I Securities markets and their agents: Situation and outlook

Contents

1	Executive summary		13
2	Macro-financial setting		15
	2.1	International economic and financial developments	15
	2.2	National economic and financial developments	24
	2.3	Outlook	32
3	Spanish markets		33
	3.1	Equity markets	33
	3.2	Fixed-income markets	41
4	Market agents		45
	4.1	Investment vehicles	45
	4.2	Investment firms	52
	4.3	UCITS management companies	56
	4.4	Other intermediaries: venture capital	57

List of exhibits

Exhibit 1:	"Proposed amendments to EU regulations on credit rating agencies"	20
Exhibit 2:	"Exchanging of preference shares"	27
Exhibit 3:	"CNMV guidelines on the content of quarterly financial reports"	35
Exhibit 4:	"Electronic trading standards"	39
Exhibit 5:	"The impact on guaranteed funds of credit institution rating downgrades"	48
Exhibit 6:	"ESMA guidelines on ETFs and structured UCITS"	51
Exhibit 7:	"EC draft regulation on European venture capital funds"	59

1 Executive summary

- Macroeconomic and financial conditions deteriorated markedly in the closing months of 2011 as a result of the deceleration of the world economy and mounting tensions around the sovereign debt crisis in a number of European countries. Growth forecasts have been revised down for both the advanced economies – the euro area in particular – and the emerging market economies, which will nonetheless continue at the forefront of growth over coming quarters. Inflation expectations remain well anchored and interest rates in the main advanced economies are likely to be left untouched for the next few months at least. The dominant concerns among many economies were once more to ensure the sustainability of public finances and press on with financial sector restructuring.

- Debt market tensions drew in a growing number of Europe's economies in what was a generally unsettled second-half period. Risk premiums touched annual highs in the month of November but tended to ease back thereafter, helped by European governments' commitment to advance in fiscal consolidation, the progress made around the Greek rescue deal and the ECB's recent extraordinary auctions of three-year loans. Deteriorating debt financing conditions caused a slump in issuance in the year's second half. Equity prices, meantime, headed sharply lower in the third-quarter period then rallied in the closing months. Of late, the release of rather more upbeat activity and employment indicators in Europe and the United States has set main world stock markets rising again.

- Spain's GDP contracted 0.3% in the fourth quarter of 2011 on weakening domestic demand, for a full-year rate of just 0.7% compared to the 1.5% of the euro area. Inflation rates moderated from a spring 2011 high of nearly 4% to 1.8% in March 2012, widening the negative differential versus the euro area to 0.8 points. Job destruction persisted through 2011 (-2%) lifting the unemployment rate as far as 21.6% of the labour force, while the public deficit closed the year at 8.5% of GDP (9.3% in 2010). Some forecasters are now auguring that the Spanish economy will re-enter recession in 2012.

- Spanish credit institutions are immersed in a root-and-branch restructuring process. The weakness of domestic activity has hit hard at sector earnings while pushing up non-performing loan ratios. Banks' funding conditions tightened anew in the second half of 2011 on the resurgence of debt market stress. Their response was to fund themselves increasingly through traditional deposits and covered instruments such as mortgage bonds, while striving to build up their top-quality capital. In addition, Spanish institutions also borrowed more heavily from the Eurosystem in the period.

- The aggregate earnings of non-financial listed companies fell by 32% as far as 21.44 billion euros at the 2011 close, while their aggregate debt dropped by 6.7%.

- Domestic equity markets were rocked by the turbulence emanating from sovereign debt markets and the worse prospects coming through for the Spanish economy. The Ibex 35 shed 6.5% in the first quarter of 2012 (on top of the -13.1% of 2011), with major price falls in the oil and gas sector, real estate and chemicals. Meantime, the index's historical volatility fell from the 65% peak of November last to around 25% in mid-March 2012. The end of restrictions on short selling in Spanish financial shares, in mid-February 2012, provided a mild boost to stock market turnover though without recouping the volumes in place before the ban was imposed, in August 2011.

- Domestic fixed-income markets remained under heavy stress through the second half of 2011. And though tensions abated in the opening stretch of 2012, by late March they were once more running high. In any event, government and corporate bond yields retreated from the peak levels of November 2011. The yield spread of Spanish ten-year bonds over the German benchmark narrowed to around 360 basis points (bp) in mid-March from a November high of 469 bp. In the first few weeks of 2012, the largely favourable progress of corporate bond spreads permitted a mild upturn in debt issuance. Specifically, fixed-income issues filed with the CNMV totalled 119 billion euros in the opening quarter, 55% more than in 2011, with commercial paper, non-convertible bonds (87% backed by government guarantee) and mortgage bonds as the most popular instruments.

- Assets under management in investment funds fell by 8% in 2011 to 132 billion euros, owing mainly to the flood of redemptions from fixed-income funds. Funds in operation and unit-holder numbers also decreased in the year, while the weight of less-liquid assets in fund portfolios dropped from 7.4% to 5.6%. Aggregate earnings of UCITS management companies declined broadly in line with industry assets, though the number of loss-making entities reduced from 35 to 32. The collective investment sector faces another unsettled period, characterised by stiff competition from deposits and other bank savings products and the changes sweeping the industry as a result of the broader restructuring of the Spanish financial system.

- Investment firm pre-tax profits receded 21.5% in the full-year period to 227 million euros. Fee income from key financial services continued in decline, while only pure brokerage houses made meaningful headway in operating cost containment. Portfolio management companies and investment advisory firms fared better as a rule than brokers and broker-dealers. In all, 31 sector operators reported full-year losses, eight more than in 2010, although the sector's solvency conditions remained within the comfort zone. The industry outlook is far from certain, given its reliance on the performance of financial markets, and the consequences for individual firms of the ongoing restructuring of the Spanish financial sector.

- The report includes seven monographic exhibits:

  – The first sets out the main points of the European Commission's proposal to modify the EU regime for rating agencies.

  – The second focuses on the trading conditions of preference shares in the last few years, and changes in their regulatory framework.

  – The third summarises the CNMV's guidelines on the quarterly financial reports that listed companies must prepare and disclose, in view of the non-standard nature of their informative content and resulting problems of comparability.

  – Exhibit four lists the organisational requirements and minimum controls proposed by the European Securities and Markets Authority (ESMA) for agents intervening in trades conducted through an organised trading platform.

  – Exhibit five explores the implications for guaranteed investment funds of credit institution rating downgrades.

  – The sixth exhibit runs through ESMA's recently published guidelines for exchange-traded funds (ETFs) and structured UCITS in view of their potential impact on financial stability and investor protection.

  – Finally, exhibit seven discusses the main features of the European Commission's draft regulation on venture capital funds.

2 Macro-financial setting

2.1 International economic and financial developments

World macroeconomic conditions turn sharply for the worse in late 2011…

Macroeconomic and financial conditions deteriorated sharply in the closing months of 2011 due to the deceleration of the world economy and the deepening sovereign debt crisis in Europe. The second-half slowdown was also more acute among European economies, labouring under increasingly constrained financing conditions and, in many cases, obliged to simultaneously keep up an intense fiscal consolidation effort. However, the opening months of 2012 have brought some faint signs of improvement in the form of rather more upbeat employment and activity indicators in the United States and the orderly restructuring of Greece's public debt.

… with the euro area, particularly, facing the threat of a re-entry to recession in 2012.

World economic growth decelerated from the 5.2% of 2010 to a final 3.8% in 2011, with rates slowing in both the advanced economies (from 3.2% in 2010 to 1.6% in 2011) and the emerging contingent (from 7.3% to 6.2%). The latest IMF forecasts, published in January 2012, calculate that the world economy will grow this year and next at rates some way below 3.5% and 4% respectively. The United States and Japan are projected to see growth of just under 2% in 2012, while the euro area, it is feared, will sink back into recession (-0.5%). Several of Europe's largest economies

could suffer GDP contraction on a major scale, particularly Italy (-2.2%) and Spain (-1.7%). The emerging economies, finally, are expected to expand in the neighbourhood of 5.5%, with China and India leading the advance.

Inflation rates in the main advanced economies moderated in the second-half period, and expectations remain anchored at low levels. Monetary policy is accordingly predicted to stay loose.

After the peak levels reached in the third quarter of 2011, inflation rates in the main advanced economies headed lower in the closing months to end the year in the interval of 2.7% to 3.4% (the exception being Japan, with a zero rate). The chief factor driving the reduction was slower climbing energy prices. Although core inflation stayed relatively tame through the second half of 2011, there were signs of prices straining higher in economies, like the United States, experiencing greater dynamism. In all, inflation expectations remain well anchored, and it seems likely that official rates will be kept on hold, except in the euro area. The activity stall affecting the euro economies in the last few months of 2011 led the ECB to cut rates on two occasions (in November and December) as far as the current 1.0%. U.S. rates, meantime, stayed at 0-0.25%, Japanese rates at 0.1% and the UK rate at 0.5%. Readings of three-month forward rates suggest that the United States will stick with its present rates for the coming quarters but some further cut may be forthcoming in the euro area.

Non-standard monetary measures have retained their primacy, particularly with the ECB…

Against this backdrop, the central banks of the advanced economies opted to prolong some of the non-conventional monetary measures adopted in previous years, and even to add a few new ones. Of particular note was the ECB's decision to temporarily accept bank loans satisfying specific eligibility criteria as collateral in its refinancing operations, and to conduct two longer-term refinancing operations with maturity of 36 months, in order to boost liquidity in the area's financial system. Both these offerings were taken up in their entirety, with over one trillion euros adjudicated. This, in theory, should suffice to cover the redemptions of euro-area banks in 2012 and 2013. A large portion of the funds borrowed by financial institutions were placed in the Eurosystem deposit facility.

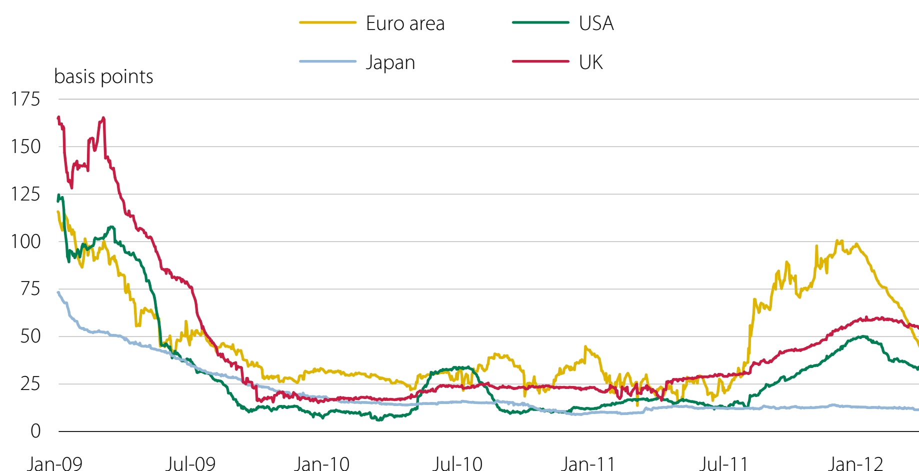
Tensions on European debt markets ran particularly high from the central months of the year to the closing weeks. During this period, the sovereign spreads of a broad set of European economies increased significantly. Tensions abated to some extent at the start of 2012 on evidence that governments were committed to pushing ahead with fiscal consolidation, the non-standard measures taken by the ECB and the new Greek rescue deal concluded in early March, with greater-than-expected private sector participation.

Sovereign debt market turmoil has placed a large strain on European interbank markets…

The stress that afflicted debt markets through 2011 was also felt in other financial markets. In interbank money markets, the three-month euro LIBOR-OIS spread widened from below 25 bp in the first six months of 2011 to 100 bp highs in the closing weeks (see figure 1). This spread also increased elsewhere, though with less intensity, reaching end-2011 levels of almost 60 bp in the United Kingdom and 50 bp in the United States. Spreads have since moderated to a fair degree though without recouping the levels recorded before summer 2011.

Three-month Libor-OIS spread

FIGURE 1



Source: Bloomberg. Data to 31 March.

… and has spread to a large number of European economies including Italy, Spain, France and Belgium…

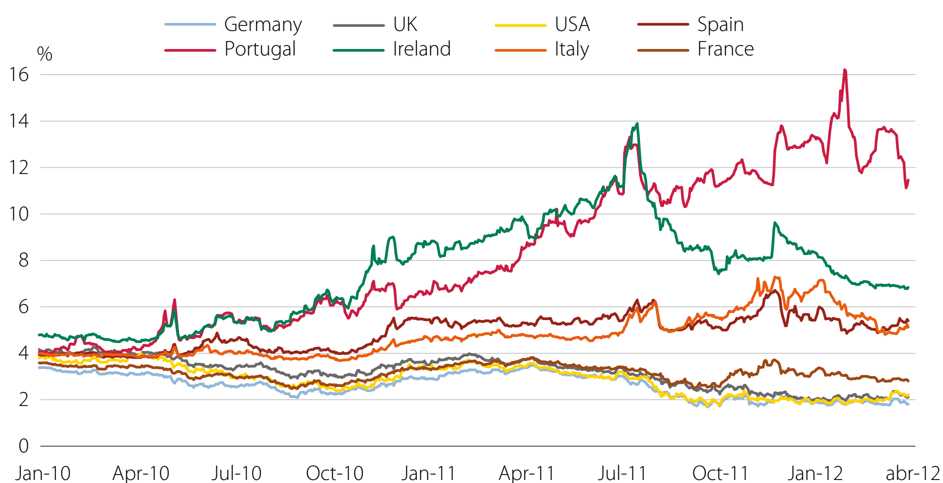
In sovereign debt markets, tensions persisted through the second half of 2011. As in previous episodes, long-term government bond yields in the United States, Germany and the United Kingdom remained at lows close to 2%. Conversely, a wide set of European countries endured a run-up in yields to late November (see figure 2), by which point the interest rate of the ten-year Italian bond was at 7.3%, the Spanish bond at 6.7% and the Belgian bond at 5.8%, with the French bond further back at 3.7%. Interest rates have since registered falls ranging from the 89 bp of the French to the 218 bp of the Italian bond.

… albeit with some mild remission in the opening months of 2012.

Credit spreads traced a similar course to government bond yields, with late 2011 highs giving way to a downward trend in the first quarter of 2012. In the case of Italy and Spain, yield spreads over the German bond narrowed from their November peaks of 550 and 469 bp respectively to around 330 and 360 bp at the end of March. The information offered by European sovereign CDS points in the same general direction (see figure 3), though of course spreads remain high from a historical standpoint.

Ten-year government bond yields

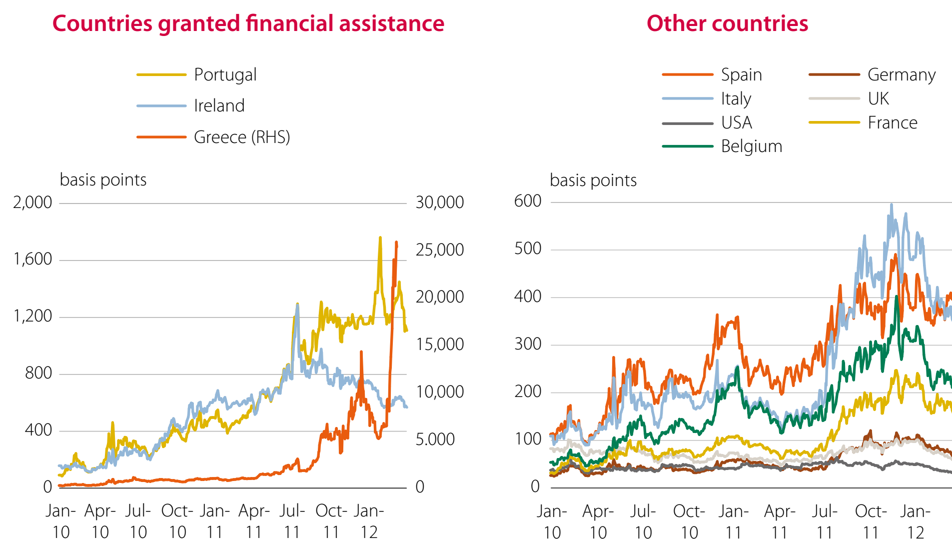
FIGURE 2



Source: Thomson Datastream. Data to 31 March.

