I Securities markets and their agents: situation and outlook

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1 Executive summary

- In the last six months[1], international markets have continued to feel the after effects of the subprime crisis against a backdrop of deteriorating global financial and macroeconomic prospects.

- After a brief respite in April and May, share price corrections[2] and high credit spreads returned with force in the year's middle months, accompanied by sluggish issuance and a dearth of activity in interbank markets. In the last few weeks, the crisis gripping American mortgage companies and insurers and the investment banking industry sent fresh shock waves running through securities and interbank markets, which were partly stilled by central bank interventions and, above all, the announcement of a rescue plan by the United States government – still to be approved by Congress at the closing date for this report.

- In order to keep the markets functioning smoothly, securities regulators in the world's main financial centres have tightened disclosure requirements on short positions, in many cases placing restrictions on naked short sales. In Spain, the CNMV reminded all members of official secondary markets about the rules penalising naked short selling, and obliged any individual or entity holding short positions in the equity securities of twenty listed financial institutions to declare all such positions in excess of 0.25% of their outstanding capital.

- In Spain, the business cycle downturn has intensified due basically to the contraction in the construction industry and the slowdown in consumption. Financial institutions suffered some deterioration in their loan-book quality, though non performing loans are still at manageable levels and their solvency is in the comfort zone.

- Non-financial companies posted lower first-half profits combined with higher debt ratios and financial charges. That said, with the exception of construction and real estate, the balance sheets of listed companies have, on the whole, suffered only moderate weakening due to slower activity and more stringent financing conditions.

- Forecasts for Spain point to further deceleration in the next three quarters[3] then a gradual recovery next year. However, estimates risk is tilted to the

1 The closing date for this report is 19 September.

2 European stock markets have recorded year-to-date losses between 23% and 27%, against around 22% for the Japanese and 14% for the Americans.

3 The European Commission is projecting 1.8% growth for the Spanish economy in 2008, eight percentage points less than the rate forecast in its Spring Report.

downside given the recent turn of international events and the scale and duration of the real estate downturn.

- The performance of Spanish equity markets has mirrored the main international trends. Following the short-lived rally of March-April, share prices began to run down steadily as of May[4], accompanied by an upswing in volatility and a contraction in liquidity. Furthermore, the price correction has reduced market turnover, discouraging the issuance of new paper, one notable exception being the *cuotas participativas* issue of savings bank Caja de Ahorros del Mediterráneo (CAM).

- One development to watch for is the narrowing distribution of the shares of exchange-listed companies. Although free-float remains at acceptable levels in most cases, the recent downward trend is an alert call to market operators who may wish to review their rules to ensure a wide enough ownership for efficient price formation.

- Spanish fixed-income markets repeated the main features of the previous semester. Prices again showed the evidence of high credit spreads while issuance activity remained slow, centring mainly on the asset-backed securities and commercial paper that are typically acquired by the entities selling the securitised loans.

- Collective investment schemes experienced a further drain in assets and unitholder numbers. Investors' growing preference for lower-risk products in today's volatile markets combined with the share price correction to drive down volumes under management[5]. At the same time, more aggressive competition from the banks eroded the relative attractiveness of conservative funds versus traditional deposits.

- Less liquid instruments again represented a low percentage of investment fund portfolios (8.4% in June 2008). However, persistent liquidity shortages in some fixed-income markets and a certain outflow of investors, oblige managers to be doubly vigilant for their exposure to hard-to-shift assets. It is also important that they follow strict valuation policies aligned with applicable accounting standards.

- Investment firm earnings were hit by the downturn in securities market trading and higher redemptions from the mutual funds under their management. This has made significant inroads into their profitability ratios, though these remain high by any standards (ROE of broker-dealers at 28% in June 2008 and that of brokers at 21%). Solvency indicators likewise continued in the comfort zone and even improved on the readings of 2007. This means firms are better primed to withstand the likely pressures on their balance sheets from the persistence of thin trading volumes and growing competition within Europe.

4 The Ibex-35 has dropped 23.9% year to date and 19.9% in the last twelve months.
5 Mutual fund assets closed the second quarter of 2008 at €214 billion euros compared to €255 billion at end-2007.

- Venture capital business continued to expand in Spain throughout 2007 by the measure of both operator numbers and industry assets. Figures for first-half 2008 indicate some tailing-off of investment volumes though transaction numbers have continued to rise. Scarce bank finance is conditioning the development of leveraged operations, though note their lower incidence in Spain compared to other countries.

