5

Million euros		2003	2004	2005	2006	2007	2008
Energy	Debt	54,159	54,776	58,586	59,191	69,172	82,613
	Debt/ Equity	0.98	1.06	0.93	0.89	0.78	0.89
	Debt/ EBITDA[1]	2.92	2.78	2.41	2.17	2.48	2.82
	EBIT[2]/ Interest expenses	2.06	3.52	4.02	4.65	4.10	3.67
Industry	Debt	10,507	10,397	12,760	15,684	13,312	14,826
	Debt/ Equity	0.61	0.69	0.75	0.78	0.61	0.86
	Debt/ EBITDA	1.98	1.91	2.07	2.07	1.82	3.92
	EBIT/ Interest expenses	4.00	6.65	6.50	5.71	5.93	2.26
Construction and real estate	Debt	24,552	32,293	48,324	111,000	138,933	119,174
	Debt/ Equity	1.59	1.93	2.16	3.10	3.08	3.72
	Debt/ EBITDA	5.91	5.71	6.52	11.52	10.83	28.42
	EBIT/ Interest expenses	3.38	2.83	2.79	2.04	1.17	0.06
Retail and Services	Debt	34,956	44,505	55,710	91,522	96,941	108,187
	Debt/ Equity	0.89	1.61	1.70	2.52	1.70	2.12
	Debt/ EBITDA	2.08	2.58	2.68	3.58	3.01	3.51
	EBIT/ Interest expenses	3.18	2.67	3.37	2.44	3.23	3.23
Adjustments[3]	Debt	-208	-5,566	-7,942	-11,199	-17,391	-20,685
AGGREGATE TOTAL[4]	Debt	123,966	136,405	167,438	266,198	300,967	304,116
	Debt/ Equity	1.01	1.26	1.27	1.71	1.48	1.65
	Debt/ EBITDA	2.80	2.90	2.90	3.86	3.96	4.70
	EBIT/ Interest expenses	2.63	3.33	3.82	3.29	3.03	1.99

Source: CNMV.

1 Earnings before interest, taxes, depreciation and amortisation.

2 Earnings before interest and taxes.

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

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

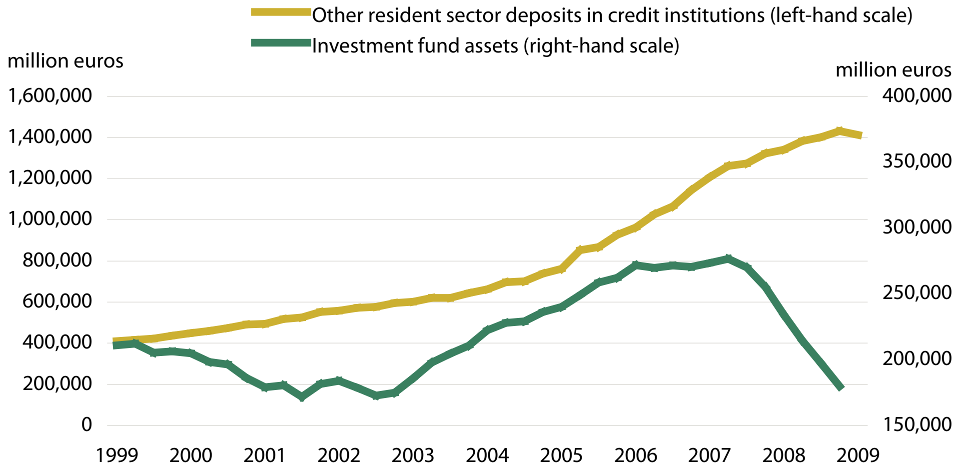
Households retain their preference for conservative investments in today's increasingly unsettled economic and financial climate.

The conduct of retail investors was again dictated by the prevailing climate of market uncertainty and the sharp downturn in the economy. Though their savings have increased, households have less chance of borrowing so also have less income to spend on acquiring financial and non financial assets[15]. Their choice of financial assets once more tended to the conservative side, with bank deposits and retirement products winning out clearly over equity and, above, all, mutual fund investment. Between January and September 2008, Spanish households withdrew around 30 billion euros from mutual funds, while their purchases of (non transferable) deposits summed over 63 billion euros.

15 Financial Accounts of the Spanish Economy, Banco de España. Data to 3Q08.

Deposits vs. mutual funds

FIGURE 6



Source: CNMV and Banco de España. Deposit data to January 20089 and investment fund data to November 2008.

Investment fund subscriptions and redemptions (million euros)

TABLE 6

Category	Subscriptions				Redemptions			
	1Q08	2Q08	3Q08	4Q08[6]	1Q08	2Q08	3Q08	4Q08[6]
Fixed income[1]	37,511	22,581.5	17,343	31,631.3	35,049	32,357.6	24,503	38,626
Balanced fxd income[2]	620	315.9	239	484.1	2,862	1,891.3	1,437	1,473
Balanced equity[3]	279	606.0	250.9	111.4	1,676	1,245.2	883	640
Spanish equity	415	344.4	157.1	200.3	1,980	733.9	868	431
Intern. equity[4]	1,867	1,545.7	926	809.6	6,457	2,735.1	2,383	1,502
Fxd-income guaranteed	3,286	2,983.5	2,692	2,426.0	2,086	1,867.5	1,785	2,843
Equity guaranteed	1,089	3,120.4	1,550	882.9	3,648	5,929.2	3,924	3,996
Global funds	1,949	1,953.1	738	641.5	8,276	5,302.1	3,570	2,813
Hedge funds[5]	164.1	77.8	8.2	104.7	50.9	26.5	14.5	132
Funds of hedge funds[4]	200.1	447.3	165.9	n.a.	98.7	234.5	101.5	n.a.
TOTAL	47,016.2	33,450.6	23,896.0	37,186.9	62,032.7	52,061.9	39,354.3	52,324.0

Source: CNMV

1 Includes: Short-term, long-term and international fixed-income and money-market assets.
2 Includes: Balanced fixed income and balanced international fixed income.
3 Includes: Balanced equity and balanced international equity.
4 Includes: Euro, international Europe, international Japan, international US, international emerging market and other international equity.
5 Estimated, provisional data for funds of hedge funds and hedge funds.
6 Data for the months of October and November.

2.3 Outlook

The main international organisations all augur a bleak 2009. The first six months are projected to be the hardest going, with main developed areas experiencing different degrees of recession, and growth slackening in the emerging world, China especially. Only in the second half can we expect some faint signs of recovery on the spur of fiscal stimulus packages and support measures for the financial system.

Forecasters augur a tough 2009 with numerous economies in recession...

...followed by some improvement in 2010, although here the outlook is clouded by uncertainty given the continuing difficulties of the international financial sector and doubts about the medium- to long-term effectiveness of the fiscal stimulus.

GDP growth should revive slightly in 2010, though progress will be modest and, in some countries, not enough to restore positive rates. However these forecasts are subject to numerous uncertainties[16]. We can detect two main downside risks for the world macro-financial outlook. The first is a prolongation of the turmoil affecting the international financial industry. Major financial institutions are still reporting heavy losses and we cannot rule out new public-sector interventions to shore up their solvency and aid in the normalisation of the credit cycle. The other big risk concerns the medium- and long-term effectiveness of the fiscal stimulus, especially in economies carrying a high level of public debt. Moreover, the countries where fiscal deterioration is greatest face the real threat of seeing their debt issues penalised with the consequent increase in the cost burden.

Macroeconomic forecasts suggest the downturn will be steeper in Spain than in the euro area and both the deficit and public debt will expand in consequence.

Forecasts for the Spanish economy posit a downturn steeper than in the euro area, and possibly more prolonged. The European Commission, specifically, projects that GDP will fall 2.0% in 2009 and 0.2% in 2010, that unemployment rates will surpass 16% this year and approach 19% in 2010, and that the public deficit in both years will be in the region of 6%. The main risk perceived is that the construction and real estate correction may exert a deeper and more lasting impact on the rest of the economy, pushing jobless totals even higher and causing further headaches for the financial sector and, therefore, borrowers. The upside is represented by the relative strength of Spain's banking industry in comparison with neighbour economies, and the country's relatively moderate public indebtedness.

3 Performance of national markets

3.1 Equity markets

Spanish equity markets continue to fall, in line with main world bourses, as concerns grow about the health of the economy and financial sector earnings sheets.

Since the last edition of this report, prices on national financial markets have been driven lower by the climate of uncertainty surrounding financial sector earnings and the overall slowdown in the Spanish economy.

Small and medium cap stocks are among the hardest hit...

The Ibex 35 fell 16.3% in the fourth quarter of 2008 on the way to full-year losses of nearly 40% – on a par with North American indices and just a little less then elsewhere in Europe (see table 2). The trend has shown no signs of changing in the first few months of 2009, with prices down by a further 19.2% to the closing date for this report[17]. Small and medium cap indices underperformed the Ibex 35 to end 2008 with losses of 57% and 46% respectively. The FTSE Latibex Top and All Share share indices shed 45% and 52% of their value respectively in the full-year period, but have welcomed in 2009 with substantial advances.

...along with construction-related sectors, real estate, financial institutions and certain cyclical industries.

The crisis has so far hit hardest (see table 8) at construction-related sectors, real estate, financial institutions and sectors of a more cyclical nature, including representatives of industry (chemicals among them) and services (hotels, for instance).

16 In recent weeks uncertainties have been mounting, especially regarding Eastern Europe.

17 15 March.

Performance of Spanish stock indices (%)

TABLE 7

	2004	2005	2006	2007	2008	1Q09 (to 13 March) % prior quarter	% Dec	% y/y[1]
Ibex 35	17.4	18.2	31.8	7.3	-39.4	-19.2	-19.2	-43.2
Madrid	18.7	20.6	34.5	5.6	-40.6	-19.8	-19.8	-44.6
Ibex Medium Cap	25.1	37.1	42.1	-10.4	-46.5	-16.4	-16.4	-48.2
Ibex Small Cap	22.4	42.5	54.4	-5.4	-57.3	-9.9	-9.9	-54.1
FTSE Latibex All-Share	31.0	83.9	23.8	57.8	-51.8	15.3	15.3	-39.5
FTSE Latibex Top	28.1	77.9	18.2	33.7	-44.7	3.0	3.0	-40.7

Source: Thomson Datastream.