Sovereign credit spreads, 5-year CDS

FIGURE 3



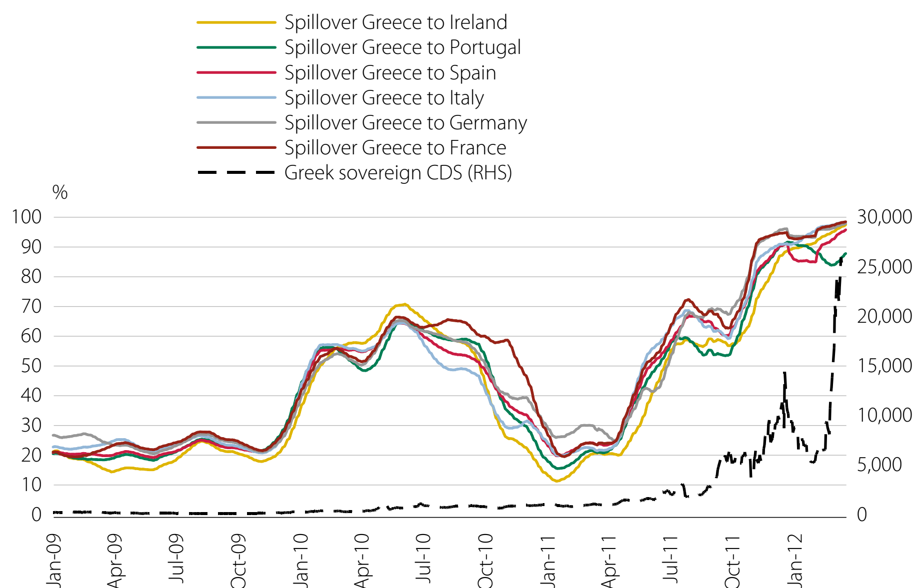
Source: Thomson Datastream. Data to 31 March.

Indicators of spillover effects between European sovereign CDS show contagion from Greece continues strong.

In this context, indicators of spillover effects between European sovereign CDS show that the systemic risk factor common to these markets, and apparently emanating from the Greek CDS, is still running extremely high (see figure 4).

Greek debt and systemic risk in European sovereign debt markets[1]

FIGURE 4



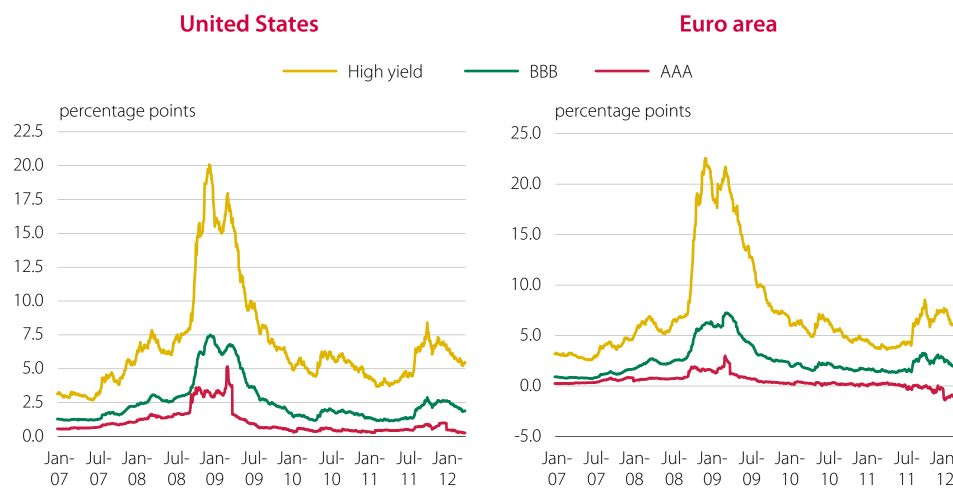
Source: CNMV.

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

The increase in sovereign risk premiums in the public sector over the closing months of 2011 spread with some virulence to corporate bond spreads in both the euro area and the United States. The impact was severest in high-yield segments, where spreads widened to around 8.5 points in October before falling back over subsequent months. The rising costs of business financing caused a stall in issuance compared to the first half of the year and the second half of 2010.

Rising sovereign risk premiums have a significant knock-on to corporate debt…

Corporate bond risk premiums[1] FIGURE 5



Source: Thomson Datastream (Merrill Lynch and IBOXX indices). Data to 31 March.

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

Net international debt issuance came to 4.9 trillion dollars in the full-year period, 26.5% less than in 2010 (6.6 trillion dollars). Most of the shrinkage traced to public sector borrowers, particularly in the United States. In general, the worsening global outlook of the second half proved a strong disincentive for issuance (see figure 6), to the extent that financial-sector issue volumes sank below redemptions in both Europe and the United States. In fact issuance activity almost dried up entirely during some weeks of the third quarter. Non-financial corporations in most regions also cut back on issuance in response to the debt crisis, after a busy first half with activity far exceeding that of the previous year. Even so, full-year sales were higher than in 2010 everywhere except the United States.

… though the impact has been nowhere harder than in primary debt markets.

Issuance returned to strength in the opening quarter of 2012 across all areas and sectors of reference, with private-sector placement especially vibrant, in Europe most of all.

International debt issuance appears to pick up in the first weeks of 2012.

Net international debt issuance

FIGURE 6

Source: Dealogic. Half-year data. Data for 2012 run to 31 March, but are restated on a semiannual basis to facilitate comparison.

Exhibit 1: "Proposed amendments to EU regulations on credit rating agencies"

Regulation (EC) No. 1060/2009 on credit rating agencies (the CRA Regulation) came into force on 7 December 2010. Under its provisions, agencies were obliged to register in the EU and to abide by certain rules of conduct, in order to mitigate the potential conflicts of interest arising from their activity and enhance the transparency and quality of the ratings issued.

On 1 June 2011, an amendment to the CRA Regulation empowered ESMA to register and supervise credit rating agencies, as a means to centralise and simplify their oversight at European level (EU Regulation 513/2011). On 31 October 2011, DBRS, Fitch, Moody's and Standard & Poor's, the main agencies operating in Europe, all added their names to the ESMA register. The CNMV played an active part in the registration of the last three firms through its involvement in the designated colleges of supervisors.

Despite the short time that the CRA Regulation has been on the statute books, the European Commission proposed substantial amendments to the text in November 2011. At the closing date for this article, its draft was under discussion in the

European Council and the European Parliament. The Commission's changes are designed to reinforce agencies' transparency, diversity, independence and civil liability. They would also make it explicitly incumbent on financial institutions and big institutional managers to perform their own credit risk assessments rather than mechanistically relying on the ratings issued by the agencies. Finally, special requisites would be introduced for sovereign debt ratings. These and other points of the new proposal are explained in the following sections.

Measures to reduce overreliance on ratings by authorities, financial institutions and investors

In this regard, the European Commission subscribes to the international consensus reflected in the 2010 principles of the Financial Stability Board (FSB), as endorsed by the G-20 summit of November 2010 and, in Europe, by the European Council agreement of 23 October 2011. As stated, under the proposed amendments to the CRA Regulation major financial intermediaries (credit institutions, investment firms, insurance undertakings, institutions for occupational retirement provisions, management and investment companies, alternative investment fund managers and central counterparties) will be bound to exercise due diligence in credit risk matters. Further, European supervisory authorities will adapt their guidelines and standards to remove any reference that could potentially trigger mechanistic reliance on ratings by competent authorities or financial market participants. This requirement will also apply to the recommendations of the European Systemic Risk Board (ESRB).

The European Commission proposal on the CRA Regulation was joined the same month by a series of modifications along these same lines to the UCITS Directive and Directive on Alternative Fund Managers, with regard to institutional investors. Previously, in June 2011, it had put forward similar amendments addressing financial institutions as part of the drafting process for the Fourth Capital Requirements Directive, and will do the same next year in regulations bearing upon insurance and reinsurance undertakings.

Enhanced disclosure and reinforced rules for sovereign bond ratings

Among other measures, the text proposes that sovereign credit ratings (those of the state or regional or local authorities) should be revised every six months instead of every 12 months. Also, where a credit rating agency issues sovereign ratings or related rating outlooks, it should publish them only after the close of business at trading venues established in the Union and at least one hour before their opening, in order to avoid market perturbations.

Increased diversity and stricter standards of rating agency independence

In order to mitigate the potential conflicts of interest arising from the "issuer pays" model, the European Commission calls for a compulsory rotation rule for the CRAs engaged by an issuer to rate either itself or its debt instruments. Specifically, the CRA engaged should not be in place for more than three years or for more than a year if it rates more than ten consecutive rated debt instruments of the issuer. However, this latter rule shall not lead to shortening the permitted

period of engagement to less than a year. The period during which the outgoing agency should not provide rating services to the issuer would be set at four years.

Also, structured finance instruments should be rated by two separate agencies and steps taken to eliminate or mitigate conflicts of interest involving agency shareholders (for instance, such that the same shareholders cannot be significantly invested in different credit rating agencies).

Civil liability of credit rating agencies

The European Commission proposes that any investor considering that a rating agency has infringed the provision of the Regulation intentionally or through gross negligence, and that such infringement can be shown to have had an impact on the credit rating on which they relied when purchasing a rated instrument, shall be entitled to bring an action against that agency for any damage caused.

Rigor in rating agency methodologies

The Commission proposes that ESMA should assess and confirm whether intended changes in agencies' rating methodologies comply with the terms of the Regulation (that they be rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing).

Greater visibility for small agencies and enhanced comparability of ratings

It is also proposed that ESMA should keep an updated list of credit ratings, to be published on its website. In order that investors can easily compare ratings, the Commission calls for agencies to convert them to a harmonised scale, developed by ESMA, so they can be presented in a standard format (agencies would nonetheless be free to use in-house scales when posting ratings on their own websites). Finally, this ESMA index would display the average of all current agency ratings on a given instrument or issuer.

Stock markets rally strongly after the third-quarter slump.

Stock markets fell in all main advanced economies over the third quarter of 2011, then rallied in the closing weeks on the release of more upbeat activity and employment indicators, especially in the United States, and some small but significant relaxing of the mood in European sovereign debt markets. Indices held to this upward course over the first quarter of 2012, with gains near to 7% or higher in all but a few cases. Market volatility reached highs of 50% in advanced economy indices and 20% in emerging equities over the fourth-quarter period, but has since cooled notably to levels nearer 20% and 10% respectively. That said, investors continued to show little appetite for risk (see figure 7).

The euro depreciates sharply in the second half of 2011…

In the foreign exchange market, the euro sank heavily against the dollar and other leading currencies through practically the whole of the second half. The prolongation of the sovereign debt crisis, the area's deteriorating economic prospects, and the liquidity injections of the ECB were the main factors detracting value from Europe's currency. This year to date, the rather more settled climate has allowed a degree of exchange-rate recovery as far as 1.34 dollars and 110 yens at the end of March.

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

	2008	2009	2010	2011	1Q 11	2Q 11	3Q 11	4Q 11	1Q 12 (to 31 March)		
									% prior qt.	% Dec	% y/y[2]
World											
MSCI World	-42.1	27.0	9.6	-7.6	4.3	-0.3	-17.1	7.1	10.9	10.9	-2.2
Euro area											
Euro Stoxx 50	-44.4	21.1	-5.8	-17.1	4.2	-2.1	-23.5	6.3	6.9	6.9	-16.4
Euronext 100	-45.2	25.5	1.0	-14.2	3.2	-1.2	-20.6	6.0	8.3	8.3	-11.3
Dax 30	-40.4	23.8	16.1	-14.7	1.8	4.8	-25.4	7.2	17.8	17.8	-3.2
Cac 40	-42.7	22.3	-3.3	-17.0	4.8	-0.2	-25.1	6.0	8.4	8.4	-15.6
Mib 30	-48.7	20.7	-8.7	-24.0	6.4	-7.1	-23.8	1.0	7.9	7.9	-23.0
Ibex 35	-39.4	29.8	-17.4	-13.1	7.3	-2.0	-17.5	0.2	-6.5	-6.5	-25.4
United Kingdom											
FTSE 100	-31.3	22.1	9.0	-5.6	0.1	0.6	-13.7	8.7	3.5	3.5	-4.0
United States											
Dow Jones	-33.8	18.8	11.0	5.5	6.4	0.8	-12.1	12.0	8.1	8.1	6.7
S&P 500	-38.5	23.5	12.8	0.0	5.4	-0.4	-14.3	11.2	12.0	12.0	5.7
Nasdaq-Cpte	-40.5	43.9	16.9	-1.8	4.8	-0.3	-12.9	7.9	18.7	18.7	10.8
Japan											
Nikkei 225	-42.1	19.0	-3.0	-17.3	-4.6	0.6	-11.4	-2.8	19.3	19.3	3.9
Topix	-41.8	5.6	-1.0	-18.9	-3.3	-2.3	-10.4	-4.3	17.3	17.3	-1.0

Source: Datastream.

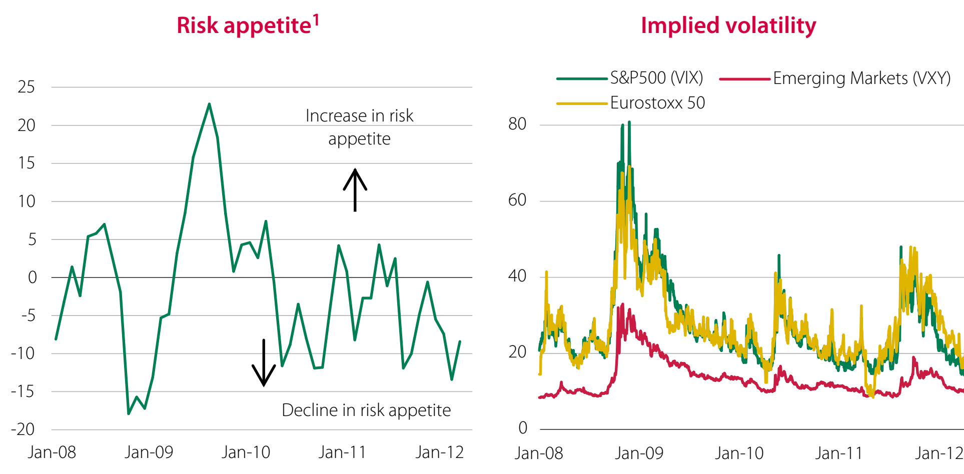
1 In local currency.

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

… while commodity prices tend to remain high.

Commodity prices have remained high since the peak readings of spring 2011, but with gaps opening up between items. Food, materials and, to a lesser extent, metals have become cheaper since the middle of last year, while oil, gold and precious metals have continued on their upward course. Oil price escalation is above all a product of geopolitical tensions in producer countries, while that of gold and precious metals primarily reflects their safe-haven role at times of financial market turmoil.

Financial market indicators FIGURE 7



Source: Thomson Datastream and CNMV.

1 State Street indicator.

2.2 National economic and financial developments

Spain's GDP shrinks by 0.3% in the closing quarter (0.7% in 2011) as domestic demand falters.

According to the latest Quarterly National Accounts data, Spanish GDP contracted three decimal points between September and December 2011, leaving the year-on-year average rate at a meagre 0.7%. The euro area too experienced a fourth-quarter slowdown of 0.3 points, though a more dynamic showing in prior quarters left the average rate at 1.5%. Nationally, the activity stall had its roots in fast fading domestic demand insufficiently countered by a positive input from the net export side. All domestic demand components lost momentum in the fourth-quarter period, from private (-1%) and government (-1.1%) consumption to housing (-2.3%) and equipment investment (-3.9%), while the positive growth contribution of external demand owed to sharply falling imports of goods and services.

On the supply side, all main branches detract from growth in the fourth-quarter of 2011.

From a supply side perspective, the variation in fourth-quarter product was sourced -1.4% from industry (-0.9% in the third quarter), -1.1% from construction (-1.0%) and -0.1% from services (0.9%). Over the full-year period, GDP increased 1.9% in industry and 1.1% in services, and contracted 3.8% in the construction branch.

Spain's inflation rate has been coming down since spring 2011, enlarging its negative differential versus the euro area…

Spanish inflation kept up the moderation initiated in spring 2011. By March 2012, the year-on-year rate was down to 1.8% (2.4% in December 2011) thanks to the slower advance of energy prices and other index components. Core inflation too continued to fall (1.2% in February), while the country's inflation differential versus the euro area closed March at -0.8 points, four decimal points lower than in December last year.

Spain: main macroeconomic variables (annual % change) TABLE 2

	2008	2009	2010	2011	Bank of Spain 2012P	Bank of Spain 2013P
GDP	**0.9**	**-3.7**	**-0.1**	**0.7**	**-1.5**	**0.2**
Private consumption	-0.6	-4.3	0.8	-0.1	-1.2	-0.5
Government consumption	5.9	3.7	0.2	-2.2	-6.3	-3.3
Gross fixed capital formation, of which:	-4.7	-16.6	-6.3	-5.1	-9.2	-2.2
Equipment	-2.9	-22.3	5.1	1.4	-7.0	-0.9
Exports	-1.0	-10.4	13.5	9.0	3.5	5.9
Imports	-5.2	-17.2	8.9	-0.1	-4.8	1.2
Net exports (growth contribution, pp)	1.5	2.8	0.9	2.5	2.5	1.5
Employment (full-time equivalent jobs)	-0.2	-6.5	-2.6	-2.0	-3.0	-0.7
Unemployment rate	11.3	18.0	20.1	21.6	23.4	23.3
Private consumption deflator	3.6	-1.2	2.4	3.2	1.5	1.2
Net lending (+)/borrowing (-) vs. the rest of the world (% GDP)	-9.2	-4.7	-4.0	-3.7	-1.4	0.0
General government surplus (+)/deficit (-) (% GDP)	-4.5	-11.2	-9.3	-8.5	-4.4	-3.0

Source: Bank of Spain and National Statistics Office (INE).