- The turmoil ensuing from the subprime lending crisis in the United States has prompted a series of initiatives to perfect the regulatory framework for financial activity. A first and vital goal is to improve transparency, as regards both the situation of issuers and borrowers and the nature of financial products and the conditions of the markets where they are traded. In this respect, the CNMV, like other securities regulators, has launched or supported initiatives to strengthen the quality of the information provided by listed and supervised companies, with special attention to asset valuation policies and the issue prospectuses of structured products. Transparency requirements in fixed-income and derivative markets will best be served by a review of European legislation, which has proved less than effective in these more straitened times.

- Also needed is more effective oversight of the activity of rating agencies. Given the difficulties of getting a global supervisory system quickly into place, we must welcome the European Commission's initiative in circulating a public consultation document proposing two alternative models of authorisation and supervision. However, Europe's authorities need to go a step further and contemplate a centralised authorisation and supervision system with binding powers in all member countries.

- Finally, the crisis has uncovered a number of weaknesses in the treatment of financial entities' liquidity risk. In the collective investment sphere, the work going on within the CESR may provide a good opportunity to tighten up the relevant rules. The CNMV, meantime, plans to revisit the definition of "money-market funds" to make the nature of the product more consistent with investor expectations.

2 Macro-financial setting

2.1 International economic and financial developments

The world growth slowdown intensifies on the heels of the real estate contraction against a backdrop of unsettled markets and strong inflationary pressures...

The international economy continued along the deceleration path that has characterised these past few quarters. The knock-on effects of financial market turbulence were joined by a severe slowdown in the real estate market in several economies and, above all, the escalating prices of food and commodities like oil. The slowdown was felt in almost all world regions though with varying intensity; the US, for instance, is projected to grow 1.0% in 2008 compared to the 1%-2% augured for the euro area and Japan. Emerging economies, meantime, lost only a little of their dynamism with exports once again the main growth driver.

... that continue to complicate monetary policy decisions.

One feature of the current world slowdown is the parallel run-up in inflation caused by rising commodity prices, most notably oil[6]. This fact has heavily conditioned the policy options of leading central banks, which have pressed on with their extraordinary cash injections to counter the frictions dominating interbank markets, at the same time as they have maintained or even hiked their interest rates, despite growth moderation, to cope with mounting inflationary tensions.

Gross domestic product (% annual change) TABLE 1

					IMF(*)		OECD(*)	
	2004	2005	2006	2007	2008S	2009S	2008S	2009S
World	4.9	4.4	5.0	4.9	4.1 (+0.4)	3.9 (+0.1)	-	
United States	3.6	3.1	2.9	2.2	1.3 (+0.8)	0.8 (+0.2)	1.8 (+0.6)	1.1 (-1.1)
Euro area	2.1	1.6	2.8	2.6	1.7 (+0.3)	1.2 (=)	1.3 (-0.4)	1.4 (-0.6)
Germany	1.1	0.8	2.9	2.5	2.0 (+0.6)	1.0 (=)	1.5 (-0.4)	1.1 (-0.5)
France	2.5	1.7	2	1.9	1.6 (+0.2)	1.4 (+0.2)	1.0 (-0.8)	1.5 (-0.5)
Italy	1.5	0.6	1.8	1.5	0.5 (+0.2)	0.5 (+0.2)	0.1 (-0.4)	0.9 (-0.4)
Spain	3.3	3.6	3.9	3.8	1.8 (=)	1.2 (-0.5)	1.6 (-0.9)	1.1 (-1.3)
United Kingdom	3.3	1.8	2.9	3.1	1.8 (+0.2)	1.7 (+0.1)	1.2 (-0.6)	1.4 (-1.0)
Japan	2.7	1.9	2.4	2.1	1.5 (+0.1)	1.5 (=)	1.2 (-0.5)	1.5 (-0.3)
Emerging	7.5	7.1	7.8	7.9	6.9 (+0.2)	6.7 (+0.1)	-	-

Source: IMF and OECD.

(*) In brackets, percentage change versus the last published forecast. IMF, forecasts published July 2008 vs. April 2008. OECD, 2008 forecasts published September 2 versus those published June, except in the case of Spain. The OECD published its 2009 forecasts in June 2008, compared here with those published in December 2007. OECD forecasts for Spain date from June 2008 and are compared with those published in December 2007.