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

Performance by sector of the Spanish stock market (%)

TABLE 8

	2004	2005	2006	2007	2008	I-09[1]
Steel	25.3	20.7	81.2	-17.5	-40.9	-18.3
Water	31.2	18.1	55.6	-0.8	-47.0	-28.6
Auto	0.6	21.8	171.1	0.0	-51.7	-14.8
Beverages	1.3	10.4	14.6	10.8	-19.2	-16.3
Construction mat. and construction	28.5	50.4	61.6	-12.0	-51.0	-6.9
Basic consumption	40.0	19.0	12.9	6.9	-22.5	-10.5
Discretionary consumption	33.7	24.8	21.2	-7.7	-39.2	-9.4
Electricity	19.6	32.9	46.1	16.9	-27.9	-13.9
Financial companies	10.1	22.5	35.5	-10.5	-47.6	-28.5
Hotels	17.3	41.8	27.9	-25.0	-64.3	-34.4
Real estate	29.5	58.9	100.4	-42.6	-58.6	-36.0
Paper	30.2	13.7	36.6	-12.4	-57.7	-14.4
Chemicals	19.2	176.1	-20.4	-58.4	-67.8	14.2
Tobacco	49.8	13.7	5.0	21.5	0.1	0.0
Telecommunications and media	16.7	-0.7	29.4	26.3	-31.4	-8.1
Utilities	21.5	27.2	42.0	18.5	-31.0	-15.2

Source: Thomson Datastream.

1 Monthly data, change 28 February 2009 over 31 December 2008.

Spanish price-earnings ratios descend once more, to around the mid-point in the European range,...

The price-earnings ratio (P/E) of Spanish shares continued trending lower, albeit less intensely than in 2008 (7.5 times in mid-March). This ratio is around the mid-point in the range of values of main European bourses, which contrasts with the bullish conduct of the Japanese multiple since late January this year.

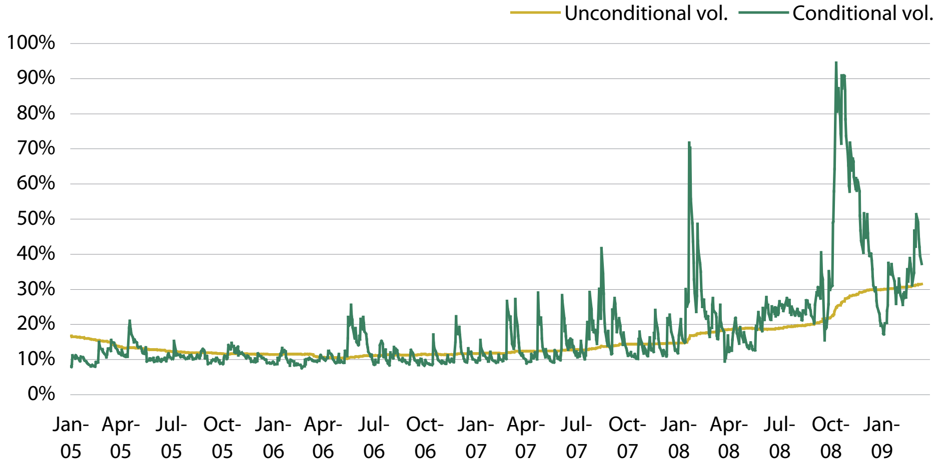
... the earnings yield gap settles at highs...

The earnings yield gap (reflecting the return premium required to be invested in equity versus long-term government bonds) has remained at highs, although with some correction of the strong uptrend begun halfway through 2008. The recent run-down in Spanish sovereign yields has kept the gap running at over 7.5% vs. the 4.4% average recorded since 2005.

...and market volatility and liquidity indicators give out tentative signs of normalisation.

Volatility on Spanish equity markets has died down slightly from the peak levels of last October, at the height of the turmoil, when it edged ahead of 90%. By mid-February, readings were down to a far more manageable 30%, though the last few weeks (see figure 7) have brought renewed signs of strain. The notable increase in the asymmetric distribution of Ibex 35 daily returns over the second half of 2008 implies that price variability is stronger on a falling than a rising index. Finally the liquidity conditions for Spanish equities (as measured via the bid-ask spread) have shown signs of improvement after the pressures felt up to October 2008.

Historical volatility. Ibex 35 FIGURE 7



Source: Thomson Datastream and CNMV. Data to 13 March.

Volatility asymmetry of the Ibex 35 FIGURE 8

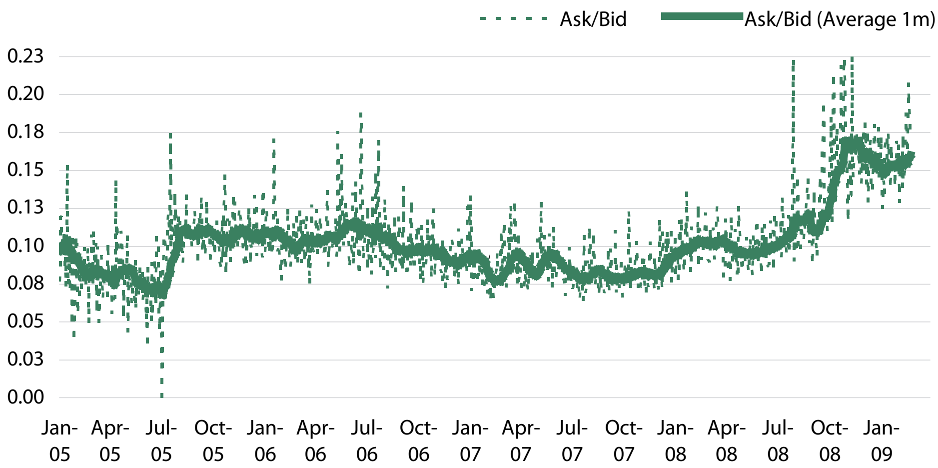
Source: Thomson Datastream and CNMV. Data to 13 March.
The parameter shown measures the sensitivity of conditional volatility to negative surprises in returns, in an asymmetric GARCH model(*).

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

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

Ibex 35 liquidity. Bid/ask spread (%)

FIGURE 9



Source: Thomson Datastream and CNMV. Data to 13 March.

Spanish stock market turnover closed the year at something over 1.2 trillion euros, 25% less than in 2007. This was accompanied by a progressive reduction in average daily trading from 6.18 billion euros in the first quarter to 4.09 billion in the last (3.04 million over January and February 2009). However the comparison is somewhat misleading because 2007 was a year of exceptionally high turnover. It can also be argued that the cause of the decline was mainly the bear run in prices of 2008 (with the Ibex 35 falling almost 40%). Indeed turnover velocity, the ratio between trading and capitalisation (in the continuous market), rose considerably between August and November 2008. Conversely, data available for the opening months of 2009 point to a year-on-year trading decrease of 57%, which is steeper than the fall in prices.

Turnover in the Spanish market recedes 25% in 2008 with falling prices as the main culprit. But the decline in volumes quickens over the first months of 2009.

Turnover on the Spanish stock market

TABLE 9

Million euros

	2005	2006	2007	2008	II-08	III-08	IV-08	I-09[1]
All exchanges	**854,145**	**1,154,294**	**1,667,219**	**1,243,387**	**318,939**	**287,680**	**253,514**	**123,961**
Electronic market	847,664	1,146,390	1,658,019	1,235,330	317,051	286,063	251,282	123,208
Open outcry	5,899	5,318	1,154	207	25	65	73	10
of which SICAVs[2]	4,864	3,980	362	25	3	7	10	7
MAB[3]	-	1,814	6,985	7,060	1,646	1,406	2,042	680
Second Market	26	49	193	32	18	10	1	0
Latibex	557	723	868	758	199	136	116	63
Pro memoria: non resident trading (% all exchanges)								
	57.4	58.4	61.6	na	65.5	na	na	

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

1 Cumulate data from 1 January to 28 February.

2 Open-end investment companies.

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

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

Companies cut back on their equity issuance as borrowing conditions toughen.

The squeeze on borrowing that confronted firms through 2008 translated as a sharp decline in equity issuance (see table 10) to a bare 7.80 billion euros, contrasting with the 23.76 billion of 2007. Practically all of this sum was in capital increases (with public offerings contributing only a residual amount).

Equity issues and public offerings[1] TABLE 10

						2008			
	2004	2005	2006	2007	2008	II-08	III-08	IV-08	I-09[2]
CASH AMOUNTS[3] (million euros)	21,735.6	2,960.5	5,021.7	23,757.9	7,812.8	356.6	40.8	7.405.8	883.0
Capital increases	18,748.0	2,803.4	2,562.9	21,689.5	7,803.3	356.6	40.8	7.405.8	883.0
Of which, rights offerings	1,101.9	0.0	644.9	8,502.7	292.0	292.0	0.0	0.0	0.0
National tranche	537.9	0.0	303.0	4,821.4	292.0	292.0	0.0	0.0	0.0
International tranche	564.0	0.0	342.0	3,681.4	0.0	0.0	0.0	0.0	0.0
Public offerings	2,987.6	157.1	2,458.8	2,068.5	9.5	0.0	0.0	0.0	0.0
National tranche	1,664.4	54.7	1,568.1	1,517.1	9.5	0.0	0.0	0.0	0.0
International tranche	1,323.2	102.5	890.7	551.4	0.0	0.0	0.0	0.0	0.0
NUMBER OF FILINGS[4]	42	27	30	35	11	4	2	4	3
Capital increases	37	25	21	26	10	4	2	4	3
Of which, rights offerings	4	0	8	8	2	2	0	0	0
Of which, bonus issues	15	6	0	0	0	0	0	0	0
Public offerings	7	2	14	12	2	1	0	0	0

1 Issues filed with the CNMV. Initial and supplemental filings.

2 Data to 28 February 2009.

3 Excluding amounts recorded in respect of cancelled transactions.

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

The variables driving stock market performance are still dominated by uncertainties.