…though job destruction continues to push up unemployment rates.

Labour market figures confirmed the continuing advance of job destruction (2% in 2011) and the unemployment rate, which by end-2011 was up to 22.8% (around 2.3 million jobless). Unit labour costs fell by around 2% with robust gains in productivity (2.8%) more than compensating the annual increase in employee pay (0.8%).

The public deficit closed last year at 8.5% of GDP (9.3% in 2010).

The figures for budgetary execution published at the end of February put the full-year general government deficit at 8.5% of GDP (9.3% in 2010), breaking down 5.1% for central government, 2.9% for the regions and 0.4% for local authorities. The deficit of the social security system stood at 0.1% of GDP. Meantime the public debt ratio scaled up from 61.2% in 2010 to 68.5% in 2011.

Spanish credit institutions are immersed in a restructuring process whose success will arm them to confront future challenges.

Spanish credit institutions pressed on with the restructuring whose goal is to prime them to operate in the new sector landscape and surmount the problems caused by the bad debt leap. For the moment, the funds obtained from the Eurosystem should allow them to cover debt redemptions in the next two years with some room to spare. However, weak domestic activity has continued to weigh on sector earnings at a time when the process of recognising real estate losses is still incomplete.

Bank sector profits sag due to shrinking net interest income and impairment losses on financial and non-financial assets.

The pre-tax losses of Spanish deposit-taking entities stood at 2.82 billion euros compared to 9.84 billion profits in 2010. Leading the decline was net interest income (down by 5 billion approximately to 29.54 billion euros) and steeper impairment losses on financial and non-financial assets (3.29 billion and 4.71 billion respectively). At the net interest income line, growth in interest income (9%) trailed far behind that of interest expense (27.3%). Operating cost containment on a moderate scale (-3.3%) was sourced mainly from personnel costs (-4.3%).

Outstanding loans to businesses and households have receded sharply, in contrast to the advance marked in the euro area.

Lending to non-financial sectors lapsed back after the subdued recovery of April to December 2010. Specifically, outstanding loans to the non-financial private sector (businesses and households) fell by 2.4% year on year to February 2012 (-2.4% to December 2011 and 0.4% to December 2010). Lending to non-financial corporations in Spain shrank by 2.2% contrasting with the 0.7% advance recorded for the euro area, where this financing modality has worked back progressively from the lows of spring 2010. Finally, lending to households also dropped back 2.7% (-2.0% in home loans and -5.2% in consumer loans) against the 1.3% increase of the euro area.

The gross NPL ratio, up to 7.9% in January 2012, has again been heavily conditioned by real estate development and construction activities.

Non-performing loan ratios expanded anew in 2011 on faltering domestic activity and rising unemployment. In January 2012, the average ratio was 7.9% (7.6% in December 2011, 5.8% in December 2010 and 5.1% in December 2009). Most delinquent loans were again linked to real estate development (20.9% in December 2011) and construction (17.7%), while mortgage delinquency rates closed the year at 3%.

Spanish credit institutions increase their reliance on Eurosystem financing in preference to wholesale credit markets…

Spanish credit institutions again struggled to raise funds on wholesale markets, especially in the second half. Escalating funding costs brought issuance to a virtual standstill in certain weeks, not only in Spain but across the European financial industry. Generally, both Spanish and European banks opted to switch into instruments of perceived higher quality, particularly mortgage covered bonds. As we can see from figure 8, much of the issued amounts, and those of asset-backed securities, were retained for use as collateral for Eurosystem credit operations. Indeed the Eurosystem borrowings of Spanish financial institutions built up from 42 billion euros in spring 2011 to 152 billion in February 2012, ahead of the levels observed in May 2010 during the first round of the Greek debt crisis.

… though the first months of 2012 have brought a degree of recovery in fixed-income issuance, prizing instruments with a state guarantee.

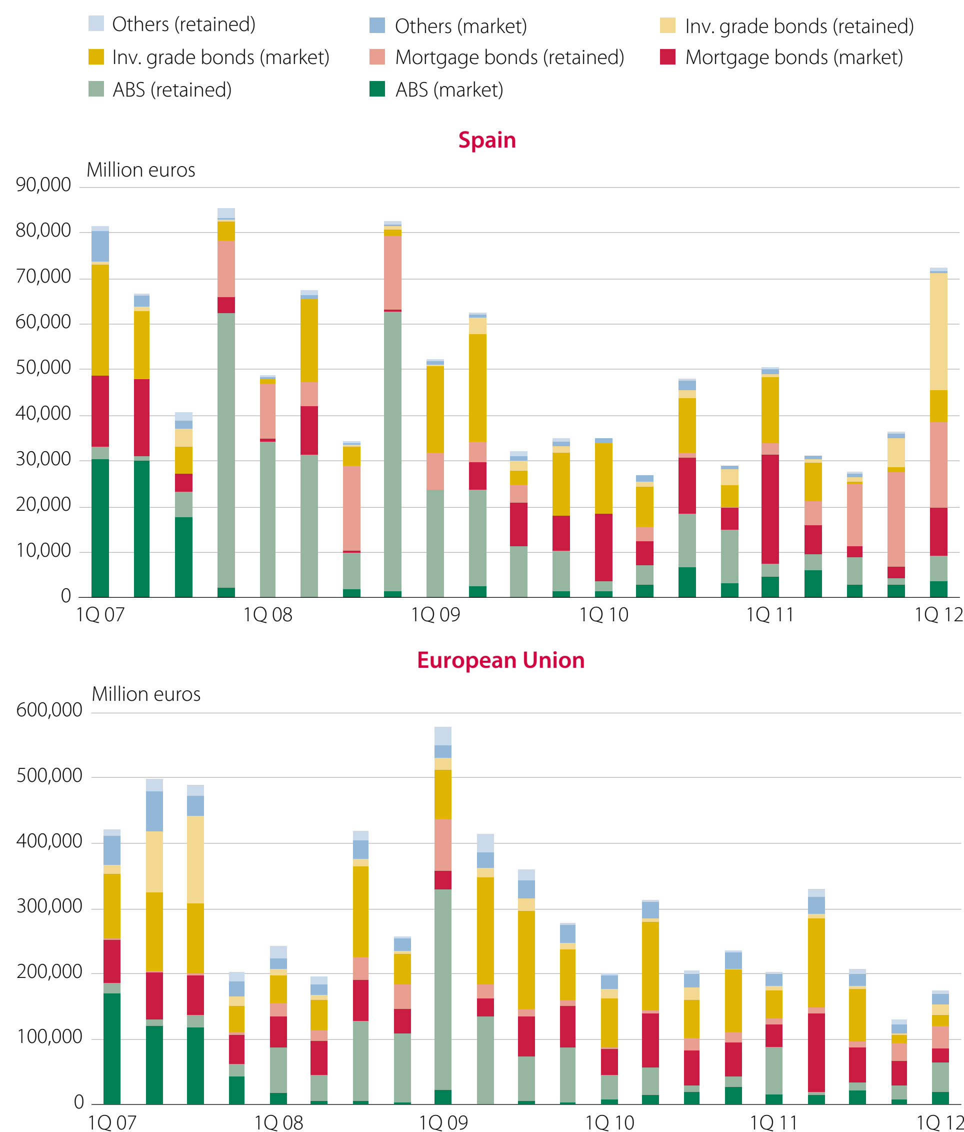
There are signs that debt financing by Spanish credit institutions may be picking up in 2012. First-quarter issuance was largely concentrated in mortgage covered bonds and investment grade instruments. Note however that 87% of the bonds issued carried a state guarantee[1] (27.2 billion euros spread across nine Spanish banks), contrasting with the scant take-up of this facility in 2011 (7.36 billion in the full-year period).

Deposits from non-financial sectors stay more or less flat, contrasting with the large increase in capital and reserve accounts.

As regards other funding sources, we can point to a certain levelling-off in deposits outstanding and a sizeable rise under the capital and reserves heading as banks move to strengthen their capital base (see exhibit 2).

1 Facility extended to 30 June 2012.

Gross medium- and long-term debt issuance by financial institutions FIGURE 8



Source: Dealogic. Data to 31 March.

Exhibit 2: "Exchanging of preference shares"

Preference shares were included, with certain limits, among the instruments qualifying as tier 1 capital under Article 7 of Law 13/1985, of 25 May, on investment ratios, capital adequacy and information requirements for financial intermediaries. However, they were never actually issued or marketed in Spain until midway through the 1990s. Since then, most issues addressing the retail market have been conducted by subsidiaries of financial institutions and marketed among their own clients. Financial institutions have also handled the marketing of preference shares issued by non-financial corporations.

In 2003, the above law was amended to provide a more comprehensive regulatory framework for these products and prevent their issue through Spanish bank subsidiaries domiciled in tax havens. As part of this process they were granted an

advantageous tax treatment whereby the interest paid by issuers became a deductable expense.

Until fairly recently, it was common for entities to redeem preference shares before maturity, at which point investors would recoup the whole of their capital plus the accumulated interest. Entities were also usually ready to buy back preference shares at holders' request, without making them wait for a redemption call. The standard practice in such cases was for the issuer to sell the original investor's shares to an interested third client in exchange for their nominal value, which at that time would broadly equate to the market price.

However preference share redemptions basically dried starting in late 2008. And this fact, coupled with the situation of the financial sector, had lowered their market price to well below nominal value. At the same time, the limited liquidity of these products, even under more favourable circumstances, meant holders had little chance of closing positions and recovering their investment without incurring further losses.

In view of the significant changes in market conditions and the practices of preference share issuers, on 23 December 2009 the CNMV issued guidelines on the verification of debt and hybrid security issues addressing retail clients, which reminded issuers of their obligation to engage a liquidity provider for preference shares. On 16 June 2010, the CNMV established as good practice that such liquidity provision should be offered via at least one multilateral trading platform. It would be bad practice, conversely, for liquidity providers to quote prices significantly at odds with the shares' fair value. The CNMV also slated as bad practice the internal matching at other than market price of trades between the issuer and/or distributor's retail clients or between clients and the institution rendering the investment service, since this would harm the interests of the investor acquiring the securities in the event that the transaction went through at above market price.

In recent months, issuers have begun to redeem, convert or exchange preference shares for other products whose regulatory treatment gives a better fit with their new regulatory capital needs. The decision to do so could respond to reputational or business motives or to the fact that the European Banking Authority – presumably thinking ahead to Basel III – omitted them from the list of instruments qualifying as top-notch capital in its end-2011 recommendations to national supervisory authorities to assist in strengthening the capital adequacy of Europe's largest banks.

A number of recent transactions have involved the exchange of preference shares for other financial products. So deep has this process run that of the 22.37 billion euros in bank preference shares in the hands of retail investors, only 8.50 billion have not been the object of an exchange offer. This figure, moreover, is likely to fall shortly, as most issuers who have yet done so have an exchange deal in the offing.

Exchanges are in all cases going through at higher than the market price of the preference shares, and in most cases at 100% of their nominal value.

The main exchange operations conducted to date are detailed below.

Main preference share exchanges TABLE E1.1

Issuer	Nominal repurchased	Securities delivered	Delivery / nominal value	Cash amount of offer	% Take-up
BBVA	3,475,000,000	Compulsorily convertible subordinated bonds	100%	3,475,000,000	98.71
Banco Santander	1,965,615,725	New shares	100%	1,965,615,725	98.88
Caixabank	4,898,000,000	Basket of securities: 30% subordinated bonds compulsorily convertible in June 2012 and June 2013 and 70% 10-year subordinated debt with 4% coupon	81%-86%		98.41
Banco Sabadell	850,000,000	Treasury shares/new shares[1]	90%-100%	867,000,000	64.57-97.71
BFA / Bankia	1,155,254,329 65% pref. shares 30% subordinated 5% perpetual subordinated	New shares[2]	75%-100%	1,155,254,329	90.7% (between 32% and 99%)
Banco Popular	1,128,227,900	Compulsorily convertible subordinated bonds	100%	1,109,375,800	98.33

1 90% of the offer will be settled immediately, and the other 10% plus a further 2% one year from the initial offer (provided the investor has not disposed of the shares delivered).
2 75% at the time of the offer and the other 25% after 18 months with lock-in.

In progress

Issuer	Nominal repurchased	Securities delivered	Delivery / nominal value
Banesto	497,500,000	Non-convertible 3-year bonds at a fixed annual rate of 3%	94.91%-96.31%

Source: CNMV.

The CNMV takes the view that the instruments delivered in exchange should be less complex and more liquid than the preference shares they are replacing. Particularly, financial institutions should steer clear of delivering perpetual or hybrid instruments or else find themselves at risk of breaching the applicable rules of conduct.

In any event, the CNMV, in its supervisory role, will ensure that exchanges, which are voluntary for both parties, go through under conditions of maximum transparency, respecting the standards in place for the marketing of financial products, so investors can arrive at a fully informed decision.

Profits of non-financial listed companies fell by 32% in 2011, with construction and real estate back into red numbers.

The aggregate profits of non-financial listed companies fell by 32% in 2011 to 21.44 billion euros (see table 3). The worst performing sector was construction and real estate, which returned to losses in 2011 (-53 million euros) after a relatively buoyant 2010. Energy and services, Spain's biggest earning sectors, saw their profits slide by 28.9% and 24.8% respectively to 10.74 and 9.45 billion euros. Lastly, industrial sector companies posted aggregate full-year profits of 948 million, 39.8% less than in 2010.

Earnings by sector[1]: non-financial listed companies TABLE 3

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	2010	2011	2010	2011	2010	2011
Energy	33,299	29,349	22,335	18,400	15,113	10,741
Industry	4,052	3,668	2,465	2,053	1,576	948
Retail and services	34,166	29,569	21,352	15,510	12,579	9,454
Construction and real estate	8,138	5,667	5,670	2,682	2,208	-53
Adjustments	-163	236	-50	345	34	355
AGGREGATE TOTAL	**79,492**	**68,489**	**51,772**	**38,990**	**31,510**	**21,445**

Source: CNMV.

1 Year-to-date.

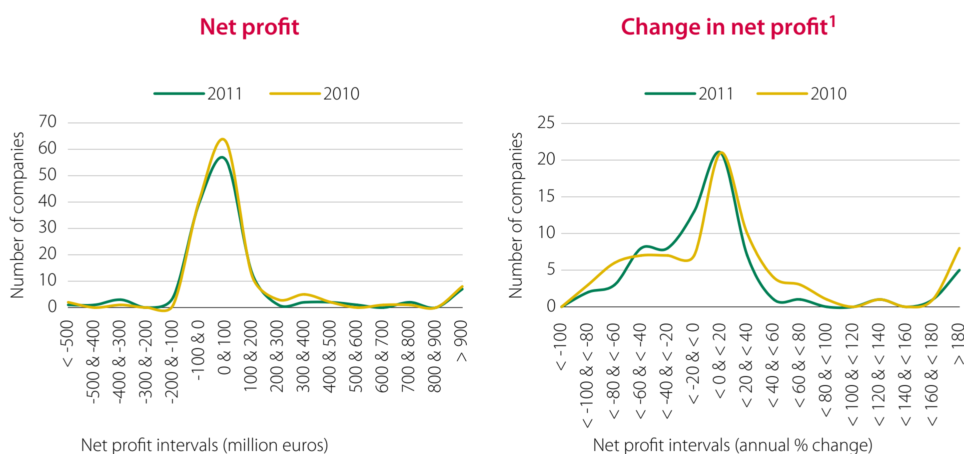
2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

Fewer companies report profits of less than 100 million euros.

Breaking down non-financial listed companies in terms of their net profit for the year, we find that fewer reported annual profits between 0 and 100 million euros (the dominant interval), while the number reporting losses deeper than 100 million euros moved up from four to nine. Finally, among the listed companies in profit over 2010 and 2011, a large proportion obtained lower profits in the second year, though the margin of difference was not that wide (se figure 9).

Non-financial listed companies by: FIGURE 9



Source: CNMV.

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

Non-financial listed companies paid down their debt by a substantial margin, prolonging the trend of the previous year. Specifically, their combined debt fell by 6.7% to 304.8 billion euros at the 2011 close, in contrast to the strong run-up of 2005-2009, when debt tallies practically doubled. Of the four sectors analysed, three – energy, construction and real estate, and retail and services – cut their debt levels in the year by 2.5%, 16.2% and 5.2% respectively (see table 4). The odd one out was the industrial sector, whose debt swelled by 15% to almost 17.2 billion euros.