In the United States, the Federal Reserve has left its funds rate unchanged since the 25 basis points (bp) cut to 2% effected on 30 April[7]. In the euro area, the ECB traced the opposite course, and raised its rates by 25 bp on 9 July to 4.25%.

Financial markets rocked by fresh turbulence in September after the relative quiet of April and part of May...

Financial markets managed a return to stability over April and most of May, but turned edgier in the year's middle months with doubts persisting about the macroeconomic outlook and the quality of financial sector banking and trading books. The result was to hold back the normalisation of money and fixed-income markets and set share prices falling. The economic slowdown is making a visible dent on banks' revenues just as they start to notice the deterioration of a part of their loan portfolios. The financial sector is also labouring under its exposure to insurance companies (monolines), some of which have already suffered a sharp revise-down in their credit ratings.

September brought a new wave of turbulence that started with the state's bail-out of two US mortgage companies (see exhibit 1) and intensified with the collapse of

6 Crude prices have been escalating almost without interruption since January 2007, when they stood at just over 50 dollars/barrel, as far as a July 2008 high of 145 dollars/barrel. Prices have since eased back to around 100 dollars/barrel.

7 The Federal Reserve initiated its rates downcycle on 19 September 2007, when they stood at 5.25%. It has announced seven cuts since then, two of 75 bp, two of 50 bp and three of 25 bp, leaving its federal funds rate at the current 2.0%.

Lehman Brothers, the purchase of Merrill Lynch by Bank of America, the nationalising of the world's largest insurer (American International Group, AIG), the suspension of trading on the Moscow stock exchange and HBOS' buy-up by Lloyds TSB (see exhibit 2). The results were not long in coming. A generalised slump in equity prices, rising credit spreads, resurgent volatility and further interventions by main central banks. And concerns about the fragile state of other investment banking names sowed additional disquiet among market agents. After this chain of events, the publication of the US government's rescue plan appears to have calmed the market waters, pending fuller details and its backing by Congress.

Exhibit 1: Freddie Mac and Fannie Mae

These companies trace their origins to the end of the Second World War and the American government's pledge that any US citizen could borrow the money needed to buy a home. With this intent, it created a series of state- or semi state-owned institutions to energise the secondary mortgage market. These goals were successfully met, meaning any local bank, cooperative or broker could arrange mortgage loans with American citizens then sell them on to these institutions for "packaging" and re-sale to the investor public. The Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) fall within the category known as Government-Sponsored Enterprises or GSEs. At the end of the 1960s, the former was privatised and the second set up in order to inject competition into the sector. Their regulation and supervision were entrusted to an office within the US Federal Department of Housing and Urban Development.

Fannie Mae and Freddie Mac grant or guarantee mortgages and also issue securitisation bonds backed by their own loans or those bought from other lenders. The total loans they can arrange or purchase are capped at a given amount, as a function of the annual increase in housing prices. They had recently entered the subprime mortgage segment in cases where borrowers were considered deserving of a good credit rating.

The size attained by these two institutions in the US mortgage market (where they are reckoned to have granted or guaranteed almost half the loans outstanding) and the relative opacity of their finances had promoted numerous calls for a revised regulatory treatment, accompanied by a growing scepticism about the quality of their bonds. The main regulatory flaws identified had to do with their low-key capital requirements and the standards being used to value their assets. They were even fined at one stage for management misconduct, although their semi-official status and the authorities' refusal to admit any problems with their regulation or capitalisation saved them from penalisation at the hands of the market and allowed them to go on raising finance at a small spread to treasuries.

In recent months, Government-Sponsored Enterprises have come increasingly under the microscope, with agents beginning to speculate that their mortgage losses might undermine their solvency and leave the Treasury no option – given their large size – but to bail them out. GSEs were also finding it harder and harder to refinance themselves. The result was that year to date (to 2 September) the Fannie Mae share has tumbled almost 81.4% and that of Freddie Mac by 84.8%.