The main drivers of stock market performance remained subject to numerous uncertainties. And agent concerns over the viability of the financial sector plus an economic downturn that is already leaving its mark on corporate income statements are powerful obstacles in the way of a recovery.

3.2 Fixed-income markets

Short rates respond to the expansionary stance of ECB monetary policy.

Short-term rates in public and private fixed-income markets have been increasingly influenced by the expansionary course of ECB monetary policy.

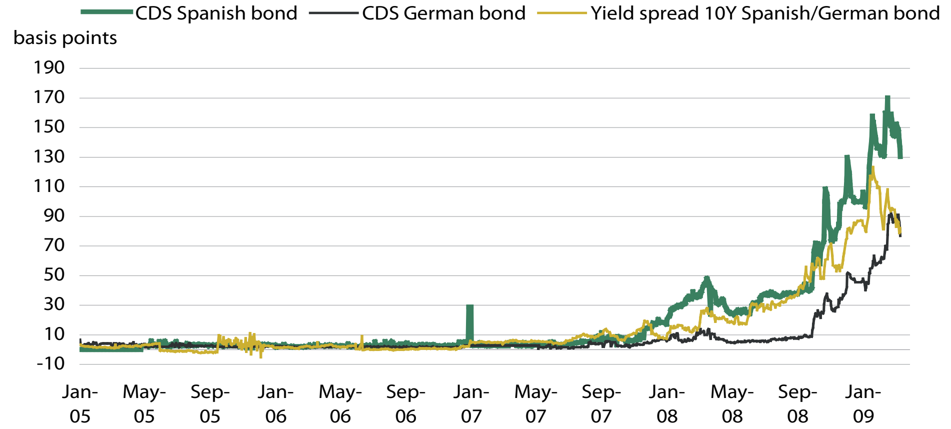
Long-term government yields head sharply lower in the second half of 2008; however...

...mounting perceptions of sovereign credit risk and increased debt issuance to fund government measures have since modified this trend.

Long-term sovereign yields fell substantially in the third and fourth quarter of 2008 on the evidence of faltering economic growth and the decrease in inflation rates. However in recent weeks new factors have emerged that have halted the yield downtrend at longer maturities. These are the mounting perception of credit risk hanging over the Spanish economy and the step-up in public debt issuance to fund government measures to ensure the liquidity of Spanish banks (see exhibit 2). The increase in the perceived credit risk of the Spanish economy, already apparent in widening spreads between the Spanish and German benchmark (which peaked at over 120 basis points at end-January and are currently hovering around 80 basis points) and the surge in the risk premium carried by CDS on Spanish government debt (see figure 10) was confirmed on 19 January, when rating agency Standard & Poor's downgraded Kingdom of Spain Debt from the top AAA slot to AA+.

Risk premium of Spanish government debt[1]

FIGURE 10



Source: Thomson Datastream.

1 Data to 13 March.

In private fixed income, interest rates on commercial paper have dropped over 3.5 percentage points since September last, outpacing the run-down in the ECB policy rate. Average 3, 6 and 12-month rates stood at 1.8%, 1.9% and 2.2% respectively in March 2009.

Long-term corporate bond yields begin falling in September in response to the worsening outlook and the downturn in inflation...

Long corporate yields also moved down notably in the same period due to the worsening macro picture and the downturn in inflation. The average rates on three, five and ten-year bonds dropped from over 5% at all maturities to 3.18%, 3.92% and 4.72% respectively. Note that rates fell more steeply at the short end of the curve (between 1.6 and 2.2 percentage points), while longer-dated instruments (10 years) actually managed a small spike in January-February before returning to December levels.

Interest rates on corporate debt[1]

TABLE 11

%	Dec 05	Dec 06	Dec 07	Dec 08	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
Short term: commercial paper[2]									
3 months	2.58	3.78	4.97	3.45	4.74	5.16	5.24	3.45	1.79
6 months	2.74	3.91	4.91	3.54	4.74	5.31	5.45	3.54	1.93
12 months	2.93	4.00	4.85	3.68	4.73	5.59	5.63	3.68	2.16
Medium and long-term[3]									
3 years	3.15	4.04	4.59	3.79	4.21	5.79	5.39	3.79	3.18
5 years	3.48	4.14	4.65	4.17	4.41	5.97	5.48	4.17	3.92
10 years	3.89	4.26	4.94	4.73	4.82	5.94	5.65	4.73	4.72

Source: AIAF.

1 Average daily data. Data for March correspond to the average level from 1/3 to 13/13.

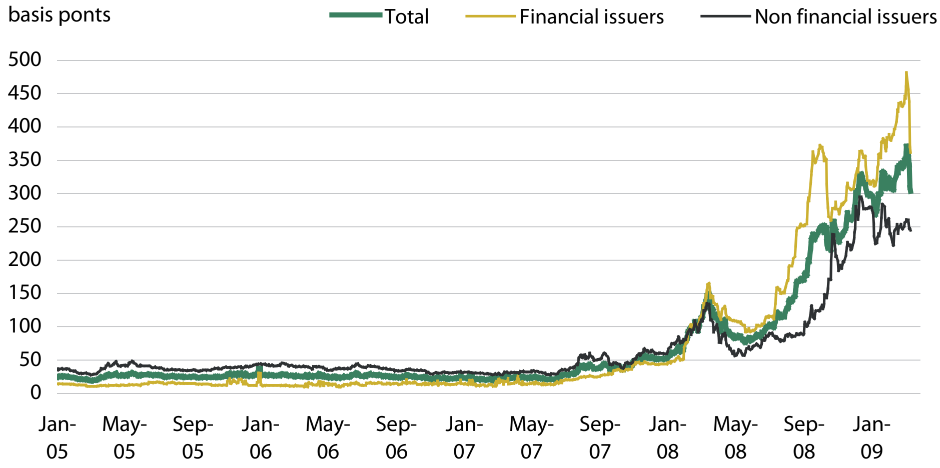
2 Traded on private fixed-income market AIAF.

3 Bond and debenture trades to maturity on AIAF.

...but credit market tensions have not gone away, to judge by the CDS spreads of Spanish issuers and financial institutions in particular.

Despite the fall in rates reported by private fixed-income market AIAF, the CDS spreads of Spanish issuers attest to the persistence of credit market tensions. As we can see from figure 11, the average risk premium carried by Spanish issuers has climbed steadily higher in recent months, from the region of 250 basis points to almost 300 basis points in March, with most of the blame presumably lying with the perceived credit risk of financial institutions. A string of rating downgrades in the sector over the second half of 2008, reflecting its high exposure to the real estate market and the downturn in the business cycle, put a visible seal on these worsening prospects.

Aggregate risk premium[1] based on the five-year CDS of Spanish issuers FIGURE 11



Source: Thomson Datastream and CNMV. Data to 13 March.

1 Simple average.

Corporate issues dwindle in comparison to 2007, and are mainly concentrated in commercial paper and asset-backed securities...

Fixed-income issues rallied from 90 billion to more than 133 billion euros between the third and fourth quarter of 2008 (see table 12). But the year still ended with a substantially lower issuance (476 billion euros compared to the 649 billion of 2007) in tune with the global deleveraging phenomenon. The decrease in issuance ran parallel with a change in the funding mix. Commercial paper was again the instrument of choice, representing between 64% and 68% of total issues in recent years, but asset-backed securities (especially popular in the year's closing months) raised their relative weight to 30% compared to the 22% of 2007 and the 17% of 2006, contrasting with the decline in recourse to non convertible bonds and debentures and mortgage bonds.

...acquired mainly by originators to stock up on eligible collateral for central bank and Treasury loans.

As remarked in earlier reports, these large quantities of asset-backed securities are mostly subscribed by the originating institution (97.8% of the total issued in 2008) in order to equip themselves with assets eligible as collateral in financing operations with the central bank and, more recently, the Treasury.

Data for the opening months of 2009 point to a resumption of issuance in certain segments though at relatively costly interest rates.

From the information we have on 2009 issuance (to date fairly scant), certain segments appear to be returning to fixed-income issuance with a preference for non convertible bonds and debentures and mortgage bonds. These sales, we can say, are going through at relatively high rates, at times in excess of CDS spreads. The difference between bond and CDS spreads may trace to a heightened perception of counterparty risk in the CDS market after the recent wave of investment bank failures (see exhibit 4 for a fuller discussion of the possible causes).