Companies managed to reduce their debt by 6.7% in 2011…

Despite this aggregate reduction in indebtedness, financial leverage (the ratio between debt and net equity) ticked up from 1.4 to 1.5 between 2010 and 2011, due to a reduction on the equity side. Construction and real estate, as table 4 shows, was the only sector to reduce its leverage, from 3.4 to 3.

… but declining equity meant this failed to translate as a reduction in financial leverage.

Gross debt by sector: listed companies TABLE 4

Million euros		2007	2008	2009	2010	2011
Energy	Debt	69,172	82,608	100,572	98,283	95,853
	Debt/ equity	0.8	0.9	1.1	0.9	0.9
	Debt/ EBITDA[1]	2.5	2.8	3.5	2.8	3.3
	EBIT[2]/ interest expenses	4.1	3.7	3.4	4.2	3.3
Industry	Debt	13,312	15,645	15,953	14,948	17,191
	Debt/ equity	0.6	0.7	0.7	0.6	0.9
	Debt/ EBITDA	1.8	2.7	3.0	2.1	4.7
	EBIT/ interest expenses	5.9	3.4	3.1	5.0	1.9
Construction and real estate	Debt	138,933	119,788	104,762	99,917	83,715
	Debt/ equity	3.1	3.8	4.1	3.4	3.0
	Debt/ EBITDA	10.8	31.9	22.5	11.2	14.8
	EBIT/ interest expenses	1.2	0.0	0.3	1.0	0.5
Retail and services	Debt	96,941	112,322	108,579	115,413	109,419
	Debt/ equity	1.7	2.1	1.8	1.6	2.0
	Debt/ EBITDA	3.0	3.6	3.7	3.4	3.7
	EBIT/ interest expenses	3.2	2.9	3.3	3.9	2.5
Adjustments[3]	Debt	-17,391,0	-20,802,0	-1,908	-1,792	-1,404
AGGREGATE TOTAL[4]	**Debt**	**300,967**	**309,561**	**327,958**	**326,769**	**304,774**
	Debt/ equity	1.5	1.6	1.6	1.4	1.5
	Debt/ EBITDA	4.0	4.6	4.8	3.8	4.4
	EBIT/ interest expenses	3.0	2.0	2.4	3.1	2.2

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.

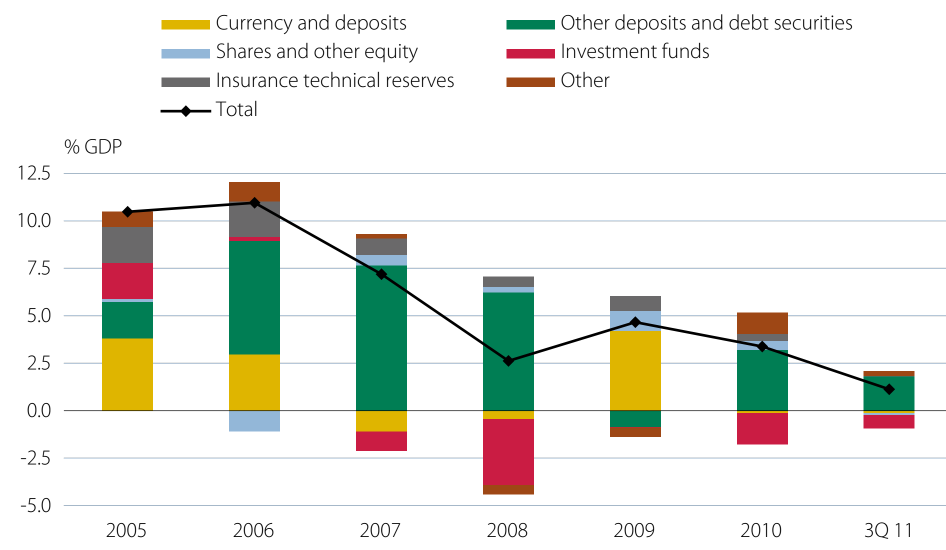
Listed companies' debt and interest coverage ratios worsen in 2011.

Meantime, the debt coverage ratio, measuring the years needed to repay existing debt assuming constant EBITDA, rose from 3.8 in 2010 to 4.4 in 2011, in tune with the stall in corporate earnings. The jump in this ratio was common to all sectors, though construction and real estate companies came off worst (up from 11.2 to 14.8) due to the greater earnings erosion suffered in the year. Companies' interest coverage ratios also deteriorated slightly in aggregate terms, with EBIT/interest expenses down from 3.1 in 2010 to 2.2 at end-2011, zeroing in on the levels of 2009. The industrial sector registered the largest fall (from 5 to 1.9), though all sectors participated in the decline.

Household savings, debt and net wealth continue on a downward course...

Household asset indicators for the third quarter of 2011 reveal further decline in the savings rate as far as 12.1% of disposable income (compared to early-2008 highs ahead of 18%). Household debt also trended lower to just over 120% of gross disposable income (from just under 130% in 2010), while net wealth contracted further on depreciating real estate and financial assets.

Households: financial asset acquisitions FIGURE 10



Source: Bank of Spain, *Cuentas financieras*. Cumulative four-quarter data.

…while what investment there is finds its way to low-risk products such as bank term deposits.

As to investment decisions, households' net financial asset purchases in the year's third quarter[2] dropped to 1.1% of GDP (3.4% in 2010 and 7% on average since the year 2000), reflecting both lower savings and a reduction in liabilities. Investment funds reported recurring net outflows while what little investment there was found its way mainly to bank term deposits (see figure 10). Finally, household liabilities receded 2.3% as a share of GDP as part of the ongoing deleveraging process.

2.3 Outlook

Latest IMF forecasts augur a global growth stall in 2012 that will be most acute in the euro area.

In its latest forecasts, published January 2012, the IMF slashed its global growth forecast for this year to 3.3% (3.8% in 2011). The revise-down (a full -0.7 percentage

2 Cumulative four-quarter data.

points) hit primarily at euro-area growth, for which forecasts were cut by 1.6 points to -0.5%. Forecasts for the emerging economies were revised down 0.7 points to 5.4%, while the United States conserved its previous rate of close to 2%.

The main downside risks lie in resurgent debt market tensions and the fiscal consolidation under way in a large number of economies. However there is also cause to believe that the reality may be less bleak.

This forecast scenario is hedged in by uncertainties. However, some factors suggest that the final growth rate may be higher than projected in the first weeks of the year. These include the brighter prospects coming through for the U.S. labour market, the orderly progress of Greek debt restructuring and the effects of the ECB's extraordinary three-year loans in securing the mid-term financing needs of euro-area banks. The downside risks primarily reside in the need to prolong the current fiscal consolidation drive, in Europe but also in the United States and Japan, through a period of meagre economic growth and weak private demand; the danger of recurring feedback between episodes of turmoil on European debt markets and the funding conditions of the area's financial sector; and the possible escalation of political risk among oil-producing countries. Nor can we rule out the risk that certain emerging economies may decelerate faster than expected.

Spain gets a steeper revise-down than most European economies.

The latest projections for the Spanish economy point to a slowdown ranging from the 1% augured by the European Commission to the 1.7% forecast by the IMF. On this reckoning, the growth lag versus the euro area could be greater than 1.5 points in the current year, easing to around one point in 2013. Spain, along with Italy, has suffered the severest revise-down of all the advanced economies, for reasons not only of the higher relative impact of the European debt crisis, but also certain home-grown issues like the weakness of the labour market, the squeeze effect on growth of the ongoing fiscal adjustment process and the high average indebtedness of Spanish households and businesses. Newly launched reforms on the employment, financial and fiscal fronts should ensure that the national economy returns to the growth path in the mid-term future, though their short-term impact is less predictable.

3 Spanish markets

3.1 Equity markets

Spanish stock markets have been hit hard by the sovereign debt crisis and the worsening prospects for the national economy.

After struggling back from a third-quarter slump, Spanish stock prices have continued to suffer the effects of the European sovereign debt crisis, despite a small decline in risk premiums, and the deteriorating outlook for the national economy. Index losses over the first quarter of the year contrast with the gains marked up in most advanced economy bourses (see table 1).

Performance of Spanish stock market indices and sectors (%)

TABLE 5

Index	2008	2009	2010	2011	3Q 11[1]	4Q 11[1]	1Q 12 (to 31 March) % prior qt.	% Dec	% y/y
Ibex 35	-39.4	29.8	-17.4	-13.1	-17.5	0.2	-6.5	-6.5	-25.4
Madrid	-40.6	27.2	-19.2	-14.6	-17.8	-0.6	-5.9	-5.9	-26.3
Ibex Medium Cap	-46.5	13.8	-5.6	-20.7	-20.6	1.0	8.0	8.0	-20.0
Ibex Small Cap	-57.3	17.6	-18.3	-25.1	-23.3	-9.4	-10.3	-10.3	-43.1
FTSE Latibex All-Share	-51.8	97.2	9.0	-23.3	-18.9	8.6	5.7	5.7	-17.3
FTSE Latibex Top	-44.7	79.3	9.7	-17.1	-15.6	11.2	10.1	10.1	-6.4
Sector[2]									
Oil and gas	-30.8	-20.1	0.3	23.2	-12.4	17.4	-20.7	-20.7	-21.2
Chemicals	-67.8	3.4	-60.0	-15.7	-22.7	-20.9	-31.1	-31.1	-56.2
Basic materials	-45.4	23.1	-5.6	-22.5	-29.6	8.2	2.5	2.5	-27.3
Construction mat. and construction	-51.0	25.5	-14.4	-13.0	-17.3	-2.0	-12.1	-12.1	-33.3
Industrial goods and services	-41.9	29.3	-1.9	-7.6	-15.5	5.9	6.0	6.0	-7.1
Health	-45.0	17.7	-22.2	-0.8	-12.6	-0.8	21.4	21.4	5.7
Utilities	-31.0	-7.8	-14.3	-13.8	-21.8	-3.7	-6.6	-6.6	-28.1
Banks	-47.9	46.3	-32.3	-18.3	-21.9	2.1	-9.0	-9.0	-32.3
Insurance	-25.0	19.8	-26.8	13.8	-12.4	4.0	-0.4	-0.4	-12.3
Real estate	-58.6	-43.8	-53.2	-42.4	-34.0	-11.1	-19.3	-19.3	-62.3
Financial services	-44.3	20.8	12.8	3.5	-11.6	-1.0	0.3	0.3	-16.3
Telecommunications and media	-31.4	23.5	-13.4	-22.7	-15.9	-6.8	-7.5	-7.5	-32.5
Discretionary consumption	-39.2	37.0	20.6	1.4	-4.4	-2.6	12.0	12.0	8.6
Basic consumption	-22.5	-8.4	15.8	-12.1	-17.1	11.2	4.3	4.3	-9.5

Source: Thomson Datastream.

1 Change vs. previous quarter.

2 Classification according to Thomson Datastream.

The Ibex followed up the -13.1% of 2011 with a slide of 6.5% in the first three months of 2012…

The Ibex 35, as we can see, followed up its 0.2% advance in the last quarter of 2011 (-13.1% in the full-year period) with a 6.5% slide in the first quarter of 2012 (see table 5). Smaller cap indices opened the year in unequal form, with the medium cap index posting a first-quarter gain of 8% (-20.7% in 2011) against the -10.3% of its small cap peer (-25.1% in 2011). Meantime, the main indices quoted on the national trading platform for Latin American shares prolonged the strong rally initiated in the fourth quarter of last year after the steep run-down of the three preceding quarters. Thus the FTSE Latibex All-Share and FTSE Latibex Top gained between 6% and 10% in the first quarter of 2012 on the heels of 2011 losses exceeding 17%.

… including steep price falls in chemicals, oil and gas, and real estate.

The worst performing sectors in first-quarter 2012 were chemicals (-31.1%, -15.7% in 2011), oil and gas (-20.7%, 23.2% in 2011) and real estate (-19.3%, -42.4% in 2011). Other sectors got off rather more lightly, including construction and related materials (-12.1%, -13% in 2011), banks (-9.0%, -18.3% in 2011) and telecommunications and media (-7.5%, -22.7% in 2011). At the other extreme, health sector companies

managed a creditable advance (21.4%, -0.8% in 2011), followed by discretionary consumption (12%, 1.4% on 2011), while industrial goods and services, basic consumption and basic materials posted more modest advances in the interval of 2.5% to 6%.

Exhibit 3: "CNMV guidelines on the content of quarterly financial reports"

Rules on the filing and disclosure of financial statements stipulate that the issuers of shares admitted to trading on an official secondary market or other regulated market headquartered in the European Union should publish a quarterly interim management report setting out quantitative and/or qualitative information. This interim management report is not required of issuers publishing a quarterly financial report in accordance with International Accounting Standard 34 on Interim Financial Reporting.

Since the entry to force of these quarterly reporting rules in 2008, companies have been diligent in complying with their formal obligations. However the actual information disclosed tends to vary in its scope and nature, making it hard to compare different issuers or, in some cases, the same issuer across different periods. For this reason, the CNMV published a set of voluntary guidelines in January 2012, which companies can apply to their mandatory interim management reports or any financial information they decide to notify as a significant event.[1] Their main points are summarised below:

- Financial variables and notes on the company's performance should refer to consolidated data, unless it only draws up individual financial statements.

- Companies should strive for consistency when preparing financial information for the market, so it is possible to refer back reliably to quantitative data published in the past.

- It is recommended that interim management reports disclosed to the market should include, at least, the following variables:

  a) Net sales (standard model), net interest income (credit institution model) and premiums recognised in the year (insurance undertaking model).

  b) Gross (EBITDA) or net (EBIT) operating profit (standard model) and nearest equivalent caption for credit institutions and insurance undertakings.

  c) Profit before taxes and profit for the year, separating out the amount attributable to the parent company and external partners in the case of consolidated statements.

  d) Other components of global earnings and total global earnings.

  e) Main items of the abridged statement of financial position.

f) Non-performing loan and capital adequacy ratios (for credit institutions), other relevant performance indicators and significant transactions, including main contingent liabilities.

– Entities should ideally define the pro forma measurements appearing in quarterly reports, indicating how they are calculated and reconciled with accounting records.

– Finally, quantitative data for a given period should be accompanied by comparative data from the previous period.

1 These guidelines are available at http://www.cnmv.es/Portal/verDoc.axd?t={f0d534b6-a12a-456b-9b6c-629f4859d3b9}

P/E ratios have been driven higher by the revise-down in corporate earnings.

The price/earnings ratio[3] (P/E) of the Ibex 35, which had been falling since the first quarter of 2011, reversed its decline in the closing months and the opening quarter of 2012, despite cumulative price falls in the period, as earnings contracted sharply under the impact of worsening prospects for domestic and world growth. The P/E of the Spanish stock exchange, meantime, dropped to the bottom end of the international reference table from the midway place occupied at the 2011 close. Specifically, the P/E of the Ibex 35 registered an end-March level of 9.7 times, improving slightly on the 9.2 of December and considerably on the 8.3 of September last (its annual low).

The earnings yield gap has stabilised in the last few months.

The earnings yield gap, which reflects the return premium required to be invested in equity versus long-term government bonds, slowed its rate of decline in 2012 relative to the prior quarter. The fall in this indicator owed mainly to rising P/E ratios and, in smaller measure, the increase in public debt yields. And it was precisely the downturn in yields over the opening months of 2012 that set it moving on a smoother course.

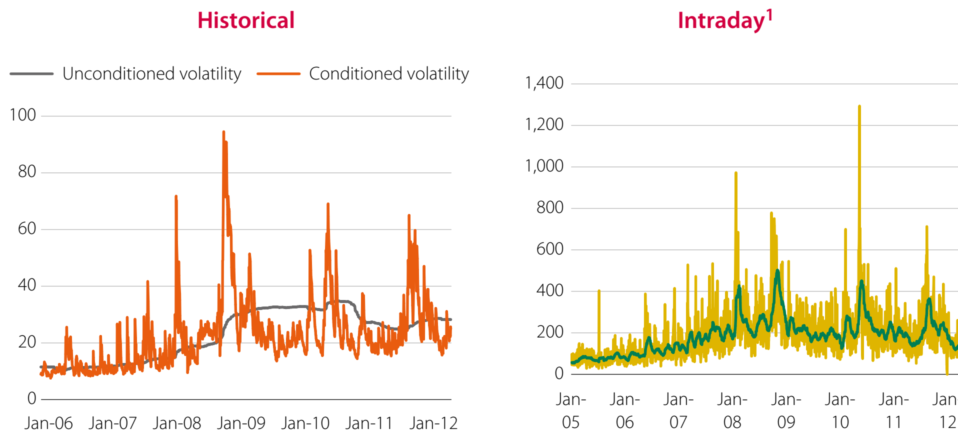
Renewed debt market tensions caused a spike in volatility…

The resurgence of sovereign debt market tensions in summer 2011 carried Ibex 35 volatility readings to an August high of 65% and it was not until the closing weeks of the year that they settled back to a more manageable 20%. At end-March 2012, volatility was running at approximately 25%. Meantime, intraday volatility, taken as the difference between the index's high and low prices in each trading session, closed March at around 150 points, at a distance from its August 2011 peak of 700 points and below the historical average recorded since 2005 (199 points).