In July 2008, the US Treasury announced a rescue plan to prevent the two companies collapsing under a combined debt of over USD 4,900 billion and to try to restore agents' shaken confidence. The plan envisaged liquidity assistance and the review of certain aspects of their regulatory framework. But the markets were kept in suspense until early September, when the Treasury and the Federal Housing Finance Agency (FHFA) released a detailed plan for taking control of the two institutions. Its main measures, received warmly by the markets, are summarised below:

- The Treasury will purchase USD 1 billion in each company's preferred stock to keep their balance sheets in the black.

- The Treasury will purchase Fannie and Freddie mortgage-backed paper in the open market. Possible creation of an MBS purchasing facility through the Treasury's general fund held at the Federal Reserve Bank of New York.

- The companies' management passes into the hands of the FHFA. Shareholders' economic and voting rights are temporarily suspended.

- Stabilisation and subsequent managing down of the two companies' mortgage-backed securities portfolios (10% a year as of 2010) in order to reduce exposure .

- Extension of liquidity facilities to the end of next year.

Exhibit 2: The events of September 2008 that will change the face of the international financial system

The speed of events in September 2008 suggests that the financial crisis is not completely over and that more political action may be called for on the regulatory front. Below we offer a brief chronology of the main incidents to date:

- <u>7 September. Nationalisation of Freddie Mac and Fannie Mae</u>. After weeks of rumours concerning the solvency of these mortgage companies, the Treasury Department finally approved their "conservatorship" (see exhibit 1).

- <u>14 September. Bank of America agrees to buy Merrill Lynch</u>. After dropping out of talks for the possible purchase of Lehman, Bank of America acquires a controlling stake in Merrill Lynch for USD 44 billion, making it the country's largest banking group.

- <u>15 September. Lehman Brothers folds</u>. The heavy third-quarter losses reported and Standard & Poor's decision to put its credit rating under review launched its shares into free fall and sent the firm scrabbling around to find a bank-sector buyer. Its failure to do so meant Lehman had no option but to file for bankruptcy. The announcement was another blow to the market's confidence, since Lehman was America's fourth largest investment bank.

- 16 September. Collapse of AIG. AIG's share price plummeted and the New York State insurance regulators pumped in USD 20 billion on 15 September to cover its immediate cash needs. Finally, on 16 September, the Federal Reserve had to step in to save the world's biggest insurer with a loan of USD 85 billion collateralised by the company's own shares and those of its subsidiaries. The US Government will receive 79.9% of AIG's shares and will hold a veto over dividend payments on ordinary and preferred stock.

- 17-19 September. The Russian stock exchange closes its doors. The sharp run-down in prices at the start of the 17 September session prompted an order from the Federal Service for Financial Markets (FSFM) to suspend trading on all the country's main exchanges. Activity resumed on 19 September.

- 18 September. Lloyds TSB acquires HBOS. The UK's fifth bank (Lloyds TSB) confirmed that it would purchase the country's largest mortgage specialist (HBOS) for around GBP 12.20 billion. The scantly diversified HBOS had been hit full on by the crisis and was having trouble refinancing itself .

Authorities and supervisory agencies have reacted differently in each case, and with varying degrees of intensity. Leading central banks have been on hand with liquidity injections for the markets. Some of these interventions were a coordinated effort, like that of 18 September involving the banks of Canada, England, Japan and Switzerland, along with the European Central Bank and the Federal Reserve.

That same day (18 September), the US government announced a financial sector rescue plan, with a cost that could run to USD 700 billion. Under its terms, which are still to be revealed in detail, the state would undertake to buy mortgage-related assets off any institution with its headquarters in the United States. Leaving aside concerns about moral hazard associated to the nationalisation of struggling banks and the concept of "systemic enterprise", there appears to be a growing international consensus about the failure of the US model and its separation between investment and commercial banking. The conversion of the last two investment banking majors (Goldman Sachs and Morgan Stanley) into commercial banks, as approved on 22 September, could be the death knell in this respect.

Finally, regulators in the world's main economies have taken precautionary moves against short selling, to stop market instability getting further out of hand. Measures were of various types: in most cases, an express prohibition or restriction on short selling across the board or in a determined subset of shares; in others, the imposing of disclosure requirements on agents holding a particular short position in certain shares. The list to date reads approximately as follows:

1) Some countries have banned all short selling on sets of listed shares, usually financials. This is the case of the United States, United Kingdom, Germany, Ireland and Australia.

2) In other countries, the prohibition is confined to naked short sales (without arrangement of a securities loan). Among the countries that have imposed such a ban, or reminded the market of its existence, are Spain, Italy, France, Netherlands, Belgium, Switzerland and Hong Kong.