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

TABLE 12

	2005	2006	2007	2008	2008 II-08	III-08	IV-08	2009 I-09[3]
NUMBER OF ISSUES	**263**	**335**	**334**	**337**	**94**	**62**	**107**	**68**
Mortgage bonds	21	37	32	47	20	8	8	29
Territorial bonds	3	6	8	8	0	0	1	0
Non convertible bonds and debentures	93	115	79	76	22	18	29	9
Convertible/exchangeable bonds and debentures	4	1	0	1	0	0	1	0
Asset-backed securities	54	82	101	108	30	23	37	13
Commercial paper facilities	80	83	106	88	21	11	29	13
Securitised	3	3	3	2	1	0	1	0
Other commercial paper	77	80	103	86	20	11	28	13
Other fixed-income issues	1	0	3	0	0	0	0	0
Preference shares	7	11	5	9	1	2	2	4
FACE VALUE (million euros)	**414,254**	**523,131**	**648,757**	**476,276**	**134,468**	**90,554**	**133,727**	**76,611**
Mortgage bonds	35,560	44,250	24,696	14,300	10,120	1,685	1,245	9,819
Territorial bonds	1,775	5,150	5,060	1,820	0	0	800	0
Non convertible bonds and debentures	41,907	46,688	27,416	10,490	3,744	4,215	1,927	9,775
Convertible/exchangeable bonds and debentures	163	68	0	1,429	0	0	1,429	0
Asset-backed securities	69,044	91,608	141,627	135,253	34,386	11,736	60,473	14,158
Domestic tranche	28,746	30,886	94,049	132,730	32,993	10,607	60,473	14,158
International tranche	40,298	60,722	47,578	2,522	1,393	1,129	0	0
Commercial paper[2]	264,360	334,457	442,433	311,738	86,118	72,868	66,853	41,760
Securitised	2,768	1,993	465	2,843	48	94	2,568	1,292
Other commercial paper	261,592	332,464	441,969	308,895	86,070	72,774	64,285	40,468
Other fixed-income issues	89	0	7,300	0	0	0	0	0
Preference shares	1,356	911	225	1,246	100	50	1,000	1,100
Pro memoria:								
Subordinated issues	11,079	27,361	47,158	12,950	1,945	1,575	7,120	6,433
Covered issues	94,368	92,213	86,161	9,170	2,200	946	928	0

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

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

3 Data to 28 February 2009.

Exhibit 4: Differences between CDS and bond spreads

The literature on credit risk valuation states that, duration being equal, bond spreads vs. risk-free assets and CDS spreads should move closely in tandem. This relationship assumes arbitrage-free conditions between bond and CDS markets as applied in intensity-based credit risk models. The corollary is that either spread should serve indistinctly to measure a given issuer's credit risk. Other studies conclude that the two spreads are cointegrated and should converge in the long term by a process of reversion to the mean[1].

In practice, the difference in spreads between the two instruments is not always close to zero, and there are times when bond spreads are higher than those of CDS and vice versa. These differences, accentuated in the last year by the onset of crisis (see figure), imply that the two instruments cannot be equivalent as yardsticks of issuer credit risk. The factors at work are various:

- Liquidity differences between CDS and bond markets. The spreads of both instruments incorporate a liquidity premium. CDS tend to be more liquid, as they are unfunded instruments requiring only a small outlay. This liquidity advantage becomes especially important when credit markets seize up. At such times, demand for protection augments and is mainly satisfied through the CDS market, given the greater difficulty of opening short positions in bonds. Accordingly it is not rare to see CDS spreads moving above those of bonds.

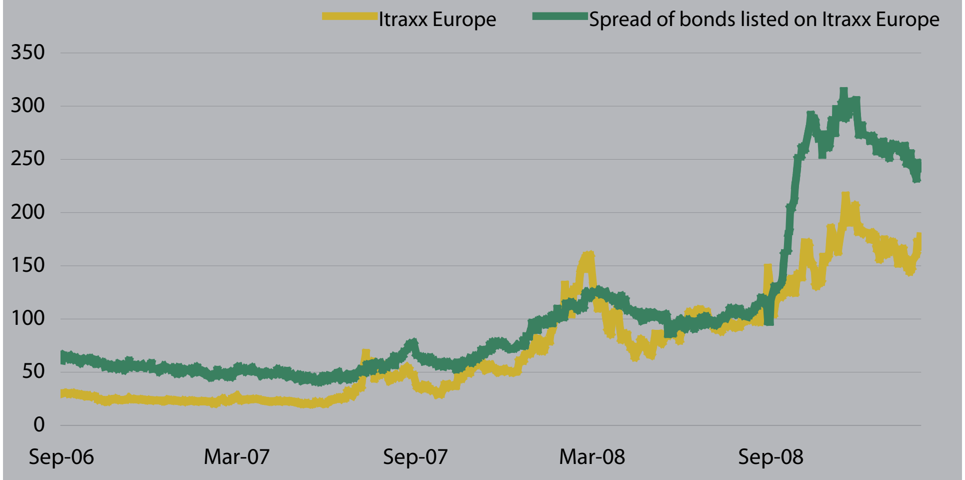
- CDS provides less than perfect coverage of issuer credit risk. Most of the CDS subscribed in Europe are of the type known as Modified Modified Restructuring (MM). The buyers of this variant are protected against any restructuring of the issuer's debt, up to and including bankruptcy. However in the case of CDS that are net settled, the recovery rate is normally set at 40% of the notional amount of the contract. Hence if some event occurs of those envisaged in the CDS contract, the buyer will receive an amount that may be more or less than would correspond to the real recovery rate on that issuer's debt.

- The counterparty risk present in CDS markets. CDS contracts stipulate that when some eligible event occurs, the protection seller should deliver a bond to the buyer or else pay him an agreed amount. As this could mean laying out a lot of cash in a short time, even to the extent of causing the seller's bankruptcy, it is normal for issuers' CDS spreads to be below those of bonds when the market perceives a clear counterparty risk.

- The CDS protection seller has an implicit option to deliver the bond of choice (cheapest to deliver) from a given basket in the event of issuer default. This implicit option tends to enlarge the spreads paid for CDS in comparison to bonds.

The last few months have seen alternating periods in the size of CDS vs. bond spreads (see figure), in which the above factors have dominated to varying degrees. For instance, CDS spreads stood well above bond spreads in the first two months of 2008, when it is reasonable to assume that the determining factor was credit market tensions (Bear Stearns failure, etc.). In these circumstances, investors would opt for the CDS market in order to shield themselves from negative credit events, meaning spread discrepancies were probably due to liquidity differences between the two instruments. Bond spreads, however, overtook CDS spreads from September onwards even though credit market tensions were unresolved. The reason, presumably, is that investors has less recourse to CDS (bringing down spreads) in view of the evident credit deterioration of the investment banks standing as counterparty in this market.

Itraxx Europe (CDS) and corporate bond spreads (basis points)



Source: Bloomberg, Markit and CNMV.

1 Haibin Zhu (2004), *An empirical comparison of credit spreads between the bond market and the credit default swap market*. BIS Working Papers no. 160.

4 Market agents

4.1 Investment vehicles

Financial collective investment schemes[18]

Financial collective investment schemes (CIS) closed the year[19] with 179.6 billion euros in assets, 30% down on the figure for one year before (see table 13). Mounting investor uncertainty, the negative returns of most risk-carrying financial instruments and intense competition from a banking sector hungry for funds were again the factors driving the shift out of investment funds into traditional bank deposits. On an aggregate basis, 85% of the decline in assets was ascribable to redemptions and the rest to portfolio depreciation, with equity instruments leading the downside.

Investment fund assets down by 30% to 180 billion euros, as investors rush to redeem their holdings.

The largest outflows in straight-number terms were in fixed income (around 19 billion euros), global funds (17.7 billion) and international equity (around 15 billion euros), although for reasons that varied with the investment objectives in each case. In fixed income and global funds, losses were due almost entirely to unitholder withdrawals. In fact fixed-income categories accounted for 63% of total redemptions (205.8 billion euros). In the case of international equity, redemptions and portfolio losses contributed to the decline in practically equal measure. All objectives pursuing a significant percentage of equity holdings performed negatively in the full-year period, with positive results confined to the fixed income and guaranteed fixed-income categories.

Fixed income, global and international equity funds register the largest outflows.

Many unitholders opted to withdraw completely, taking their numbers down by more than two million to a year-end total of just over 6 million. Fixed income funds lost over half a million members, international equity funds around 400,000 and global funds a further 350,000.

Unitholder numbers drop by over two million...

Despite this gloomy picture, the number of investment funds actually rose slightly from 2,926 in 2007 to 2,936 at the 2008 close. Increases were bunched in fixed income (30 more funds) and, to a lesser extent, guaranteed funds (13 more), while all other categories saw their numbers decline.

...though the number of funds actually rises slightly.

18 Although this term 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.

19 Data to November 2008.

Main investment fund variables

TABLE 13

Number	2006	2007	2008 I	2008 II	2008 III	2008 IV[6]
Total investment funds	**2,822**	**2,926**	**2,942**	**2,950**	**2,932**	**2,936**
Fixed income [1]	606	600	609	614	616	630
Balanced fixed income [2]	212	204	203	197	195	196
Balanced equity [3]	222	207	206	205	204	204
Spanish equity	118	123	123	122	117	117
International equity [4]	467	481	477	482	469	463
Guaranteed fixed-income	220	251	256	251	255	261
Guaranteed equity	559	590	592	601	600	593
Global funds	418	470	476	478	476	472
Assets (million euros)						
Total investment funds	**270,406.3**	**255,040.9**	**234,043.9**	**214,251.8**	**197,305.6**	**179,604.6**
Fixed income [1]	116,511.9	113,234.1	116,544.0	107,349.4	100,931.9	94,278.1
Balanced fixed income [2]	15,314.5	13,011.9	10,551.0	8,488.5	7,175.8	5,996.7
Balanced equity [3]	10,149.2	8,848.0	6,811.6	5990.9	5,092.8	4,102.6
Spanish equity	10,416.4	7,839.4	5,369.9	4,584.1	3,612.5	2,749.0
International equity [4]	24,799.6	22,698.4	14,962.8	13,433.5	10,472.7	7,856.0
Guaranteed fixed-income	14,484.8	17,674.4	19,253.8	19,841.0	20,968.0	21,469.5
Guaranteed equity	44,796.6	42,042.1	38,521.4	36,633.2	33,782.8	31,176.7
Global funds	33,933.3	29,692.6	22,029.4	18,931.4	15,269.2	11,976.0
Shareholders						
Total investment funds	**8,637,781**	**8,053,049**	**7,420,379**	**7,023,292**	**6,520,089**	**6,026,860**
Fixed income [1]	2,960,879	2,763,442	2,620,712	2,498,451	2,389,795	2,228,281
Balanced fixed income [2]	524,827	493,786	434,935	359,904	319,445	279,989
Balanced equity [3]	357,013	331,214	289,184	263,926	236,645	216,285
Spanish equity	317,386	288,210	219,842	204,259	180,472	169,765
International equity [4]	1,258,426	1,089,868	942,733	907,345	758,463	691,529
Guaranteed fixed-income	497,540	549,108	552,116	542,500	552,515	546,583
Guaranteed equity	1,783,867	1,715,144	1,639,760	1,575,766	1,513,064	1,422,055
Global funds	937,843	822,277	721,097	671,141	569,690	472,373
Return[5] (%)						
Total investment funds	**5.59**	**2.73**	**-1.96**	**-0.56**	**-0.79**	**-1.82**
Fixed income [1]	1.95	2.71	0.54	0.57	0.48	0.47
Balanced fixed income [2]	4.18	1.93	-2.32	-1.29	-1.29	-3.93
Balanced equity [3]	10.34	2.69	-7.56	-2.91	-4.73	-13.22
Spanish equity	33.25	8.02	-12.01	-7.66	-9.73	-25.25
International equity [4]	14.98	2.13	-15.06	-2.73	-11.31	-26.17
Guaranteed fixed income	0.83	2.78	1.02	-0.01	0.80	1.51
Guaranteed equity	4.66	2.44	-2.56	-1.94	0.42	1.44
Global funds	4.01	1.47	-2.56	-0.29	-2.17	-5.86