3 On one-year forward earnings.

Ibex 35 volatility

FIGURE 11



Source: Thomson Datastream and CNMV. Data to 31 March.

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

… and depressed market liquidity conditions, though both variables have been improving in recent weeks.

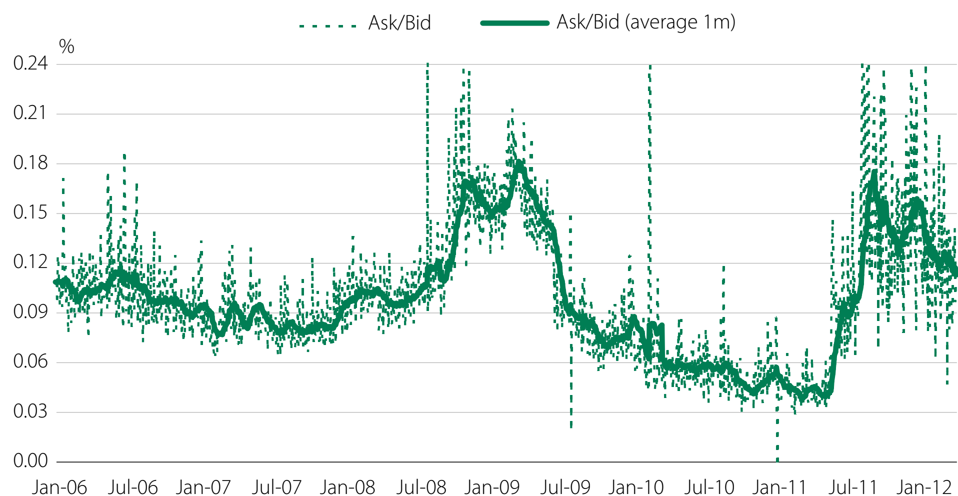
The liquidity conditions of the Ibex 35 (measured through the bid/ask spread) improved in the first quarter of 2012, after the severe deterioration that set in last summer following the flare-up of European sovereign debt tensions and the August ban on the short selling of certain shares. The monthly moving average of this indicator was down to 0.11% at end-March compared to the 0.16% of the 2011 close, but higher than the 0.10% average of the last six years (see figure 12).

Stock market turnover contracts 30% in the first quarter of 2012…

The Spanish stock market had a first-quarter turnover of 173 billion euros, 30% down on the year-ago period (see table 6). Average daily trading stood at 2.66 billion, against the 3.22 billion of the preceding quarter and the 3.62 billion of full-year 2011. At least part of the trading dip in the last fourth months of 2011 and the first weeks of 2012 may owe to restrictions imposed on the short selling of Spanish financial shares. Indeed the lifting of the ban around mid-February triggered a brief surge in trading volumes which had however wound down by the end of March (see figure 13).

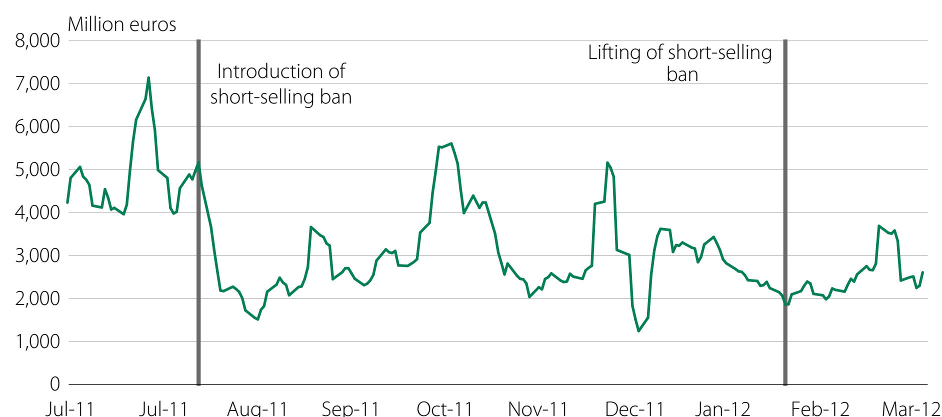
Ibex 35 liquidity. Bid-ask spread

FIGURE 12



Source: Thomson Datastream and CNMV. Data to 31 March.

Daily trading on Spanish stock markets[1] FIGURE 13



Source: CNMV.

1 Five-day averages.

… while equity issuance is enlivened by capital strengthening processes in the Spanish banking sector.

Equity issuance was enlivened, as it was last year, by the capital strengthening measures taken by Spanish financial institutions. Quarterly issue volumes were concentrated in three bank sector capital increases. Funds raised came to 3.78 billion, 17% more than in the same period last year (see table 7).

Turnover on the Spanish stock market TABLE 6

Million euros

	2008	2009	2010	2011	3Q 11	4Q 11	1Q 12[1]
All exchanges	**1,243,387**	**886,135**	**1,037,284**	**925,667**	**234,262**	**206,281**	**173,115**
Electronic market	1,235,330	880,544	1,032,447	920,879	233,070	204,922	171,819
Open outcry	207	73	165	48	11	7	17
of which SICAVs[2]	25	20	8	6	1	0	0
MAB[3]	7,060	5,080	4,148	4,380	1,088	1,278	1,207
Second Market	32	3	3	2	0	1	0
Latibex	758	435	521	358	93	73	72
Pro memoria: non resident trading (% all exchanges)							
	66.0	64.6	75.3	n.a.	n.a.	n.a.	n.a.

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

1 Cumulate data from 1 January to 31 March.

2 Open-end investment companies.

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

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

Capital increases and public offerings[1]

TABLE 7

	2008	2009	2010	2011	3Q 11	4Q 11	1Q 12[2]
CASH AMOUNTS[3] (million euros)	**16,349**	**11,391**	**16,013**	**17,317**	**6,336**	**2,946**	**3,778.4**
Capital increases	16,340	11,389	15,407	17,221	6,336	2,850	3,778.4
Of which, through POS	292	17	959	6,441	8	2,737	1,284.7
National tranche	292	15	62	6,032	8	2,685	1,284.7
International tranche	0	2	897	410	0	52	0.0
Public offerings	10	2	606	96	0	96	0.0
National tranche	10	2	79	95	0	95	0.0
International tranche	0	0	527	1	0	1	0.0
NUMBER OF FILINGS[4]	**54**	**53**	**69**	**92**	**26**	**26**	**22**
Capital increases	53	53	67	91	26	26	22
Of which, through POS	2	2	12	8	3	2	3
Of which, bonus issues	1	11	15	22	8	7	2
Public offerings	2	1	3	2	0	1	0

Source: CNMV.

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

2 Data available to 31 March 2012. Figures for this quarter include the ceiling amount of a Bankia offer (1.27 billion) to exchange preference shares and subordinated debt. The number of securities and final amount of the transaction will depend on investor take-up.

3 Excluding amounts recorded in respect of cancelled transactions.

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

Exhibit 4: "Electronic trading standards"

Since the enactment of the Market Abuse Directive (MAD) in 2003 and the Directive on Markets in Financial Instruments (MiFID) in 2004, technological advances and the advent of new market structures have counselled the development of guidelines to ensure consistent, efficient and effective supervisory practices among ESMA members with regard to the operation of automated trading environments. Studies undertaken by the Committee of European Securities Regulators (CESR) as input for the review of the MiFID[1] and on the subject of microstructural market issues[2] highlighted the need for a more in-depth analysis of algorithmic trading, with particular reference to high frequency trading and its impact on the markets.

This was the background to the draft guidelines on operational arrangements for trading platforms and investment firms in automated trading environments published as a consultation paper on 20 July 2011. The final report was approved by ESMA's Board of Supervisors on 20 December 2011 with the title *Guidelines on systems and controls in an automated environment for trading platforms, investment firms and competent authorities*[3] whose regime will become effective on 1 May 2012.

The new guidelines are aimed at regulated markets and multilateral trading facilities (MTFs) operating electronic trading systems, and investment firms that

execute client orders and/or deal on own account through an electronic trading system and employ algorithmic trading techniques. They also address investment firms rendering direct market access (DMA) and sponsored access (SA) services as part of the order execution packages marketed to clients. It bears mention that these guidelines do not conflict with current regulations; their goal is to set out detailed standards for the period transpiring to the entry to force of the MiFID/MiFIR and MAD/MAR.

The ESMA guidelines are primarily intended to ensure investors adequate protection and to guarantee markets' integrity and orderly functioning in the context of automated trading. To this end, the European securities authority has specified a series of arrangements to be rolled out by regulated markets and MTFs, on the one hand, and investment firms on the other.

Regulated markets and MTFs should have the following arrangements in place, among others: i) adequate pre-trade controls, such as the possibility to limit the number of orders which each member, participant or user with access can send to the trading platform; ii) conformance tests to ensure that members', participants' or users' IT systems are compatible with the trading platforms' electronic trading systems; iii) automatic and discretionary mechanisms to constrain or halt trading in response to significant variations in price to prevent trading becoming disorderly; iv) adequate due diligence of the member, participant or user before accepting their market access, and the ability to check their respective controls and arrangements afterwards; v) clear organisational requirements for members who are not regulated entities; and vi) rules and procedures designed to prevent, identify and report instances of possible market abuse and market manipulation, including ill-designed orders and algorithms, that are proportionate to the nature, size and scale of the business done through the trading platform.

Investment firms, according to the ESMA guidelines, must have arrangements in place that include an appropriate governance process for developing or buying algorithms and ensuring they are used in a cautious fashion, staff with the necessary up-to-date skills and expertise to run and monitor the behaviour of their live algorithms, and pre-trade controls which address erroneous order entry and maintain pre-set risk management thresholds. They also emphasise investment firms' responsibility for all order flow to venues from clients using direct market access or sponsored access, and call for them to conduct adequate due diligence on clients using these services and establish means to immediately halt their trading, if required.

1 Ref: CESR/ 10-802.
2 Ref: CESR/ 10-142.
3 Document available at http://www.esma.europa.eu/system/files/2011-456_0.pdf

3.2 Fixed-income markets

Spanish fixed-income markets endured some tense times in the second half of 2011, following the mid-year flare-up in Europe's ongoing sovereign debt crisis. Government and corporate bond yields and spreads climbed to annual highs in the month of November, while private-sector debt issuance tailed off sharply. The stress weighing on markets was alleviated somewhat in the opening weeks of 2012 on the prospect of a new rescue deal for Greece, the evidence that European governments were committed to deepening the fiscal consolidation process, and the three-year refinancing operations conducted by the ECB (with tranches in December 2011 and February 2012). This encouraged financial institutions to renew their purchasing of public debt, contributing, in turn, to the downtrend in yields that opened 2012. By end-March, however, domestic fixed-income markets were facing a new wave of turmoil.

Domestic fixed-income markets had a tough second half, though conditions have improved slightly in the first months of 2012…

In this context, treasury bill rates dropped faster than their corporate equivalents over the first quarter of 2012. Between January and March, the average monthly rates on three, six and twelve-month bills fell by between 182 and 283 bp to 0.38%, 0.64% and 1.33% respectively, while interest rates on commercial paper dropped by an average of 26 bp (see table 8).

… ushering in a downtrend in rates at the short end…

Short-term interest rates[1] (%) TABLE 8

	Dec 09	Dec 10	Dec 11	Sep 11	Dec 11	Mar 12[3]
Treasury bills						
3 month	0.44	1.63	2.20	1.48	2.20	0.38
6 month	0.61	2.76	3.47	2.41	3.47	0.64
12 month	0.88	3.26	3.27	3.21	3.27	1.33
Commercial paper[2]						
3 month	0.76	1.37	2.74	1.76	2.74	2.49
6 month	1.25	2.52	3.52	3.21	3.52	3.21
12 month	1.63	3.04	3.77	3.52	3.77	3.55

Source: Thomson Datastream and CNMV.

1 Monthly average of daily data.

2 Interest rates at issue.

3 Data to 31 March.

Long government bond yields fell between 33 and 125 bp in the first-quarter period to 2.76%, 3.83% and 5.17% in three, five and ten-year tenors respectively (see table 9). The larger drop in three-year yields can be partly explained by reference to the ECB's recent liquidity operations, which would tend to boost purchases of public debt instruments of similar maturity. Long-term corporate bond yields decreased more sharply than their sovereign equivalents in the first three months of 2012.

… and in longer maturities, for both public and private debt.

Medium and long corporate bond yields[1] (%)

TABLE 9

	Dec 09	Dec 10	Dec 11	Sep 11	Dec 11	Mar 12[2]
Government bonds						
3 year	1.95	3.87	4.01	3.76	4.01	2.76
5 year	2.67	4.65	4.65	4.40	4.65	3.83
10 años	3.75	5.38	5.50	5.20	5.50	5.17
Corporate bonds						
3 year	3.14	4.31	5.63	4.98	5.63	3.77
5 year	4.30	5.44	6.35	5.63	6.35	4.86
10 year	4.88	6.42	9.24	7.25	9.24	8.14

Source: Thomson Datastream, Reuters and CNMV.

1 Monthly average of daily data.

2 Data to 31 March.

Sovereign risk premiums have pulled back from the highs of November 2011…

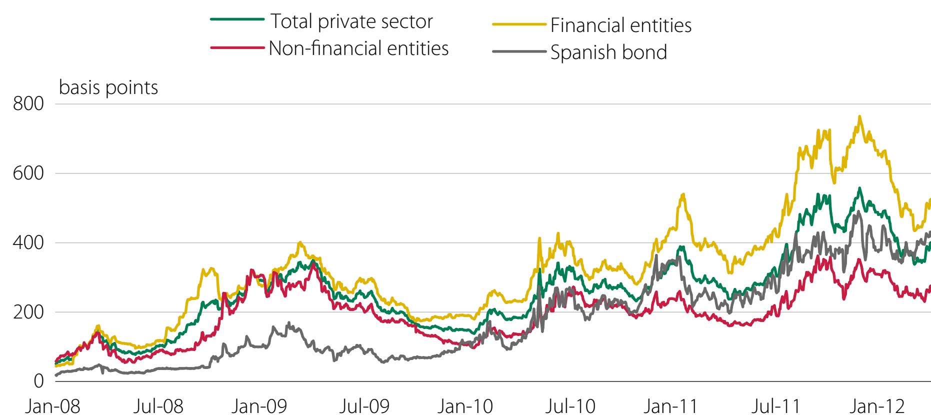
Spain's sovereign risk premium, as derived from the bono/Bund spread and CDS premiums, rose once more at the end of the opening quarter after retreating progressively from the peak levels of November 2011. By end-March, Spanish bond spreads were testing 360 bp, while CDS were moving a little above the 430 bp mark. This was some way short of the 480 bp recorded by both indicators in November 2011. Note however that Spain's risk premium has come down more slowly since end-2011 than that of other euro members like Belgium or Italy (see figure 3).

… accompanied by a narrowing movement in corporate spreads, with the banks sector to the fore.

Corporate bond spreads have narrowed considerably since the year's outset, with the banking sector to the fore. As with sovereign risk, a determining factor has been the ECB's extraordinary liquidity lines. As we can see from figure 14, the average spreads of Spanish financial institutions, based on five-year CDS, decreased from last November's peak of 765 bp to 525 bp at end-March 2012, while those of non-financial corporations charted a smoother course to 275 bp approximately on the same date.

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

FIGURE 14



Source: Thomson Datastream and CNMV.

1 Simple average. Data to 31 March.

In this period of respite, the volume of fixed-income issues registered with the CNMV recovered to 119 billion euros, 55% more than in the first quarter of 2011 (see table 10), with financial institutions accounting for 99.3%.

The result has been an upturn in debt issuance…

Though these are early days yet, we can make some preliminary remarks about changes in the issuance mix versus 2011. One observation would be the growing popularity of non-convertible bonds and, to a lesser extent, commercial paper and covered bonds, at the expense primarily of asset-backed securities.

… which to 31 March was 55% higher than in the first quarter of 2011.

Specifically, commercial paper issues summed 48.71 billion, 95% more than in the year-ago period and accounting for 41% of first-quarter issuance. Their steady rise to prominence since the fourth quarter of last year owes to banks' current accent on tapping their retail networks, using these instruments to supplement traditional deposits.