3) Finally, most countries have tightened their transparency rules on this kind of trade, requiring that short positions be disclosed to the market. In most cases, the disclosure threshold has been set at 0.25% of the issuer's outstanding capital.

The second and third quarters of 2008 have witnessed a sharp fall in share prices, increased volatility and a downturn in trading volumes...

The losses accumulated by main stock indices in the second quarter of 2008 ranged from 2% to 9% (see table 2). And the bear run has continued into the third-quarter period[8], after the difficulties at US investment banks. Year to date, losses run from the 23%- 27% of euro area indices to the 14% of the United States, with the UK and Japan in between at -18% and -22% respectively. Markets' implied volatility died down during the share price rally, then rose once more to slightly ahead of the recent-year average. Another keynote trend has been the declining turnover of main European and Asian markets compared to the vitality of the United States (see figure 1).

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

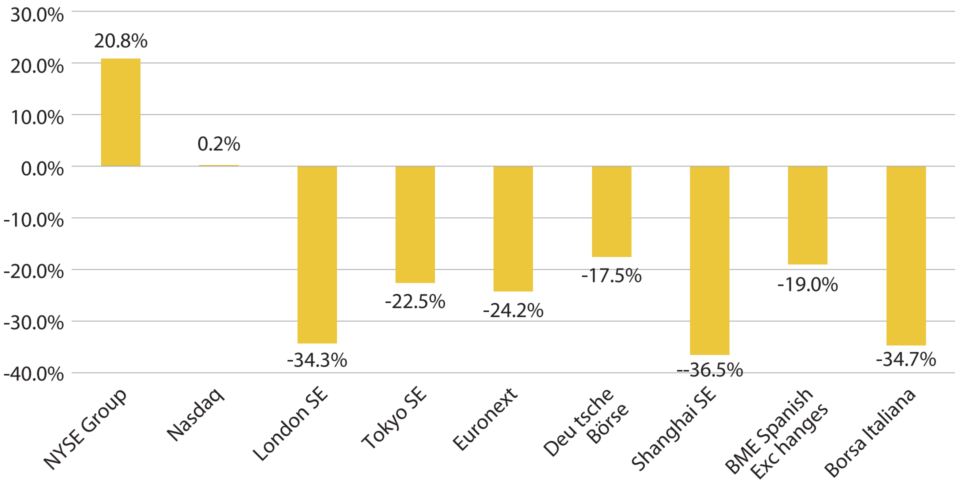
							III 08 (to 19 September)		
	2004	2005	2006	2007	I 08[2]	II 08[2]	%/prior quarter	%/Dec	% y/y[3]
World									
MSCI World	12.8	7.6	18.0	7.1	-9.5	-2.5	-8.3	-19.0	-20.1
Euro area									
Euro Stoxx 50	6.9	21.3	15.1	6.8	-17.5	-7.6	-3.0	-26.1	-25.5
Euronext 100	8.0	23.2	18.8	3.4	-16.2	-6.1	-4.2	-24.6	-25.7
Dax 30	7.3	27.1	22.0	22.3	-19.0	-1.8	-3.6	-23.3	-20.0
Cac 40	7.4	23.4	17.5	1.3	-16.2	-5.8	-2.5	-23.0	-24.0
Mib 30	16.9	13.3	17.5	-6.5	-17.3	-5.1	-7.0	-27.0	-29.7
Ibex 35	*17.4*	*18.2*	*31.8*	*7.3*	*-12.6*	-9.2	-4.1	-23.9	-19.9
United Kingdom									
FT 100	7.5	16.7	10.7	3.8	-11.7	-1.3	-5.6	-17.7	-17.4
United States									
Dow Jones	3.1	-0.6	16.3	6.4	-7.6	-7.4	0.3	-14.1	-17.3
S&P 500	9.0	3.0	13.6	3.5	-9.9	-3.2	-1.9	-14.5	-17.4
Nasdaq-Cpte	8.6	1.4	9.5	9.8	-14.1	0.6	-0.8	-14.3	-14.3
Japan									
Nikkei 225	7.6	40.2	6.9	-11.1	-18.2	7.6	-11.6	-22.1	-27.4
Topix	10.2	43.5	1.9	-12.2	-17.8	8.8	-13.0	-22.1	-26.7

Source: Datastream.
1. In local currency.
2. Change over previous quarter.
3. Year-on-year change to the reference date.