1 Includes: Short and long fixed income, international fixed income and money market funds. Also FIAMM to December 2006.

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

3 Includes: Balanced equity and balanced international equity.

4 Includes: Euro equity and international equity Europe, Japan, United States, emerging markets and others.

5 Annual return for 2006 and 2007 and non annualised quarterly return for each quarter of 2007 and 2008. Returns for fourth quarter 2008 (incomplete) are stated on a quarterly basis to facilitate comparison.

6 Data to November.

The Madoff fraud affects 224 Spanish schemes but extends to only 0.05% of industry assets.

After the Lehman Brothers failure, the financial world was rocked by another scandal in the month of December – the Madoff investment fraud – which nonetheless had little direct effect on Spanish collective investment schemes (see exhibit 5 for a detailed discussion of the regulatory and supervisory changes following the Madoff collapse). In a press release of 16 December, the CNMV disclosed the direct exposure of Spanish schemes to products affected by the Madoff fraud, based on the latest available information (corresponding to 31 October 2008). On that date, exposed assets summed 106.9 million euros, just 0.05% of the CIS total. Of this amount, 56.5 million corresponded to funds (0.03% of their assets) and 50.4 million to SICAVs (0.2%). Of the 224 CIS affected, 39 were investment funds (7 funds of hedge funds) and 185 SICAVs. Average exposure per positioned fund was 4.7% against 3.2% per positioned SICAV.

Exhibit 5: The impact of Madoff on Collective Investment Schemes from the standpoint of their regulation and supervision

The alleged pyramid-selling swindle or Ponzi scheme operated by Bernard Madoff through his firm Bernard L. Madoff Investment Securities has had a huge impact on the collective investment scheme management industry, as the investment funds exposed to Madoff strategies (basically UCITS and hedge funds acting as feeders) were the principal vehicle for defrauding investors.

Madoff's business was purportedly the management of portfolios on behalf of CIS managers and the provision of custody services to fund depositories.

Considering the Madoff scandal from the standpoint of European fund industry legislation, the UCITS Directive stipulates that manager and depository must be two separate entities acting independently in defence of investors' best interests. In addition, any fund manager or depository delegating management or custody functions is required to exercise strict controls over the conduct of the delegate entity.

The transposition of the UCITS Directive in Spain gave rise to a more explicit and detailed legal text. Not only does it expressly prohibit delegating management duties to sub-custodians, but depositories must prepare a written report on the latters' credit quality and potential risk factors, as well as retaining control of any cash accounts opened with an intermediary (through authorised signatures for example). Finally, the depository must replicate and track the progress of the fund's net asset value.

Regarding hedge funds, Spanish regulations governing the funds of funds segment establish a qualitative, quantitative and operational checklist for the selection of investments, subject to regular review (the set of controls known as due diligence).

In sum, the Madoff case provides food for thought regarding the supervision and regulation of collective investment schemes, but also the whole structure of asset custody. It has brought home the degree of complexity these systems have acquired in today's global, sophisticated markets and the need to pay them greater regulatory attention. To this end, the European Commission has announced that it will review the enforcement of UCITS Directive rules on securities depositories in different Member States.

Analysis reveals a decline in the volume of less-liquid assets held by CIS, which are mainly concentrated in securitisations and financial fixed-income assets rated below AA.

The liquidity of investment fund holdings is a supervisory priority for the CNMV in today's complex financial landscape. Recent analyses of the private fixed-income portfolio, which is where liquidity problems might in theory be greatest, put the volume of less-liquid assets[20] at around 14.46 billion euros in November 2008 (8.6% of total investment fund assets); a considerable 6.80 billion less than the previous estimate. Of the total volume of less-liquid assets, about two thirds are securitisation-related while the rest comprise financial fixed-income instruments rated below AA. Despite this moderation of less-liquid holdings, the CNMV will be keeping a permanent watch on the funds and managers where their weight is highest.

Estimated liquidity of investment fund assets TABLE 14

Type of asset	Less-liquid investments		Total
	Million euros	% total	Million euros
Financial fixed income rated AAA/AA	456.8	2.9	15,528.3
Financial fixed income rated below AA	4,520.6	35.1	12,874.1
Non financial fixed income	128.7	3.1	4,190.7
Securitisations	10,351.7	88.4	11,709.3
AAA-rated securitisations	8,183.7	86.7	9,434.4
Other securitisations	2,168.0	95.3	2,274.9
TOTAL	**15,457.8**	**34.89**	**44,302.3**
% of investment fund assets	8.6	-	24.7

Source: CNMV. Data to November 2008.

In today's adverse climate for the collective investment industry...

The short-term outlook for the collective investment industry remains weak, with various factors militating against a renewed inflow of resources. First we have the worsening national economic and financial situation which has not only reduced investors' available funds but has also undermined their confidence, inclining them more towards low-risk instruments like bank deposits or government bonds[21]. And recent shocks like the Lehman Brothers collapse or the Madoff fraud have only accentuated this trend.

...the CNMV will go on working to ensure fund managers apply suitable valuation policies and inform investors appropriately.

The CNMV will keep its sights trained on the liquidity of CIS investments as well as on the valuation policies being applied by their management companies and the information given to investors.

Real estate collective investment schemes

The surge in redemption orders puts a strain on the liquidity of real estate CIS, already struggling to cope with the slump in market activity.

The situation of Spanish real estate schemes is right now highly complex, especially in the case of real estate investment funds. The surge in redemption orders received from investors throughout 2008 has bitten deeply into their liquidity; already intrinsically less than that of other types of collective investment vehicle. And the scant activity of a real estate market immersed in an intense correction phase has only added to the problem.

The result has been a large decline in assets and unitholder numbers throughout 2008,...

The result has been a steady decline in the assets under management in real estate funds, which fell by 1.10 billion euros to a November total of some 7.50 billion eu-

20 Data for the private fixed-income portfolio (which excludes investments in commercial paper and financial instruments with a term to maturity of less than one year) have been taken from a key reporter, with less-liquid assets defined as all those where the difference between the average indicative prices of a range of contributors and the average of executed prices is at some point greater than 5%.

21 Provided the security is held to maturity.

ros (see table 15). Funds also lost a total of 50,000 unitholders between January and November to end this last month below the 100,000 mark.

......accompanied by a gathering run-down in returns.

Aggregate returns moved down steadily as the year progressed, but did not actually turn negative until the closing quarter.

The scale of outflows has forced the two largest funds to suspend redemptions for two years. And one manager has said it will wind up the fund if it cannot meet all orders received in this period.

Of the nine funds in existence at the closing date for this report, two had entered liquidation and a further two (the largest) had been forced to alter their redemption conditions. The manager of Santander Banif Inmobiliario, the sector's biggest fund by asset volume[22], approached the CNMV in February 2009 for authorisation to suspend redemptions for a two-year period due to its inability to meet current orders[23]. This measure, which the CNMV subsequently approved[24], will give the management company time to arrange the orderly sale of fund assets in order to reimburse its unitholders. Also, the manager has stated that the fund will be wound up in the following cases:

- Before the two years are up, if the fund's assets drop below the legal minimum of 9 million euros after the payment of redemptions.
- After the two years are up, if redemptions orders have not by then been fully met.

In the case of the next largest fund by assets, BBVA Propiedad FII[25], the manager opted to give investors the chance to sell their units at end 2008, prior to suspending redemptions for a period of two years. The financial institution BBVA decided to acquire holdings in the fund, allowing it to meet the orders presented in their entirety.

Main real estate fund variables TABLE 15

	2004	2005	2006	2007	2008 I	2008 II	2008 III	2008 IV
FUNDS								
Number	7	7	9	9	9	9	9	9
Shareholders	86,369	118,857	150,304	145,510	144,197	141,037	135,307	97,784
Assets (million euros)	4,377.9	6,476.9	8,595.9	8,608.5	8,563.8	8,394.0	8,166.7	7,489.5
Return (%)	6.65	5.35	6.12	5.30	1.16	0.87	0.35	-1.12
COMPANIES								
Number	2	6	8	9	8	8	8	8
Shareholders	121	256	749	843	839	839	938	938
Assets (million euros)	56.4	213.9	456.1	512.9	349	359.2	363.8	365.3

Source: CNMV. Data to November.

1 Fourth-quarter returns are those for October-November restated on a quarterly basis

Real estate CIS will continue facing difficulties if redemption orders persist at these levels.

The liquidity problems of real estate CIS will not go away while redemptions remain at current levels. It is foreseeable therefore that other funds may opt to modify or restrict their redemption conditions to facilitate to the orderly disposal of their assets.