The most popular instruments in the first-quarter mix were commercial paper,…

But pride of place in the first-quarter mix goes to non-convertible bonds, whose issue volume of 31.30 billion euros topped the full-year total for 2011 (20.19 billion euros). Most of the surge was in government-backed bonds, whose 27.20 billion sales accounted for 87% of issuance in this category, compared to 7.36 billion and 36% respectively in full-year 2011.

… non-convertible bonds, 87% of them state-guaranteed,…

Mortgage bond issuance also expanded to 26 billion euros, 35% up on the year-ago figure and equating to 22% of the first-quarter total, while territorial bonds – backed by loans granted to government authorities – came in at 3.20 billion (2.93 billion in the first quarter of 2011). Conversely, sales of asset-backed securities were 65% down on the year-ago total at just 9.19 billion euros, equating to 8% of first-quarter issuance (24% in 2011).

… and mortgage covered bonds,…

Convertible bond issues came to 1.13 billion euros (almost double the total for 2011), while preference shares issues dried up entirely. Banks, indeed, have tended to prioritise higher-quality capital instruments to aid their compliance with national standards and those of the European Banking Authority.

… while preference share issues dried up entirely.

Foreign debt financing, which had fallen 6.3% in 2011 on lower commercial paper issuance, staged something of a come-back in the opening quarter as far as 17 billion euros (13 billion in the year-ago period).

Foreign debt financing also picked up in early 2012.

Gross fixed-income issuance

TABLE 10

filed[1] with the CNMV	2008	2009	2010	2011	2011 3Q	2011 4Q	2012 1Q[2]
NUMBER OF ISSUES	**337**	**512**	**349**	**356**	**58**	**128**	**117**
Mortgage bonds	47	75	88	115	10	44	27
Territorial bonds	8	1	9	42	18	16	8
Non-convertible bonds and debentures	76	244	154	87	14	27	48
Convertible/exchangeable bonds and debentures	1	6	3	9	0	2	1
Asset-backed securities	108	76	36	48	9	20	15
Commercial paper facilities	88	73	59	53	7	19	18
Securitised	2	2	2	2	0	1	0
Other commercial paper	86	71	57	51	7	18	18
Other fixed-income issues	0	0	0	0	0	0	0
Preference shares	9	37	0	2	0	0	0
NOMINAL AMOUNT (million euros)	**476,276**	**387,476**	**226,449**	**288,992**	**38,435**	**113,496**	**119,537**
Mortgage bonds	14,300	35,574	34,378	67,227	5,250	23,743	26,000
Territorial bonds	1,820	500	5,900	22,334	7,437	10,162	3,200
Non-convertible bonds and debentures	10,490	62,249	24,356	20,192	981	13,312	31,305
Convertible/exchangeable bonds and debentures	1,429	3,200	968	7,126	0	4,944	1,128
Asset-backed securities	135,253	81,651	63,261	68,413	10,449	20,210	9,195
Domestic tranche	132,730	77,289	62,743	62,796	10,116	18,844	7,810
International tranche	2,522	4,362	518	5,617	334	1,366	1,385
Commercial paper[3]	311,738	191,342	97,586	103,501	14,317	41,125	48,708
Securitised	2,843	4,758	5,057	2,366	259	648	616
Other commercial paper	308,895	186,583	92,529	101,135	14,058	40,477	48,092
Other fixed-income issues	0	0	0	0	0	0	0
Preference shares	1,246	12,960	0	200	0	0	0
Pro memoria:							
Subordinated issues	12,950	20,989	9,154	29,277	4,664	16,208	2,772
Covered issues	9,170	4,794	299	10	0	0	0

abroad by Spanish issuers	2008	2009	2010	2011	2011 3Q	2011 4Q	2012 1Q[4]
NOMINAL AMOUNT (million euros)	**112,366**	**149,686**	**127,731**	**119,631**	**13,838**	**23,627**	**17,354**
Long-term	39,894	47,230	51,107	51,265	3,597	12,135	0
Preference shares	0	3,765	0	0	0	0	0
Subordinated debt	70	2,061	0	242	0	242	17,354
Bonds and debentures	39,360	41,404	50,807	51,023	3,597	11,892	0
Asset-backed securities	464	0	300	0	0	0	11,144
Short-term	72,472	102,456	76,624	68,366	10,241	11,492	11,144
Commercial paper	72,472	102,456	76,624	68,366	10,241	11,492	0
Securitised	425	108	248	322	36	114	28,498

Source: CNMV y Bank of Spain.

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

2 Data to 31 March.

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

4 Data for the month of February.

4 Market agents

4.1 Investment vehicles

Financial collective investment schemes[4]

Investment fund assets fall back 8% on continuing redemptions …

Investment fund assets dropped by 5.7% in the second half of 2011 (8% in the full-year period) to an end-December total of just over 132 billion euros (see table 12), under the dual pressure of high net redemptions and the depreciation of portfolio instruments, which was most intense in equity securities. On the first score, investment funds endured second-half withdrawals bordering on six billion euros (over 10.80 billion in the full-year period, see table 11). This net outflow extended to most categories, with fixed-income funds the worst affected (2.76 billion euros in the second half and an annual sum of just over 10.40 billion), followed by guaranteed equity, absolute return and balanced fixed income funds with net redemptions in the full-year period of 3.06, 2.34 and 1.92 billion respectively. Only guaranteed fixed-income funds were able to meaningfully buck the trend, taking in the net sum of 7.20 billion euros, 80% of it in the first six months.

Investment fund subscriptions and redemptions (million euros)[1] TABLE 11

	Subscriptions				Redemptions			
Category	**1Q 11**	**2Q 11**	**3Q 11**	**4Q 11**	**1Q 11**	**2Q 11**	**3Q 11**	**4Q 11**
Fixed income[2]	7,888.3	6,478	5,963	6,875	13,297.5	8,737	7,193	8,406
Balanced fixed income[3]	358	518	232	225	1,138	893	553	674
Balanced equity[4]	270	335	45	166	267	435	193	241
Euro equity [5]	575	524	472	514	595	454	419	466
Intern. equity[6]	2,490.5	721	321	304	2,522.1	801	842	489
Fixed-income guaranteed	7,424	2,595	2,203	1,744	2,008	2,224	1,156	1,350
Equity guaranteed[7]	829	622	751	369	1,625	1,717	1,356	934
Global funds	1,534	839	572	317	507	601	631	577
Passively managed[8]	221	149	197	358	237	108	301	553
Absolute return[8]	1,166	382	237	362	1,332	1,290	1,034	829
Hedge funds	30	38	31	–	24	28	17	–
Funds of hedge funds	2	4	2	–	30	28	11	–
Total	**22,756**	**13,164**	**10,993**	**11,336**	**23,529**	**17,259**	**13,677**	**14,620**

Source: CNMV.

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

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

Main investment fund variables*

TABLE 12

				2011			
Number	**2009**	**2010**	**2011**	**1Q**	**2Q**	**3Q**	**4Q**
Total investment funds inversión	**2,536**	**2,408**	**2,310**	**2,417**	**2,389**	**2,341**	**2,310**
Fixed income[1]	582	537	508	542	530	520	508
Balanced fixed income[2]	169	160	140	158	152	146	140
Balanced equity[3]	165	138	128	136	132	130	128
Euro equity[4]	182	172	148	171	157	153	148
International equity[5]	242	232	220	223	222	222	220
Fixed income guaranteed	233	276	351	303	324	335	351
Equity guaranteed[6]	561	499	420	485	470	436	420
Global funds	187	192	203	197	203	204	203
Passively managed[7]	69	61	59	61	57	59	59
Absolute return[7]	146	141	133	141	142	136	133
Assets (million euros)							
Total investment funds	**170,547.7**	**143,918.2**	**132,368.6**	**144,428.0**	**140,351.3**	**134,033.7**	**132,368.6**
Fixed income[1]	84,657.2	56,614.6	46,945.5	51,552.7	49,449.9	48,228.6	46,945.5
Balanced fixed income[2]	8,695.5	7,319.0	5,253.6	6,570.0	6,251.9	5,715.8	5,253.6
Balanced equity[3]	3,879.,6	3,470.5	2,906.1	3,484.5	3,345.6	2,897.5	2,906.1
Euro equity[4]	6,321.6	5,356.8	4,829.2	5,656.3	5,687.2	4,610.8	4,829.2
International equity[5]	5,902.4	8,037.3	6,281.2	7,909.0	7,751.6	6,028.4	6,281.2
Fixed income guaranteed	21,033.4	26,180.2	35,058.0	32,084.4	32,742.1	34,241.7	35,058.0
Equity guaranteed[6]	25,665.8	22,046.5	18,014.5	21,181.6	19,827.6	18,699.9	18,014.5
Global funds	3,872.5	4,440.3	5,104.7	5,481.7	5,718.1	5,154.3	5,104.7
Passively managed[7]	3,216.6	2,104.8	1,986.2	2,193.0	2,172.2	2,060.0	1,986.2
Absolute return[7]	7,303.0	8,348.1	5,989.7	8,314.8	7,405.1	6,396.8	5,989.7
Unit-holders							
Total investment funds	**5,475,403**	**5,160,888**	**4,834,062**	**5,160,482**	**5,044,106**	**4,942,074**	**4,834,062**
Fixed income[1]	2,041,487	1,622,664	1,383,813	1,524,438	1,466,938	1,419,006	1,383,813
Balanced fixed income[2]	290,151	270,341	206,938	251,992	238,275	227,046	206,938
Balanced equity[3]	182,542	171,336	145,150	162,861	156,631	151,551	145,150
Euro equity[4]	299,353	266,395	237,815	253,365	248,355	247,166	237,815
International equity[5]	458,097	501,138	448,539	493,906	493,057	465,814	448,539
Fixed income guaranteed	570,963	790,081	1,042,658	967,561	990,997	1,019,905	1,042,658
Equity guaranteed[6]	1,188,304	1,065,426	912,298	1,027,392	981,572	946,448	912,298
Global funds	88,337	105,719	127,336	114,244	124,088	130,519	127,336
Passively managed[7]	85,403	90,343	100,416	85,254	82,371	95,948	100,416
Absolute return[7]	270,766	277,445	229,099	279,469	261,822	238,671	229,099
Return[8] (%)							
Total investment funds	**5.73**	**0.35**	**-0.08**	**0.95**	**0.03**	**-2.37**	**1.35**
Fixed income[1]	1.91	0.11	1.56	0.63	0.33	0.01	0.58
Balanced fixed income[2]	6.85	-0.54	-1.34	0.90	0.09	-3.47	1.20
Balanced equity[3]	16.47	-0.98	-5.64	2.23	-0.31	-10.13	3.02
Euro equity[4]	32.41	-2.94	-11.71	6.11	-0.45	-19.67	4.05
International equity[5]	37.28	14.22	-10.83	-0.49	-1.15	-15.70	7.53
Fixed income guaranteed	3.81	-0.67	3.28	0.89	0.36	1.28	0.71
Equity guaranteed[6]	3.56	-1.79	0.14	0.71	-0.48	-0.76	0.68
Global funds	10.90	3.22	-4.64	0.98	-0.14	-8.10	2.90
Passively managed[7]	–	-2.36	-7.33	3.74	-0.30	-13.94	4.11
Absolute return[7]	–	1.53	-1.87	0.28	-0.35	-2.71	0.93

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

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

1 Includes: Euro and international fixed income and money market funds.
2 Includes: Balanced euro fixed income and balanced international fixed income.
3 Includes: Balanced euro equity and balanced international equity.
4 Includes: Euro equity.
5 Includes: International equity
6 Includes: Guaranteed and partially guaranteed equity.
7 New categories as of 2Q09. All absolute return funds were previously classed as global funds.
8 Annual return for 2008, 2009 and 2010. Quarterly data comprise non-annualised quarterly returns.

As we can see from table 12, investment fund returns declined by 1.1% in the second half of 2011, with fourth-quarter gains (1.35%) failing to offset the losses of the third quarter (-2.37%). Most categories served up a negative performance from July to September. Worst hit were those carrying most exposure to equities, in line with the run-down in stock prices. By the end of the year, funds were running an aggregate annual return of -0.08%, down from the 0.35% of 2010. In pure equity funds, the year-long decline exceeded 10%.

… and, to a lesser degree, dwindling portfolio returns.

Fund numbers headed gradually lower after the mild upturn of the opening quarter. The year closed with 2,310 funds on the official registers, 98 fewer than at end-2010. The decrease, as in previous years, traced mainly to inter-fund mergers. Unit-holder numbers fell from 5.16 million at the 2010 close to 4.8 million one year later. Fixed-income funds bore the brunt of the decline, with 73% of net investor outflows, while growth was confined to guaranteed fixed-income funds, which added 250,000 to their investor roll, and, in smaller measure, global and passively managed categories.

Fund and unit-holder numbers continue in decline.

Preliminary data for January 2012 point to a prolongation of these trends, with fund and unit-holder numbers in decline and fixed-income fund redemptions still running high. Aggregate fund returns, meantime, held in positive territory over the year's first weeks.

Preliminary data for January show a similar picture.

Estimated liquidity of investment fund assets TABLE 13

	Less-liquid investments					
	Million euros			% total portfolio		
Type of asset	**Jun 11**	**Sep 11**	**Dec 11**	**Jun 11**	**Sep 11**	**Dec 11**
Financial fixed income rated AAA/AA	4,391	3,998	2,195	22.8	18.9	23.0
Financial fixed income rated below AAA/AA	2,384	2,055	3,448	20.6	22.9	17.6
Non-financial fixed income	171	150	164	4.2	5.0	5.6
Securitisations	2,246	2,135	1,654	49.7	57.1	52.0
AAA-rated securitisations	609	617	383	49.3	99.0	92.3
Other securitisations	1,636	1,519	1,271	49.8	48.7	45.9
Total	**9,192**	**8,338**	**7,461**	**26.0**	**22.6**	**21.1**
% of investment fund assets	**6.6**	**6.2**	**5.6**			

Source: CNMV.

As table 13 shows, fund liquidity conditions improved in the second-half period as regards private fixed-income investments, with the volume of less-liquid assets down to 7.46 billion in December from the 9.19 billion euros of mid-year. Also, their relative weight in total industry assets fell from 6.6% in June to 5.6% in December 2011, prolonging the trend mapped out since 2009. In straight-number terms, exposure reduced most steeply in financial fixed-income assets of high credit quality (AAA/AA), down from 4.39 to 2.19 billion euros. The proportion of less-liquid assets also decreased (by some 600 million) for asset-backed securities, but increased for medium-to-low rated fixed-income instruments (by more than one billion euros).

The share of less-liquid assets reduced in 2011 to 5.6% of the industry total.

Exhibit 5: "The impact on guaranteed funds of credit institution rating downgrades"

CNMV Circular 6/2010, like the now repealed Circular 3/1998 before it, stipulates that the guarantors of UCITS with a specific objective of optimum returns secured by a third-party guarantee (generally known as "internal guarantee" funds) must meet the same solvency requirements as those regulatorily determined for the counterparties in derivative transactions. This requirement is detailed in provision 20.1 of Circular 6/2010, which states that the guarantor's credit rating as assigned by Standard & Poor's, Moody's or Fitch must be, at least, favourable in both the long and short term, i.e., indicating at least a strong or satisfactory capacity respectively to meet payment commitments in a timely manner.

Cases arose in 2009 where the credit institution extending the guarantee subsequently had its rating revised to below the regulatory cut-off. For this reason, the CNMV issued a communication (published 16/01/2009) urging fund managers operating an internal guarantee mechanism to notify a significant event – for publication by the CNMV and disclosure in the next periodic report – whenever a guarantor lost the required credit rating as a result of post-commitment downgrades.

Although, under current provisions, guaranteed funds whose authorisation predates such a revise-down are free to continue operations, the launch of new internal guarantee funds remains contingent on the guarantor complying with the stipulated rating threshold. This condition stems from the fact that internal guarantee funds are relieved of complying with many of today's legal limits. Specifically, they are exempt from the global limit on exposure to derivative products and the diversification limit on derivative underlyings (points 3 and 4 of Article 39 of Royal Decree 1309/2005), as well as counterparty limits in derivatives trading.

The law is however strict in requiring the guarantors of internal guarantee funds to keep up a minimum credit rating, whether or not they exceed the stated limits. And this could lead to situations of regulatory arbitrage with schemes where the guarantee is extended to unit-holders (commonly known as "external guarantee" funds) and to which such rating conditions do not apply.

In view of this circumstance, the CNMV is thinking of amending its Circular 6/2010 such that the rating requirement will only apply to the guarantors of internal guarantee funds that stand to overshoot the regulatory limits. This would mean fewer schemes would have to opt for the external guarantee format, which not only has tax disadvantages but also pushes up managers' administrative and operating costs in cases where they have to pay unit-holders individually on expiry of the fund guarantee (as opposed to a single payment to the fund itself in the case of an internal guarantee).