8 Data to 19 September.

Annual change in turnover on main world exchanges[1] (Jan-Aug 08 / Jan-Aug 07)

FIGURE 1



Source: World Federation of Exchanges.

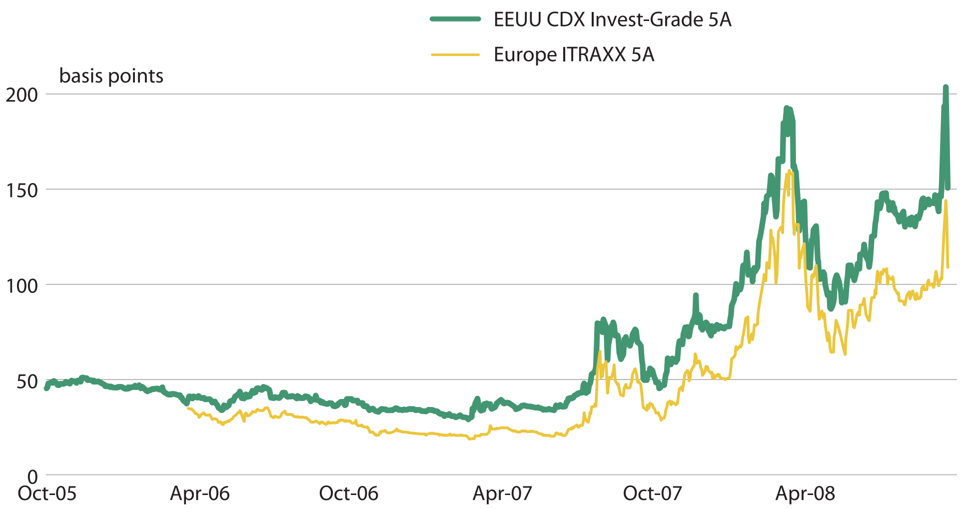
1 Exchanges appear in the figure by order of trading volumes between 1 January and 31 August 2008. Changes on the basis of amounts in local currency.

In fixed-income markets, financing tensions relaxed in the opening weeks of the second quarter, but since the end of May have been mounting once more in tune with agents' changing risk perceptions. The CDS[9] spreads of top-rated issuers now stand at around 150 bp in the United States and 110 bp in Europe (see figure 2). Financing constraints are apparent in the virtual shutdown of primary markets, especially for high-yield bonds and structured products, the little activity there is being mainly confined to conventional corporate bonds from investment grade issuers.

...a renewed increase in CDS spreads upkeep of issuance activity...

Credit risk indices

FIGURE 2



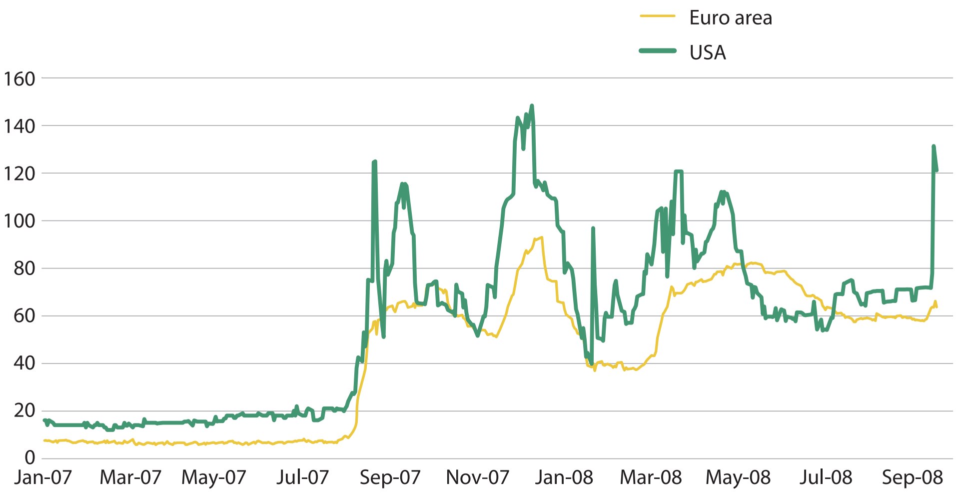
Source: Thomson Datastream. To 19 September.