22 With assets representing almost 46% of the real estate fund total.

23 Spanish regulations provide a series of mechanisms in the event of large-scale redemption orders which funds cannot meet, given the less liquid nature of the assets they invests in.

24 In March, the manager sent a new notice to the CNMV confirming the regulator's authorisation to suspend fund redemptions from 28 February 2009 to 28 February 2011 and adding that it would earmark an amount equal to 10% of the fund's assets for the prorated payment, in two instalments, of redemptions applied for up to 27 February 2009. It also advised that most asset sales would have to wait until at least the second half of 2010, in view of the current conditions of real estate markets.

25 With assets representing over 20% of the real estate fund total.

This movement may be accentuated by a deeper decline in fund returns due to sinking real estate prices and, in some cases, the impact of extraordinary appraisals.

Hedge funds

Hedge funds face a series of impediments to the implementation of their strategies...

The business landscape for hedge funds has also become trickier in the last few months. Difficulties finding finance have got in the way of some of their strategies, and they have had to confront short sale restrictions in many jurisdictions on top of the general turbulence sweeping financial markets.

...along with a wave of investor redemption orders which has intensified in recent weeks. Some managers have responded by amending their prospectuses (notice periods, proration, partial redemptions, etc...)

Moreover, hedge funds too have had to cope with a wave of investor withdrawals. In February, nine hedge fund managers notified the CNMV[26] that they had met redemption orders for an amount exceeding 20% of the fund's assets. Of these nine notifications, four concerned hedge funds as such while five concerned funds of hedge funds[27]. Certain funds of hedge funds had a harder time raising the cash required, as their underlying funds had restricted or suspended their own redemption regimes. In these circumstances, some managers opted to amend prospectuses, with the most common changes affecting notice periods, prorated allocation of redemptions beyond a certain percentage of the fund's assets and the introduction of partial redemptions or payments confined to the liquid portion of the portfolio.

For at least the first three quarters of the year, hedge funds numbers, ...

The number of funds of hedge funds in operation remained at around twenty throughout the year, and the number of hedge funds at around 25. However, five schemes (4 funds of hedge funds and 1 hedge fund) are now being wound up after their managers notified the CNMV of their intention to de-register.

...assets and unitholders pursued a stable or slightly upwards course.

The combined assets of these collective investment schemes climbed to over 2 billion euros in the third quarter of 2008, but by the end of the year were back down to 1.80 billion, as a result of the dent taken in fund returns (see table 16) and rising redemption volumes. The number of investors holding funds of hedge funds also receded slightly at the end of the year after a strong progression to the month of September. In November, concretely, unitholder numbers exceeded 11,100 compared to just over 5,000 at the 2007 close.

However, financial market conditions plus investors' heightened risk perceptions will continue to hold back sector development.

It seems likely that funds will have to go on contending with scarce financing, liquidity shortages on certain markets and the withdrawal of investor confidence, suggesting their assets and unitholder numbers will see more erosion in the months ahead.

26 In compliance with article 28 of Royal Decree 1309/2005, dated 4 November, implementing Law 35/2003 of 4 November on Collective Investment Undertakings.

27 Only three such notifications had been received previously (in January 2009, October 2008 and July 2008).

Main hedge fund variables

TABLE 16

	2007			2008			
	II	III	IV	I	II	III	IV
Funds of hedge funds							
Number	22	30	31	38	39	41	40
Shareholders	1,456	3,142	3,950	5,488	8,582	9,739	9,596
Assets (million euros)	600.2	829.2	1,000.0	1,129.6	1,389.6	1,427.5	1,252.1
Return[1] (%)	1.08	-2.14	1.22	-2.31	2.2	-7.56	-13.75
Hedge funds							
Number	9	17	21	25	23	25	25
Shareholders	183	251	1,127	1,335	1,429	1,583	1,576
Assets (million euros)	152.0	210.2	445.8	546.3	603.9	597.7	550.3
Return[1] (%)	3.18	-2.2	-1.31	-1.95	1.48	-0.29	-6.92

Source: CNMV. Data to November.

1 Fourth-quarter returns are those for October-November restated on a quarterly basis.

4.2 Investment firms

Investment firms have seen their activity increasingly impaired by the financial crisis and its manifold impacts on prices, confidence and market turnover. The slowdown affecting main business lines, namely order processing and execution, issue placement and underwriting and CIS subscriptions and redemptions, has cut deeply into sector earnings and pushed more and more companies into losses.

The financial crisis wears away at investment firm business lines.

Broker-dealers obtained aggregate pre-tax profits of 314.5 million euros between January and November 2008[28], representing a 53% decline versus the same period in 2007 (see table 17). Performance was, however, notably uneven, with the ten biggest earners (out of a total of 49) accounting for 80% of total profits.

Aggregate profits of broker-dealers fall by 53% in the first eleven months...

Aggregate income statement

TABLE 17

Thousand euros	Broker-dealers			Brokers		
	Nov 08	Nov 07	% change	Nov 08	Nov 07	% change
I. NET INTEREST INCOME	146,741	116,110	26.4	8,758	13,853	-36.8
II. RESULT ON SECURITIES TRANSACTIONS	-46,807	115,337	ns	-3,348	443	ns
III. NET FEE INCOME	522,174	729,541	-28.4	137,843	212,041	-35.0
Fee income (=1 to 9)	758,915	992,177	-23.5	157,483	279,979	-43.8
1. Order processing and execution	539,234	648,148	-16.8	58,846	116,985	-49.7
2. Distribution and underwriting	36,179	54,464	-33.6	4,745	2,381	99.3
3. Securities custody and administration	18,929	23,090	-18.0	338	1,524	-77.8
4. Portfolio management	15,874	25,135	-36.8	19,093	24,200	-21.1
5. Design and advising	18,860	50,391	-62.6	2,680	1,965	36.4
6. Search and placement	12	9	33.3	0	0	-
7. Margin trading	12	21	-42.9	0	0	-
8. Fund subscriptions and redemptions	72,225	126,150	-42.7	27,133	67,862	-60.0
9. Others	57,590	64,769	-11.1	44,648	65,062	-31.4
Fee expense	236,741	262,636	-9.9	19,640	67,938	-71.1
IV. GROSS INCOME (=I+II+III)	622,108	960,988	-35.3	143,253	226,337	-36.7
10. Operating expenses	334,600	382,756	-12.6	124,429	135,300	-8.0
V. NET OPERATING INCOME (=IV-10)	287,508	578,232	-50.3	18,824	91,037	-79.3
11. Depreciation and other charges	74,273	68,197	8.9	5,518	7,280	-24.2
12. Other profit and loss	101,273	157,201	-35.6	12,231	29,869	-59.1
VI. PROFIT BEFORE TAXES (=V-11+12)	314,508	667,236	-52.9	25,537	113,626	-77.5
VII. NET PROFIT	314,508	667,236	-52.9	25,537	113,626	-77.5

Source: CNMV.

ns Not significant as the comparison is between positive and negative numbers.

28 Excluding the figures of one broker-dealer which books part of its proprietary trading under "Other profit and loss", with a grave distorting effect on aggregates such as "result on securities transactions" and thereby "gross income" and "net operating income".

...due to the thinning out of main fee income streams (order processing and execution and CIS subscriptions and redemptions).

Broker-dealers reported lower revenues from their brokerage activity, basically the provision of investment services to outside clients, as well as in certain dealer lines such as own-account trading. Overall, their fee income dropped by more than 23% in the reference period[29]. Fees from order processing and execution, accounting for over 70% of aggregate inflows at this income statement line, were down 17% on the prior-year period. This was accompanied by substantial declines in revenues from CIS subscription and redemptions (-43%), reflecting the overall weakness of the industry, issue distribution and underwriting (-34%), with primary market issuance shrinking to near zero, and transaction design and advisory services (-63%).

Gross income and net operating income come down sharply…

The combined result was a gross income figure of 622.1 million euros, 35% less than in 2007. The decline was even steeper at the net operating income line (50%), since operating expenses reduced at a slower rate then revenues, causing a degree of erosion in operator efficiency ratios. Extraordinary income too moved down in year-on-year terms.

Brokers aggregate pre-tax profits dropped by 77% to 25.5 million euros between January and November 2008, a sharper decline in percentage terms than their broker-dealer counterparts. Concentration is even greater in this market segment, with the seven biggest-earning firms (out of a total of 53) accounting for 85% of aggregate profits.

...on the reduced revenues flowing in from ordinary activities.

The fee income of these firms, which are legally confined to third-party rather than proprietary trades, decreased by 35% to 137.8 million euros. As with the broker-dealer group, the decline traced mainly to their two largest revenue streams: the processing of market orders (almost -50%) and CIS subscriptions and redemptions (-60%).

The gross income reported was 143.3 million, 37% less than in 2007, while net operating income fell by more than 79% due to the downside resistance of operating expenses. Here too the outcome was a loss of relative efficiency in comparison to prior years. Finally, extraordinary income dropped by almost 60% with respect to 2007.

The returns on equity of brokers and broker-dealers slump from over 60% in 2007 to below 30% in 2008...

These results took a heavy toll on the aggregate return on equity (ROE)[30] of the investment firm sector (see figure 12). Specifically, the aggregate ROE of broker-dealers slumped from 63% in 2007 to 27% in 2008, while that of brokerage firms plunged even deeper (from 62% to 21%). This is a far cry from the buoyant readings of the past few years and closer to the levels recorded at the start of the decade. An analysis of the components driving this reduction[31] lays the blame on two main factors: namely, lower asset productivity and the deterioration of sector efficiency[32]. Although extraordinary items also contributed on the downside, their influence was less intense (see figure 13).