Real estate investment schemes

Real estate schemes continued to struggle against the tide, as they have done for the past few years. 2011 closed with six real estate investment funds in operation, one fewer than at end-2010. In September, concretely, one fund transformed itself into a real estate investment company and subsequently a public limited company. Of the six funds still extant, only five can be considered active, with the other subject to a dissolution agreement and poised to enter liquidation.

Fund numbers dropped by one to six, though only five were active at the 2011 close.

In four of the five active funds, the proportion of assets in the hands of investors belonging to the manager's financial group ranged from 47% to 98%. All five offered redemptions at several points in 2011, which in all but one case were met through funds put up by the controlling group. The result was to further swell the percentage of investor assets held by the financial parent of the management company.

And each of these five reported a large proportion of assets in the hands of the manager's financial group.

As we can see from table 14, assets under management in real estate funds decreased by 26.5% in 2011 to 4.49 billion euros (6.12 billion at end-2010), due almost entirely of the aforementioned dissolution. Unit-holder numbers, meantime, slumped by more than 60% to fewer than 30,000. Fund returns remained stuck in negative territory, as they have been since 2009, though with losses a little less deep than in previous years.

Real estate fund assets and unit-holders dropped 26.5% and 60% respectively, though returns held up better than in previous years.

Main real estate scheme variables

TABLE 14

	2008	2009	2010	2011	2011			
					1Q	2Q	3Q	4Q
FUNDS								
Number[1]	9	8	7	6	7	7	6	6
Unit-holders	97,390	83,583	75,280	29,735	33,747	31,963	31,412	29,735
Assets (million euros)	7,407	6,465	6,116	4,495	6,083	5,995	4,597	4,495
Return (%)	0.69	-8.31	-4.74	-3.24	-0.67	-0.65	-1.03	-0.93
COMPANIES								
Number	9	8	8	8	8	8	9	8
Shareholders	937	928	943	943	943	943	944	943
Assets (million euros)	372	309	322	313	320	318	1,663	313

Source: CNMV.

1 Funds filing financial statements.

For real estate investment companies, the picture was broadly the same as in 2010. Both company and shareholder numbers held constant in the year (see table 14), while assets under management fell by 2.8% to 313 million euros.

The business landscape for real estate investment companies remained basically unchanged.

Hedge funds

The hedge fund industry experienced mixed fortunes in 2011, with funds of hedge funds faring worse overall and a degree of advance among pure hedge. This divergent performance has been observable for some years now, reflecting funds of funds greater vulnerability to the economic and financial crisis. Between January and October 2011, specifically, this category of funds saw their unit-holders and

Funds of hedge funds lose further ground in 2011 in terms of both assets and unit-holders…

assets shrink by 2.3% and 3.9% respectively (10.4% and 12.9% between January and October 2010). This, however, pales in comparison to the experience of 2009-2010, when assets under management contracted 32% and unit-holder numbers dropped to almost half (see table 15). Finally, funds of hedge funds reported an aggregate -1.5% return between July and October 2011 (-2.6% year to date), contrasting with the gains of the two preceding years. A total of 27 funds were in operation at the October close, one fewer than at end-2010.

Main hedge fund and fund of hedge fund variables

TABLE 15

				2010	2011			
	2008	2009	2010	4Q	1Q	2Q	3Q	4Q[2]
FUNDS OF HEDGE FUNDS								
Number[1]	40	38	28	28	28	27	27	27
Unit-holders	8,151	5,321	4,404	4,404	4,240	4,137	4,046	4,043
Assets (million euros)	1,021.3	810.2	694.9	694.9	667.2	636.1	617.4	611.2
Return (%)	-17.8	7.85	3.15	2.13	-0.01	-1.03	-1.50	-0.03
HEDGE FUNDS								
Number[1]	24	29	33	33	33	36	36	36
Unit-holders	1,589	1,917	1,852	1,852	1,958	2,022	2,057	2,045
Assets (million euros)	539.4	652.0	646.2	646.2	693.5	738.9	703.9	729.8
Return (%)	-4.82	14.94	5.37	3.11	1.79	0.51	-6.81	2.32

Source: CNMV.

1 Schemes that have filed financial statements.

2 Data to October 2011. The return stated corresponds to the month of October.

… while pure hedge funds manage a reasonable advance.

Hedge funds, meantime, managed to grow both assets and investor numbers (by 12.9% and 10.4% respectively), despite the slacker business of the second half. The year closed with 36 funds in operation, three more than in December 2010.

Foreign UCITS marketed in Spain

After two years of strong expansion, investment in foreign UCITS marketed in Spain reduced by around 18% in 2011…

After two years of rapid growth, investment in foreign UCITS marketed in Spain receded 15.8% in the last six months of 2011 (18.3% in the year) as far as 29.97 billion euros. With this, the observed movement out of Spanish into foreign schemes appears to have abated.

… despite an increase in their number.

Investor numbers also fell significantly in the year's second half as far as 761,380 (-11.2%). Conversely, the number of foreign schemes operating in Spain rose from 695 at end-June 2011 to 739 at the annual close, with French UCITS basically accounting for the difference.

Outlook

Industry prospects remain troubled in the face of fierce competition from deposits and other bank savings products.

The outlook for the Spanish collective investment industry remains clouded by uncertainty. Unit-holder redemptions continued to drain funds of their assets, albeit on a smaller scale than in previous years. So much so that industry size has been practically cut in two in terms of assets and investors since the crisis erupted

in mid-2007. And competition from high-interest bank deposits is unlikely to go away. Fund managers have responded to the new business framework[5] by rationalising their fund offerings and cutting back operating costs, at the same time as they have been caught up in the broader reorganisation of the Spanish financial system.

Exhibit 6: "ESMA guidelines on ETFs and structured UCITS"

In view of the growing interest in ETFs, and concerns voiced about their impact on financial stability and possibly investor protection, ESMA published a consultation paper in July 2011 touching on certain aspects of ETFs and structured UCITS. Based on the responses to this paper, ESMA drew up a series of draft guidelines on ETFs and other UCITS which track indexes, lend assets or invest in total return swaps or strategy indices. This document too was sent out to public consultation for a two-month period starting in January 2012.

The key points of the ESMA proposal are summarised below:

- All ETFs should be clearly identified as such in their fund rules, prospectus and marketing communications and should bear the identifier "ETF". In the case of ETFs that are actively managed, this characteristic should be clearly stated in the prospectus, which should also indicate the strategy the fund will follow to outperform an index, the main risks entailed by this strategy, and how investors can obtain information on the make-up of its portfolio.

  The ESMA text devotes particular attention to secondary market investors, who do not figure as unit-holders in the records of the fund management company. It recommends that prospectuses and marketing communications should at least inform these shareholders about their status and rights. Specifically, they should be given the right to redeem their units directly from the ETF, at least when market makers are not able to provide liquidity.

- Tougher disclosure requirements should be introduced for index-tracking UCITS, in order to strengthen investor protection. Prospectuses should offer a detailed description of indexes and how they will be tracked. In the case of leveraged products, the prospectus should disclose the leverage policy and associated risks, with particular regard to reverse leverage, as well as specifying how daily calculation of leverage may influence medium- to long-term returns.

- Enhanced transparency is also recommended in the case of UCITS lending portfolio securities or engaging in repo transactions. Prospectuses should include a detailed description of the risks involved in these activities and the fund's policies with regard to collateral and fees received. Collateral arrangements should comply with the criteria set out for OTC derivatives, as stipulated in the level three rules of ESMA's forerunner CESR. ESMA now

5 See article by Cambón, M. I. and Losada, R. (2012). "Development of mutual fund managers and products offered from 1995 to 2010". *CNMV Bulletin*, quarter I.

proposes extending these requirements, and that the diversification rules of the UCITS Directive should apply to both collateral received and the assets in the scheme's portfolio.

– As regards UCITS investing in total return swaps, the UCITS portfolio, the underlying to the swap and any collateral posted must all comply with the Directive's diversification and qualifying asset rules. The text also calls for increased transparency in prospectuses and annual reports. Specifically investors should be informed about the underlying strategy, counterparties and the type and level of collateral required.

– UCITS investing in "strategy indices" should meet a number of conditions over and above those set out in the Directive; namely, to be sufficiently diversified, to be an adequate benchmark for the market to which they refer, to have a rebalancing frequency enabling replication and compliant with the disclosure rules of the Directive and, lastly, to be publicised appropriately.

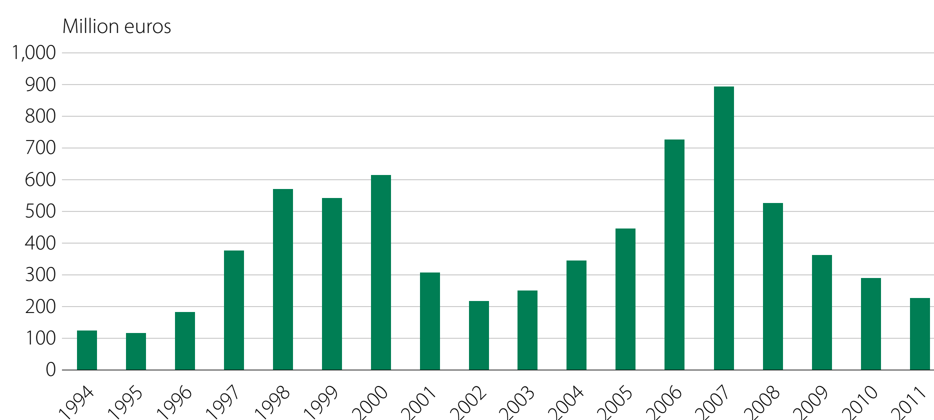
Finally, the text offers a series of reflections on whether synthetic ETFs or structured UCITS are a suitable product for retail investors, given the risks entailed by their mode of operation, while acknowledging that this is a horizontal question best dealt with in the context of the current MiFID review.

4.2 Investment firms

Financial market turmoil again takes its toll of investment firm profits, down by 21.5% in 2011.

Investment firms remained under the influence of financial market turbulence, especially in the second half, and the downturn in collective investment. The sector's aggregate pre-tax profits, at 227 million euros, were 21.5% down on those of the previous year. As figure 15 shows, profits have kept falling year after year since the onset of the crisis, though the rate of decline is apparently slowing. In nominal terms, 2011 profits were close to the levels of 2002, at the height of the previous crisis, and just a quarter of those reported in 2007 up to the outbreak of the present one.

Aggregate investment firm earnings FIGURE 15



Source: CNMV.

Broker-dealers reported pre-tax profits of 217 million over full-year 2011, 22% less than in 2010 (see table 16). The decline, following on from the -20% of the previous year, traced mainly to net fee income, down from 533.8 million in 2010 to 490.5 million at the 2011 close (-8%). Fees from order processing and execution (68% of the total) fell by 4.6%. Among smaller items, fees from UCITS marketing and issue placement and underwriting suffered the biggest slide, while those from investment advice, portfolio management and other services advanced in the period.

Broker-dealer profits drop 22% on lower fee income.

There were mixed fortunes for the remaining captions making up broker-dealer gross income, with a 10% fall in net interest income to 91.5 million euros offset by an almost six-fold surge in gains on financial investments as far as 272 million euros. Similarly, broker-dealers reported 198 million in exchange losses, contrasting with the 48.6 million gains of 2010.

Gross income captions perform unevenly…

Aggregate income statement (2011)

TABLE 16

	Broker-dealers			Brokers			Portfolio managers		
Thousand euros	**Dec 10**	**Dec 11**	**% var.**	**Dec 10**	**Dec 11**	**% var.**	**Dec 10**	**Dec 11**	**% var.**
1. Net interest income	102,054	91,542	-10.3	1,629	2,480	52.2	407	682	67.4
2. Net fee income	533,858	490,517	-8.1	109,165	97,884	-10.3	10,097	7,987	-20.9
2.1. Fee income	798,152	776,641	-2.7	126,055	112,349	-10.9	20,994	18,476	-12.0
2.1.1. Order processing and execution	555,207	529,711	-4.6	38,176	36,354	-4.8	–	–	–
2.1.2. Issue placement and underwriting	8,499	7,446	-12.4	2,748	2,870	4.5	–	–	–
2.1.3. Securities custody and administration	22,367	21,060	-5.9	366	440	20.2	-	–	–
2.1.4. Portfolio management	13,880	16,186	16.6	19,489	12,351	-36.6	18,020	16,582	-8.0
2.1.5. Design and advising	49,433	55,025	11.3	2,790	5,349	91.7	1,160	1,894	63.3
2.1.6. Search and placement	36	484	1,249.6	304	61	-80.0	–	–	–
2.1.7. Margin trading	9	8	-15.0	27	42	55.9	–	–	–
2.1.8. UCITS marketing	65,487	59,588	-9.0	23,946	21,381	-10.7	34	0	-100.0
2.1.9. Others	83,233	87,133	4.7	38,209	33,501	-12.3	1,779	0	-100.0
2.2. Fee expense	264,294	286,124	8.3	16,890	14,465	-14.4	10,897	10,489	-3.7
3. Result of financial investments	48,588	271,955	459.7	456	623	36.8	51	186	265.6
4. Net exchange income	24,445	-198,307	–	-3	78	–	9	30	252.5
5. Other operating income and expense	1,635	3,952	141.6	-1,413	-1,617	-14.5	13	-40	-413.5
GROSS INCOME	**710,580**	**659,659**	**-7.2**	**109,834**	**99,448**	**-9.5**	**10,577**	**8,845**	**-16.4**
6. Operating expenses	415,433	426,672	2.7	97,582	89,736	-8.0	9,305	7,211	-22.5
7. Depreciation and other charges	6,006	21,532	258.5	2,817	1,943	-31.0	118	109	-7.5
8. Impairment losses	12,888	4,076	-68.4	-23	12	–	0	0	–
NET OPERATING INCOME	**276,253**	**207,379**	**-24.9**	**9,457**	**7,757**	**-18.0**	**1,154**	**1,525**	**32.1**
9. Other profit and loss	2,265	9,861	335.3	19	412	2,103.9	38	0	-100.0
PROFITS BEFORE TAXES	**278,519**	**217,240**	**-22.0**	**9,476**	**8,169**	**-13.8**	**1,192**	**1,525**	**27.9**
10. Corporate income tax	81,685	68,687	-15.9	3,024	2,681	-11.3	254	484	90.9
PROFITS FROM ONGOING ACTIVITIES	**196,834**	**148,553**	**-24.5**	**6,452**	**5,488**	**-14.9**	**939**	**1,041**	**10.9**
11. Profits from discontinued activities	0	0	–	0	0	–	0	0	–
NET PROFIT FOR THE YEAR	**196,834**	**148,553**	**-24.5**	**6,452**	**5,488**	**-14.9**	**939**	**1,041**	**10.9**

Source: CNMV.

… while operating costs and provision charges rise.

Finally, broker-dealer gross income closed the year at 659.7 million euros, 7% less than in 2010. Higher operating expenses and provision charges made deeper inroads into the sub-sector's net operating income, which, at 207.4 million, was a full 25% down on the same figure for 2010.

Broker profits also betray the effects of falling net fee income, despite some progress in operating cost containment.

Brokers, meantime, saw their pre-tax profits slide by 14% to 8.2 million euros (9.5 million in 2010). Behind this decline was a 10.3% drop in net fee income from 109.2 to 97.9 million euros. In general, investment service business slowed over 2011, the exception being investment advisory services which earned almost double the amount of the previous year (see table 16). Broker gross income closed at 99.5 million euros, 9.5% less than in 2010, while net operating income fell by 18% to 7.8 million despite operating cost containment (-8%) and lower depreciation and other charges (-31%).

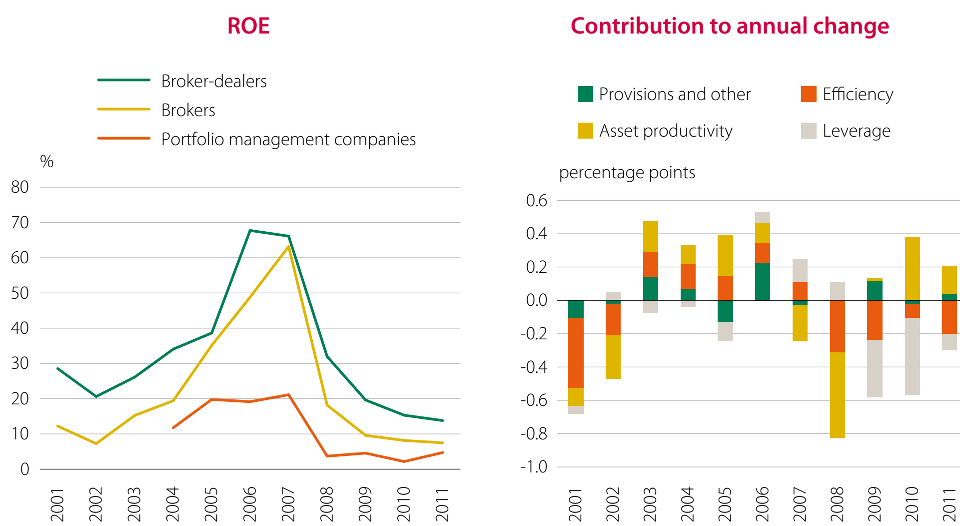
Portfolio managers raise their profits 28% with the help of operating cost containment.