9 Credit default swap.

...and continuing problems finding funds on the interbank market.

Problems persisted on interbank markets, where the spread between non-transferable deposits and repos continued at highs, especially in a US traumatised by recent events. In the three-month term, these spreads were hovering around 120 bp in the US and 64 bp in the euro area.

Three-month interbank rates: depo-repo spread FIGURE 3



Source: Thomson Datastream. To 19 September.

In currency markets, the euro stayed more or less flat against the dollar in the second quarter, while gaining new ground against the yen. The situation has since reversed, with the euro dropping 9.7% against the dollar this quarter to date[10] (to 1.42/euro) and 8.1% against the yen (to 153/euro).

2.2 National economic and financial performance

The Spanish economy slows more steeply as consumption and construction investment rein back sharply...

The deceleration of the Spanish economy that commenced towards end-2007 intensified in second-quarter 2008 with GDP growing just 0.1% vs. the prior quarter (1.8% in year-on-year terms). This sharper-than-expected slowdown owes to the adjustment in construction investment and consumption due to weaker household income and the declining value of financial and real estate assets. Disposable income is being squeezed between higher unemployment and inflation, while household wealth has been eroded by falling prices of both properties and equity investments.

A look at the second-quarter growth mix reveals the sluggish advance of households' final consumption spending (a quarterly 0.1%), along with a decline in gross fixed capital formation (a quarterly -1.7%) with all components, including equipment investment[11], contributing on the downside. Conversely, the growth contribution of the external sector turned positive in the period thanks to the more rapid moderation of imports versus exports.

10 Data to 19 September.
11 Equipment investment fell by 0.8% in the quarter, construction investment by 2.4% (its third consecutive decline) and investment in other products by 0.8%.

The Spanish economy has thus seen itself affected by the international slowdown and the continuing tensions on interbank and corporate bond markets. Simultaneously, its real estate sector is undergoing a sharp correction in a context of reduced availability of bank finance and deteriorating consumer and business confidence. Institutional forecasters have taken note and have substantially revised down their near-term growth figures for the Spanish economy, simultaneously rolling back the horizon for its recovery. In the September advance on its autumn report, the European Commission put Spain's full-year growth rate at 1.4% (versus the 2.2% forecasts of its spring report) accompanied by an inflation rate of 4.5% (3.8% previously).

..leading to a sizeable revise-down in growth forecasts for the next few quarters.

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

					European Commission			
	2004	2005	2006	2007	2008A	2008S	2009A	2009S
PGDP	**3.3**	**3.6**	**3.9**	**3.7**	**3.0**	**1.4[2] (2.2)**	**2.3**	**1.8**
Private consumption	4.2	4.2	3.8	3.5	2.7	2.2	2.4	1.9
Government consumption	6.3	5.5	4.8	4.9	5.0	5.0	4.9	4.3
Gross Fixed Capital Formation, of which:	5.1	6.9	6.8	5.3	3.0	1.4	0.6	-1.5
Equipment	5.1	9.2	10.4	10.0	5.9	4.3	5.8	1.5
Exports	4.2	2.6	5.1	4.9	4.7	4.0	4.6	4.9
Imports	9.6	7.7	8.3	6.2	5.2	4.5	4.2	3.0
Net exports (growth contribution, pp)	-1.7	-1.6	-1.2	-0.8	-0.5	-0.4	-0.1	0.3
Employment	2.7	3.2	3.2	3.0	2.1	1.3	1.7	0.7
Unemployment rate[1]	10.6	9.2	8.5	8.3	8.5	9.3	9.1	10.6
HICP	3.1	3.4	3.6	2.8	2.9	4.5[2](3.8)	2.7	2.6
Current account (% GDP)	-5.9	-7.5	-8.8	-10.0	-9.6	-11.0	-9.8	-11.2
General government (% GDP)	-0.3	1.0	1.8	2.2	1.2	0.6	0.6	0.0

Source: Ministry of Economy and Finance, National Statistics Office (INE) and European Commission.
S: Spring report forecasts A: Autumn report forecasts.
1 Eurostat definition.
2 In September, the European Commission revised its growth and inflation forecasts for a number of European economies (before publication of its autumn report). In Spain's case, it lowered its 2008 GDP growth forecast from 2.2% (spring report) to 1.4% and raised its inflation forecast from 3.8% to 4.5%.