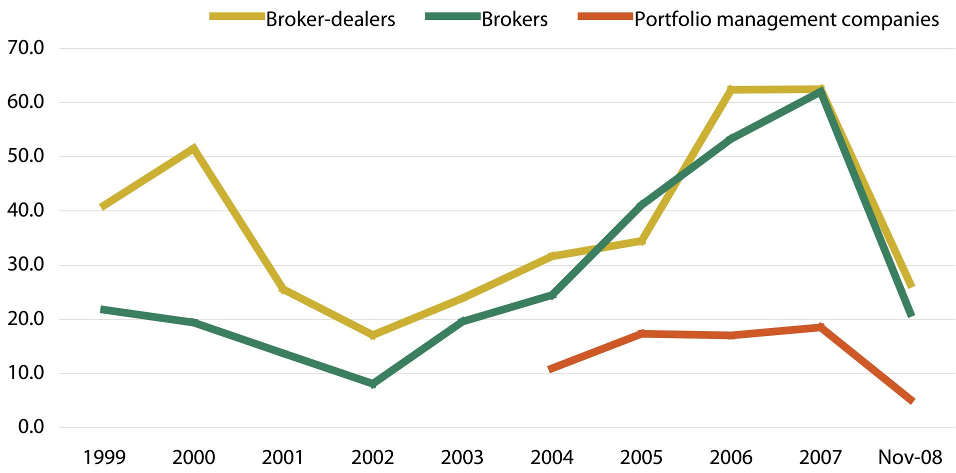
29 January-November 2008 vs. the same period in 2007.

30 Annualised pre-tax profits to November 2008.

31 For a fuller description of change factors for ROE see the exhibit in the first report on "Securities markets and their agents" published in CNMV Bulletin I 2008.

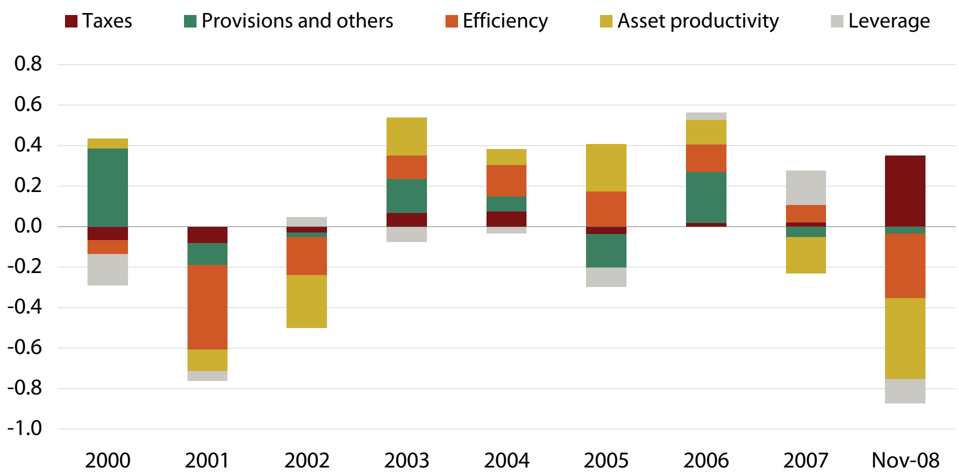
32 Traditional measurements of efficiency set company income flows against the expenses incurred in their generation. But in today's setting of sharply falling share prices, and remembering that stock market orders constitute investment firms' main revenue source, it could be argued that part of the downturn in efficiency is exclusively price driven (in fact the number of orders processed in national equity markets grew by almost 7% in 2008).

ROE before taxes FIGURE 12
Broker-dealers, brokers and portfolio management companies



Source: CNMV and authors.

Breakdown of year-on-year change in ROE: Broker-dealers and brokers FIGURE 13



Source: CNMV and authors.

The decline in sector profitability ratios has been paralleled by an increase in the number of firms reporting losses. Specifically, 31[33] firms were running pre-tax losses at 30 November 2008 (18 brokers, 10 broker-dealers, and 3 portfolio management companies), compared to just 9 firms at end-December 2007. Note however that five of this group accounted for almost 70% of the sector's total red numbers.

More firms enter losses (9 to 31), though their volume is heavily concentrated in a small number of operators.

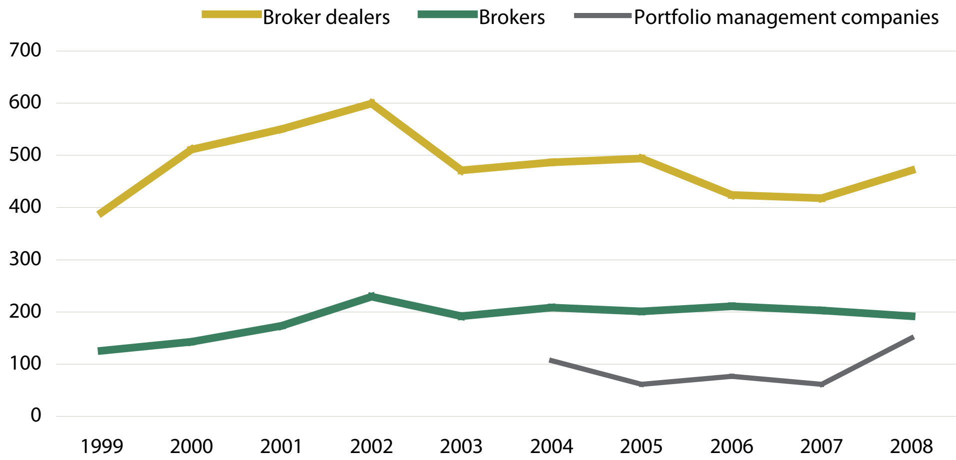
Investment firms as a whole remain comfortably compliant with capital adequacy requirements. As figure 14 shows, the aggregate position of broker-dealers strengthened in the year (with equity almost six times above the minimum requirement) while that of brokers held at similar levels (equity three times higher than required). Most of this improvement stems directly from the reserves built up over previous years. The number of firms running a tighter margin (less than 50%) was also slightly down versus December 2007 (from 14 to 11).

The sector has managed some improvement in its already solid equity position, thanks to the reserves built up in previous years.

33 Of a total 113.

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

FIGURE 14



Source: CNMV and authors.

Today's testing situation may invite some degree of sector restructuring.

These intermediaries seem certain to have some tough months ahead in which their business will continue to suffer, especially areas dependent on financial market trading. The main concern now is that a prolonged slowdown could lead to excess capacity in the investment industry, in which case firms will need to take a hard look at their cost structures and make the opportune strategic decisions.

4.3 Other intermediaries: venture capital[34]

The number of venture capital entities continues to expand...

A total of 55 venture capital entities (VCEs) joined the CNMV register in 2008, breaking down 25 companies, 21 funds and 9 venture capital fund managers. This compares with the 61 new VCEs registering in 2007 (33 companies, 16 funds and 12 managers).

Movements in the VCE register in 2008

TABLE 18

	Situation at 12/31/2007	Entries	Retirals	Situation at 12/31/2008
Entities	**276**	**55**	**9**	**322**
Venture capital funds	76	21	2	95
Venture capital companies	134	25	5	154
Venture capital fund managers	66	9	2	73

Source: CNMV.

...though with both investments and transactions closing lower than in 2007.

According to data provided by the Spanish industry association (ASCRI) the investment of venture capital companies operating in Spain amounted to 2.95 billion euros. This was 32.3% less than one year before but just 5.2% down versus 2006, and stands more or less in line with the decline reported in remaining European countries. The number of industry transactions also reduced by a more moderate

34 Due to changes in CIS manager accounting rules (CNMV Circular 7/2008 of 26 November), the data available at the closing date for this report did not allow for an accurate review of the industry's 2008 performance, which we will accordingly leave for our next issue.

5.7%[35] with respect to 2007. Divestments in the period summed 604 million euros across a total of 336 transactions, 62% and 16% down respectively on the equivalent figures for 2007.

Financing constraints will condition the volume, nature and destination of future investments.

The future of sector investment and transaction numbers is currently clouded by uncertainty. On the one hand, cash rich entities will find themselves able to buy in advantageous conditions and thus attain medium- and long-term returns ahead of the market average. On the other, entities needing leverage (LBOs) will have to negotiate their way through credit constraints and all that they entail in terms of financing conditions – higher costs, smaller amounts, and shorter repayment periods – potentially pushing up their recourse to syndicated loans. Only the VCEs with the best track records will find financial institutions eager to lend. In the meantime, financing difficulties have caused a shift in industry investment practices towards less leveraged transactions[36], the acquisition of minority stakes and an offering better geared to today's more selective investors, focused on sectors combining greater earnings predictability with a more favourable regulatory framework[37]. Some restructuring is also on the cards which should favour those intermediaries best primed to negotiate a less accommodating future.

5 Transparency in non equity financial markets

5.1 Introduction: transparency and the crisis

Financial markets cannot function without proper transparency, though this requirement also has its costs.

Properly functioning securities markets require the right measure of transparency to facilitate efficient price formation and maintain investor confidence. Disclosure is a key way to alleviate information asymmetry and, thereby, to prevent situations of inequality in which those "in the know" can profit at the expense of others. However, transparency also has its costs. On the one hand, we have the costs of setting up suitable mechanisms to gather and disseminate information and, on the other, companies must consent to be bound by market discipline, since one of the benefits of transparency is that investors can accurately judge the performance of market intermediaries.

Participants need to be informed about the assets they can trade in and about the trading process itself.

Participants need to be informed about the characteristics of marketable securities and about the trading process in itself. This means having access to data on demand and supply conditions and on the outcome of exchange transactions. Specifically, the first things an investor must know are the number and scale of orders outstanding and at what price he can buy and sell. These disclosures relative to the conditions pertaining before a trade are known collectively as pre-transparency. A second set of variables, including prices fetched and volumes exchanged, are known after each transaction, so come within the category of post-transparency.

Transparency is an enshrined principle of equities market regulations and trading practices, but this is not the case with bonds and structured products.