Finally, portfolio management companies grew their aggregate pre-tax profits by 28% as far as 1.5 million at the 2011 close. Despite a 21% slide in net fee income, with falling portfolio management revenues (-8%) contrasting starkly with the advance of investment advisory business (63%), cost-cutting efforts at the operating expenses line (-22.5%) helped lift net operating income to a year-end total of 1.53 million euros (32% more than in 2010).

Investment firm ROE falls from 14.7% in 2010 to 13.2% in 2011, in line with sector earnings…

Sector-wide return on equity (ROE) dropped from 14.7% in 2010 to 13.2% in 2011, in line with the downtrend in investment firm earnings. By type of enterprise, the ROE of broker-dealers shrank from 15.3% to 13.8% and that of brokers from 8.1% to 7.5%. Conversely, the ROE of portfolio management firms strengthened in the year from 2.2% to 4.7%. As figure 16 shows, the decrease in aggregate ROE traced mainly to efficiency losses and, to a smaller extent, a reduction in leverage, while asset productivity again contributed on the upside, as in 2010.[6]

Pres-tax ROE of investment firms FIGURE 16



Source: CNMV.

6 For a fuller description of how to interpret the elements in this equation, see the exhibit "ROE breakdown" in (2008). "Securities markets and their agents: situation and outlook", *CNMV Bulletin*, quarter I.

The number of loss-making entities (before taxes) was 31 at the 2011 close. This was eight more than in 2010, in a break with the downward trend of the two previous years. Of this total, 13 were broker-dealers (10 in 2010), 17 brokers (12 in 2010) and the other one portfolio management company (the same number as in 2010). Losses in the year amounted to 26.3 million euros versus the 16 million of 2010, a difference of 64%. The figure, moreover, equated to around 12% of aggregate sector earnings, double the percentage of one year before.

… while the number of loss-making entities moves up by eight to 31 at the 2011 close.

Investment firms remained comfortably compliant with capital standards, though margins have narrowed by around 30% since the entry of a stricter regulatory framework in June 2009. Between 2010 and 2011, aggregate solvency margins reduced slightly sector-wide. Broker-dealers, concretely, reported an end-2011 equity surplus of 3.5 times (3.6 in 2010) against the 1.9 of brokers (2.0 in 2010) and the 1.1 of portfolio managers (1.2 in 2010).

Sector capital standards hold up reasonably well.

Investment advisory firms (IAFs) have enjoyed a notable expansion since they were authorised in 2009 with the transposing to Spanish law of the MiFID directive. This was equally evident in the numbers of firms in operation (up by 30 to 82), the volume of assets under advice (up 9% to 17.2 billion euros) and the number of advisory contracts outstanding (up 56% to 3,789). Professional clients accounted for 81% of assets advised against the 12% drawn from retail customers. The fees earned by IAFs came to 29.8 million euros, 43.5% more than in 2010, but this was not enough to prevent a 6% decline in earnings to 6.4 million euros at end-2011 (see table 17).

IAF business continues to expand, with assets under advice up by 9% in 2011.

Main investment advisory firm variables

TABLE 17

Thousand euros	2009	2010	2011	2011 1H	2011 2H	% semi-annual change	% annual change
NO. OF ENTITIES	**16**	**52**	**82**	**64**	**82**	**28.1**	**57.7**
ASSETS UNDER ADVICE[1]	**1,410,985**	**15,802,743**	**17,206,331**	**16,498,814**	**17,206,331**	**4.3**	**8.9**
Retail customers	364,284	1,715,084	2,168,957	1,895,320	2,168,957	14.4	26.5
Professional customers	1,046,702	13,995,206	13,963,983	14,501,823	13,963,983	-3.7	-0.2
Others	0	92,453	1,073,391	101,671	1,073,391	955.7	1,061.0
NO. OF CONTRACTS	**317**	**2,431**	**3,789**	**3,158**	**3,789**	**20.0**	**55.9**
Retail customers	293	2,345	3,635	3,037	3,635	19.7	55.0
Professional customers	24	79	127	109	127	16.5	60.8
Others	0	7	27	12	27	125.0	285.7
FEE INCOME[2]	**3,183**	**20,745**	**29,778**	**14,116**	**29,778**	**111.0**	**43.5**
Fees received	3,183	20,629	29,586	14,080	29,586	110.1	43.4
From customers	2,776	17,132	24,801	11,720	24,801	111.6	44.8
From other entities	407	3,497	4,773	2,360	4,773	102.2	36.5
Other income	0	116	192	36	192	433.3	65.5
EQUITY	**1,500**	**10,057**	**11,475**	**10,469**	**11,475**	**9.6**	**14.1**
Share capital	1,043	3,014	3,895	3,386	3,895	15.0	29.2
Reserves and retained earnings	36	242	1,186	2,915	1,186	-59.3	390.1
Profit/loss for the year[2]	421	6,801	6,394	4,168	6,394	53.4	-6.0

1 Period-end data at market value.

2 Cumulative data for the period.

Investment firm prospects hang on the eventual stabilisation of financial markets and the knock-on effects of the restructuring process in the Spanish banking sector.

The outlook for the investment services sector will again hang mainly on the performance of financial markets. Traditional revenue streams like secondary market brokerage services or issue placement are thinning out progressively, and investment fund marketing is doing little better. However, some of the slack may be taken up by new business lines like investment advisory services. There is also the prospect of an imminent sector reorganisation, along similar lines to what is happening now with UCITS managers, as part of the broader restructuring of the Spanish financial system. Indeed, in recent years, credit institutions have been taking a growing slice of the investment services market, with many of them opting to wind up subsidiaries and take on the business themselves.

4.3 UCITS management companies

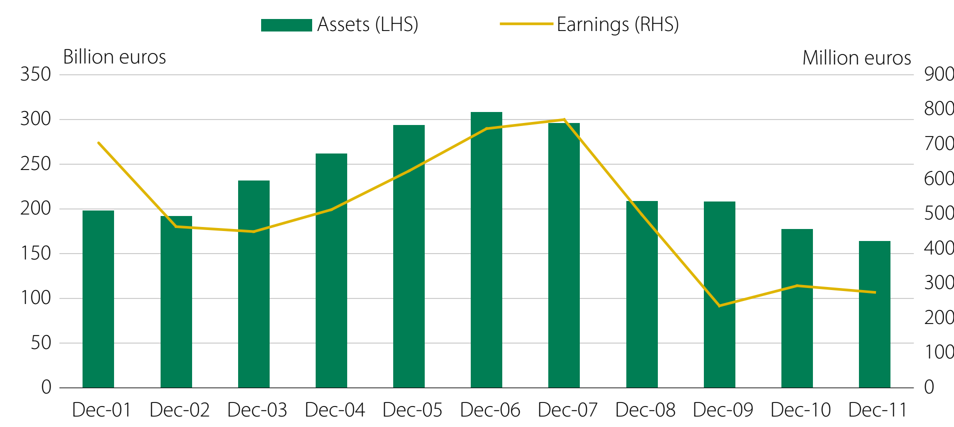
Fund manager assets contract in 2011, albeit less sharply than in previous years.

Assets under management in UCITS management companies (SGIIC) fell by 6.5% in the second half (7.6% in the full-year period) to just over 164 billion euros. The rate of decrease was however less severe than in 2010 (see figure 17 and table 18).

ROE holds at 20%, despite earnings erosion, while the number of loss-making entities falls back slightly.

The decline in managed assets was mirrored by a 6.4% decline in pre-tax profits to 274.6 million euros. Revenues from fund management fees fell by a rather steeper 8.8% to stand at 0.9% of industry assets in December 2011. ROE held flat at around 20%. Despite the profits slide, the number of loss-making entities dropped from 35 in June to 32 in December (34 at end-2010), while their combined losses, at 11.3 million euros, were 44.3% down on the equivalent figure for 2010.

UCITS management companies: assets under management and pre-tax profit FIGURE 17



Source: CNMV.

The restructuring of the Spanish financial sector is changing the face of the fund management industry.

UCITS management companies pressed on throughout the year with the task of streamlining their investment fund offerings by means of multiple inter-product mergers. Financial sector restructuring also generated movements in the sector. In fact of the ten companies that ceased operation in 2011 (five in each semester) half did so as a result of parent group reorganisation.[7]

7 Aside from the ten retirals stated, two companies did not file financial statements at end-2011 due to ongoing merger processes, and have since applied for de-registration.

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

Million euros

	Assets under management	UCITS management fee income	Average UCITS management fee (%)	Fee ratio (%)[1]
2002	192,099	2,259	1.18	72.7
2003	231,458	2,304	1.00	73.8
2004	262,132	2,670	1.02	73.6
2005	293,973	2,976	1.01	72.2
2006	308,476	3,281	1.06	71.5
2007	295,922	3,194	1.08	70.5
2008	209,014	2,302	1.10	70.8
2009	203,379	1,702	0.84	68.6
2010	177,676	1,622	0.91	68.1
2011	164,125	1,479	0.90	66.6

Source: CNMV.

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

4.4 Other intermediaries: venture capital

The number of venture capital entities registered with the CNMV rises slightly to 336.

The number of venture capital entities (VCEs) increased in the year from 333 to 336 (see table 19). Of this total, 143 were venture capital companies (VCCs), 114 venture capital funds (VCF) and 79 VCE management companies. During 2011, 19 entities joined the register (seven VCCs, seven VCFs and five VCE managers) against 16 retirals (14 VCCs, one VCF and one management company). Most retirals were due to general business slackness or else were designed to avoid non-compliance with the compulsory investment ratios introduced by new sector legislation, and in 65% of cases corresponded to entities new to the market (operating for under five years).

New entrants had a number of characteristics worthy of note:

– Most VCEs (70%) opted for the simplified regime, in line with the trend of these past four years.

– New VCEs are gearing investment towards start-ups or growth enterprises, which account for the bulk of their transactions.

– The sectors targeted were basically technology, industry, energy and health, though funds also went into the restructuring of SMEs in financial difficulties.

– New entities tend to concentrate on the domestic market, with some even confining themselves to a single Spanish region (autonomous community). There are also two funds specialising in Latin American and Indian companies respectively.

– Finally, the public sector is present through a series of funds promoted by autonomous communities and other official entities.

Movements in the VCE register in 2011 TABLE 19

	Situation at 31/12/2010	Entries	Retirals	Situation at 31/12/2011
Entities	333	19	16	336
Venture capital funds	108	7	1	114
Venture capital companies	150	7	14	143
Venture capital management companies	75	5	1	79

Source: CNMV.

Venture capital investment in Spain falls by 7% to 3.25 billion euros.

According to preliminary data furnished by the Asociación Española de Entidades de Capital-Riesgo (ASCRI), venture capital investment in Spain receded 7% in 2011 to 3.25 billion euros. Despite the contraction, this was more than double the figure for 2009. Investment activity was at its most intense in the first half of the year, with two-third of all transactions bunched between January and July. International funds were strongly to the fore, accounting for 60% of total investment as well as five of the largest transactions (representing 47%).

83% of capital raised came from international funds. Disposals in 2011 were on a par with the previous year.

Leveraged buyouts accounted for two thirds of the year's investment. New capital raised totalled 3.26 billion euros, 26% less than in 2010, with 17% of this amount captured by Spanish operators and the rest by foreign funds. Finally, disposals summed 1.56 billion euros, similar to the 2010 total, although the number of transactions was significantly higher (556 in 2011 versus 337 in 2010).

For companies facing problems of access to bank lending, internationalisation may offer the best way forward.

The outlook for the venture capital sector is not that bad. And certainly the presence of large international funds suggests that Spain holds out attractive investment opportunities. As in previous years, however, the scale and intensity of sector investment will largely depend on having access to bank finance. Though ASCRI estimates that the sector will not see a full-blown recovery until 2013, companies' best preparation may be internationalisation. In fact, some VCEs are already making prospections in emerging markets, with Latin America as the first port of call.

Exhibit 7: "EC draft regulation on European venture capital funds"

SMEs are of vital importance in the European economy and their current difficulties raising finance are therefore a cause of grave concern. The impact of the crisis on their business and earnings has left many unable to finance themselves out of cashflow, at the same time as borrowings have been constrained by the weakness of bank lending. In fact, Europe's SMEs are heavily reliant on the bank finance channel, while other formulas, like venture capital or capital markets, have made little headway with this type of firm.[1]

Hence the need to open up SME financing channels other than the banking sector. This need is especially patent in early-stage companies with growth potential, whose innovative bent and capacity for job creation makes them strategically important for the economy.[2] In Europe, generally, suppliers of this kind of funding, primarily the organised venture capital sector (venture capital funds and companies), informal sources like business angels, or the securities markets themselves, including the so-called alternative markets, are far smaller and less developed than in the United States.[3]

In December 2011, the European Commission sent the European Parliament and Council the draft of a regulation introducing uniform Europe-wide rules for venture capital funds specialised in the financing of unlisted small and medium-size enterprises, for immediate adoption via the co-decision procedure.[4] The goal of the Commission's proposal is to remove superfluous obstacles in national legislation and promote the cross-border marketing of this kind of fund. Its approval will harmonise aspects of national regulations in countries, like Spain, with an existing regime for venture capital entities, while providing a first-time framework for this activity in other Member States.[5] Its provisions will foreseeably come into force at end-2012.

The proposal reserves the denomination of European Venture Capital Funds (henceforth EVCFs) for those meeting a series of conditions, chiefly: i) they must invest 70% of their aggregate capital contributions and uncalled committed capital in unlisted SMEs, ii) SME investments must take the form of equity or quasi equity instruments (for example, subordinated loans), and iii) they must not use leverage (that is, the fund may invest no more than the amount of capital committed by investors, so borrowing will not be permitted). All funds operating under this denomination must comply with a set of uniform rules and quality criteria (concerning, among others, disclosure to investors and operational requirements) when raising capital on a cross-border basis. This single regulatory code should ensure that investors know exactly what they are getting with an EVCF.

At the same time, the proposal takes a restrictive line regarding the investors eligible to buy into an EVCF. Specifically, qualifying funds can only be marketed to professional investors, as defined by the MiFID, along with others traditionally present in the venture capital market (family offices and business angels), provided they commit a minimum investment of 100,000 euros. The door is left open, however, to a wider participation in future extending to the general public.

The texts grants an EU-wide passport to all venture capital fund managers compliant with the above requirements, enabling them to target eligible investors in any Member State. This is because the smaller size of the kind of SME-oriented venture capital fund addressed by the draft regulation would normally bar them from taking up the passport envisaged in the 2011 Directive on Alternative Investment Fund Managers (AIFMD), which is confined to management companies running a portfolio of over 500 million euros. Also, the legal framework established by the AIFMD is primarily geared to hedge funds and private equity houses, while that of the Commission's proposal is more closely aligned with the size, investment policy and investor target of the standard venture capital fund.

1 See, for example, chapter 2 of the CNMV Annual Report 2010, available at http://www.cnmv.es/DocPortal/Publicaciones/Informes/AnnualReport2010_weben.pdf or the explanatory memorandum for the Proposal for a Regulation of the European Parliament and the Council on European Venture Capital Funds, available at http://ec.europa.eu/internal_market/investment/docs/venture_capital/111207-proposal_en.pdf
2 See, for example, Arce, Ó., López, E. and Sanjuán, L. (2011). *Access of SMEs with growth potential to the capital markets*. CNMV Working Paper No. 52, November 2011, available at http://www.cnmv.es/DocPortal/Publicaciones/MONOGRAFIAS/N52_Enen.pdf
3 The average capital managed by venture capital funds in Europe is far short of the optimal levels to conduct a diversified investment strategy that injects significant funds into a range of companies and thus has a real impact on the economy. The average venture capital fund in the EU holds around 60 million euros in assets, compared to the 130 million euros of a fund in the United States. Some studies consider that an average size of around 280 million euros is needed to have a decisive influence in investee sectors. See Lerner, J., Pierrakis, Y., Collins, L. and Bravo Biosca, A. (2011). Atlantic Drift - Venture capital performance in the UK and the US. NESTA. Research report.
4 *Proposal for a Regulation of the European Parliament and the Council on European Venture Capital Funds*. Available at http://ec.europa.eu/internal_market/investment/docs/venture_capital/111207-proposal_en.pdf
5 Only nine Member States have a dedicated legal regime for this kind of fund. The rest apply the general provisions of company law.