The nature of trading and regulatory intervention have brought about differences in the transparency regime affecting equity markets and all others. The former are centralised markets in which retail investors participate in relevant numbers, and

35 Provisional data.

36 Investment in leveraged transactions has already fallen 22 percentage points, from 54% of outlays in 2007 to 32% in 2008. In fact such transactions accounted for only 3% of the total closed in 2008.

37 Note, for instance, the volume of investment reaching firms in the energy and natural resources sector (34% of the 2008 total).

where transparency practices are thoroughly established. This is not the case of either fixed income or structured product markets, where tradings tend to be bilateral and, in the second case, OTC.

The financial crisis has laid bare transparency shortcomings in these instruments, which...

The financial crisis has brought to light certain transparency shortcomings in corporate debt markets, affecting especially structured products and CDS. And these are now thought to have contributed greatly to the generation and spread of distrust.

...have caused liquidity to contract sharply in certain debt market segments...

In private debt markets, one of the first consequences of the financial crisis was the seize-up of liquidity in various segments, accompanied by a widening of bid/ask spreads and, more recently, a significant divergence between CDS spreads and those of the corresponding bond markets. The result was to complicate the valuation of certain structured products. Hence the growing conviction that more fluid information (especially post-trade) could help rebuild market confidence, get trading volumes back to normal and restore the credibility of product valuations.

Analyses conducted on the crisis and its aggravants have led to a series of recommendations on financial market practices, including those put forward by the Financial Stability Forum (FSF) in its April 2008 report on "Enhancing Market and Institutional Resilience". Among its conclusions was the need to enlarge post-trade transparency in secondary markets as a means to improve financial product valuation and obtain reliable data on the transfer of risk.

FSF and G-20 recommendations and IOSCO study groups concur on the need for more rigorous post-trade transparency.

Among the initiatives launched since the start of the crisis we can cite the G-20 proposals at the Washington summit concerning the role of transparency in non equity markets, especially in structured products, and the work of the IOSCO Task Force on transparency in non regulated markets and products. Further, IOSCO's working group on markets has been scrutinising structured product markets and how stricter post-trade transparency requirements might impact on their operation.

5.2 The state of play

Private debt markets suffer a transparency deficit in both pre- and post-trade segments.

Private debt market suffer from a dearth of information at both the pre- and post-trade stages. Some price information can be had in the pre-trade segments but only through costly recourse to information aggregators whose services tend not to reach the retail investor. In bonds, post-trade information is provided by regulated markets for their own instruments, by dealer or client-access trading platforms and occasionally by associations such as the ICMA (International Capital Market Association). Data, basically, is controlled by wholesale participants giving rise to an asymmetry of power between the retail investors who trade through intermediaries and can call on them for information, and retail investors who trade direct, relying purely on the data they can find in newspapers, the Internet or regulated markets as the case may be. What we have then is a situation in which the near absence of post-trade reporting, confined to some exchange-traded instruments in a small group of countries, has caused leading institutional investors (banks, investment funds, hedge funds,...) major headaches with the valuation of their portfolios and hindered the generation of reliable statistics.

Structured markets too have a lack of disclosure mechanisms for post-trade information.

In most cases, structured product markets too fail to provide even the most basic post-trade disclosures, which should include the name of the issuer, the name of the tranche, plus the amount, price and date of the transaction. As we write, the following information is available by type of product:

- Asset-Backed Securities (ABS): The lack of information is attributable here to the absence of an established secondary market. Participants base their strategies on holding investments to maturity, and trading is typically bilateral between the investor and the dealer, who enjoys the better access of the two. In cases like this where the secondary market is underdeveloped, a standard post-trade disclosure regime could help considerably towards efficient price formation and product valuation.

In the case of ABS, the information deficit has its roots in the absence of an established secondary market,...

- Collateral Debt Obligations (CDOs): Information on these products is extremely hard to find. This is so even for intermediaries, who have to use indicative prices or a series of benchmarks to determine execution prices. These benchmarks may rest in turn on the price of a bond or class of bonds, valuation models, or else tools that generate proxies for different tranches, maturities, spreads, etc...

...with CDOs, even intermediaries have little direct information,

- Asset Backed Commercial Paper (ABCP): Here too we can talk about a transparency deficit both pre- and post-trading. These products are normally held to maturity so there is no active secondary market. The most common shortcomings identified are a certain opacity regarding underlying assets, frequently of a longer duration than the ABCP itself, and regarding the liquidity commitments made by the issuer. Many of these products are held by money-market investment funds operating daily redemption windows, and doubts about the valuation of portfolio assets could easily drive away investors.

... ABCPs are thin on transparency at both the pre- and post-trade phase,...

- Credit Default Swaps (CDS): Although more post-trade reporting (volume, price) would be welcome, this market is relatively rich in price information compared to other structured products.

...while CDS do rather better especially with regard to price.

5.3 Transparency in the MiFID and the United States

The transparency rules for European markets are set out in the Directive on Markets in Financial Instruments (MiFID). This Directive establishes a comprehensive regime of disclosure requirements in the equities trading sphere, to be applied to regulated markets, multilateral trading facilities (MTF) and financial intermediaries internalising orders (systematic internalisers).

In Europe, transparency requirements are laid down in the MiFID, which regulates extensively for equity markets...

However, this regime was not extended to markets in financial instruments other than shares. The argument most often cited for such unequal treatment is that these are essentially wholesale markets. Private debt markets tend to operate through bilateral rather than centralised trades, which entails searching for a counterparty and, frequently, the engagement of dealers. The participation of retail investors is limited, and tends to involve only "buy and hold" decisions rather than active trading.

...but not for markets in securities other than shares.

The MiFID texts specifies a review period for the exemption of non equity markets. Specifically, its article 65 calls on the European Commission to report to the Parliament and Council within two years from its entry to force on the possible extension of the scope of its provisions to transactions in financial instruments other than shares.

Its text, however, specifies a review period for the exemption of these markets.

In 2006, the European Commission asked the CESR to conduct a study...

Accordingly, the Commission asked the CESR to analyse the situation of corporate bond markets, following this at end-2006 by a request for technical assistance on a number of related points. The result was a report published in August 2007, just as financial markets were feeling the first impact of the crisis.

...which found no evidence of market failure.

In its conclusions, the CESR argued that there was no evidence of market failure and therefore no case for regulatory intervention to extend transparency requirements to markets in non equity instruments.

However the CESR re-opened its debate in view of the deepening financial crisis.

However, as the crisis deepened, the Committee decided to re-open its study, focusing on how the transparency conditions of non equity markets might have aggravated events. A new document has gone out to public consultation and a final draft should be ready for approval some time this summer. Although it does not identify market failures requiring regulatory action, the feeling to date, unlike in the previous study, is that greater transparency would be a good thing.

The situation in Europe contrasts with the TRACE system in place in the U.S. since 2002.

The situation in Europe stands in stark contrast to the United States, where the TRACE information system, in place since 2002, provides detailed post-trade information on a wide variety of fixed-income securities. Between 2002 and 2005, the system went through three stages in which the number of instruments covered was progressively enlarged just as the reporting time was shortened. System intermediaries transacting in any of these securities are obliged to provide information on OTC trades, part of which is made publicly available. For each transaction, the intermediary must state the bond, the date and time of the trade, the amount, the price, the fees applicable, the identity of the counterparty, etc.

5.4 The traditional case against more transparency

The first argument against refers to the wholesale nature of these markets …

Two objections are traditionally raised to increasing the transparency of financial markets. The first denies the existence of any market failure due to lack of transparency, alleging that information is privately available and that these are predominantly wholesale markets, whose participants report no difficulties in obtaining pre- and post-trade data from market news services.

…yet more and more retail investors are taking part, and institutions too need access to clearer, timelier information.

However this private information is often incomplete (in the case of transactions closed, for instance) and the fact it is available does not suffice of itself. And while admitting that these markets have traditionally been a wholesale domain, there are still three good reasons for improving their transparency. One is the growing presence of retail investors in bond but also in structured product markets. Another is the fact that behind many institutional investor trades are numerous retail investors who may be unable, for lack of information, to properly monitor and assess the decisions that wholesale intermediaries are making on their behalf. And yet another is that the complexity of certain instruments calls for tighter disclosure requirements, especially on past transactions, so investors can refine their buy and sell strategies.

The second equates excessive disclosure requirements with a loss of liquidity, but this is far from proven.

The second big argument against greater transparency equates overzealous transparency requirements with a reduction in market liquidity. To date, however, the empirical evidence is inconclusive on this score. In fact, analyses run on the introduction of the TRACE system in the United States have detected some decrease in secondary market bid/ask spreads.

There is no firm proof, then, that increased transparency may drive intermediaries out of the market with the subsequent pressure on liquidity. What does seem likely, however, is that they will increasingly draw their revenues from brokerage fees rather than transaction spreads.

Greater transparency could change the way intermediaries are compensated.

5.5 Conclusions

Europe's official position on the regulation of post-trade transparency in non equity markets is shifting only slowly, despite the evidence thrown up by the financial crisis.

In fact we can distinguish two currents of opinion. Some authorities say that the crisis should not undo the conclusions of the CESR's August 2007 report, and insist that the industry itself can deliver transparency objectives by means of self-regulation. Others, however, feel that while post-trade disclosures or the lack of them are neither the cause of the meltdown nor a quick-fix solution, it would be unwise simply to let things lie on bond, structured product and CDS markets, while all the lessons of the crisis and the recommendations of international organisations are urging action to improve transparency. At the same time, the argument that greater transparency means less liquidity has failed to find empirical support.

European authorities line up on two different sides.

The CNMV's view is that there is sufficient evidence to posit market failures with regard to transparency in markets in financial instruments other than shares. Specifically, it sees undeniable signs of information asymmetry between major participants and retail investors, which warrant the coordinated introduction of measures to enhance transparency on the terms of the transactions closed on the relevant bond and derivative markets.

The CNMV believes there is evidence enough to support the existence of market failures, and to justify the coordinated extension of transparency requirements to fixed-income and derivative markets.