Spain's financial institutions confront these uncertain times from a position of relative strength, since they have invested little in the products worst hit by the subprime debacle, in general do not operate the kind of vehicles (conduits, etc.) that the crisis has made unviable and maintain only limited exposure to leveraged buyouts and none whatsoever to monolines[12]. However, they still have serious challenges ahead of them:

Spanish financial institutions maintain a sound position, but with some major risks ahead:

- The impairment of a part of their loan books due to the rise in non-performing loans, though note that loan loss ratios continue low. Portfolio impairment originates in the increased financial pressure weighing on higher leveraged agents exposed to the business slowdown and rising interest rates.

(i) loan-book impairment due to the rise in non-performing loans, and

12 See the Banco de España Financial Stability Report of April 2008.

ii) the scant demand for paper in certain wholesale markets.

- Slack demand for paper in certain wholesale markets. Although the retail model dominates in the Spanish industry, part of banks' business growth in recent years has been financed through the wholesale markets using medium and long-dated instruments. But the recent turbulence has thinned the supply of funds to certain markets, forcing them to take money at shorter maturities. One manifestation of this has been higher net borrowings from the Eurosystem[13], though these still have little weight in sector balance sheets. Another is the step-up in the issuance of commercial paper.

Non-financial companies feel the effects of slowdown in their income statements...

The latest income statements of non-financial companies show some profits erosion due to the slowdown. As we can see from table 4, the aggregate net profits of non-financial listed companies came to €18.84 billion at the June 2008 close, 1.9% down on the equivalent period in 2007. Performance was notably uneven across sectors. The worst affected were construction and real estate which saw their combined profits slump from over €5.40 billion euros in first-half 2007 to €821 million red numbers one year later. Service sector profits also fell, though less dramatically (8% to €5.77 billion), while industrial firms reported earnings on a par with 2007. At the other extreme were the energy companies, which near doubled their profits in first-half 2008 (see table 4), thanks to the run-up in energy prices.

Earnings by sector: listed companies TABLE 4

	EBITDA[1]		EBIT[2]		Net profit	
Million euros	1H07	1H08	1H07	1H08	1H07	1H08
Energy	13,831.4	15,906.4	9,654.1	11,482.2	6,460.7	12,857.8
Industry	3,670.1	3,689.9	2,713.8	2,605.7	1,763.6	1,790.5
Construction and Real Estate	7,268.8	4,314.8	5,503.5	2,169.0	5,407.5	-821.0
Services	15,581.9	15,447.9	9,576.2	9,578.9	6,280.1	5,775.3
Adjustments	-1,940.8	-2,004.3	-1,378.2	-1,422.7	-710.2	-763.5
AGGREGATE TOTAL	**38,411.3**	**37,354.7**	**26,069.4**	**24,413.1**	**19,201.8**	**18,839.2**

Source: CNMV.
1 Earnings before interest and taxes.
2 Earnings before interest, taxes, depreciation and amortisation.

...in a framework of more stringent financing conditions.

The tougher financing conditions companies face is reflected in a dearth of fixed-income issues (see table 12) and a deceleration in bank finance which is also considerably more expensive. In effect, commercial lending growth in the Spanish banking sector dropped from around 30% at end-2006 to 18% approximately in first-half 2008. But here too, certain differences are apparent: lending to industry (ex. construction) is expanding at year-on-year rates exceeding those of some quarters of 2006 and 2007 (in annual terms). Conversely, the growth of lending to construction and real estate operators slowed from 34% to 12% and 51% to 17% respectively between December 2006 and March 2008. This more moderate credit growth has had a stabilising effect on companies' indebtedness (as a percentage of assets or equity), which had been climbing steadily higher with the years. By contrast, their financial charge ratios

13 Spanish credit institutions' net borrowing from the ECB rose from around €20 billion in September 2007 to more than €47 billion in June 2008. This translates as an increase in the Spanish bank's' share of total Eurosystem lending from 4%-5% to around 10%.

Gross debt by sector: listed companies TABLE 5

Million euros		2003	2004	2005	2006	2007	1H08[1]
Energy	Debt	54,159	54,776	58,586	59,191	69,172	73,119
	Debt/ Equity	0.98	1.06	0.93	0.89	0.78	0.77
	Debt/ EBITDA[2]	2.92	2.78	2.41	2.17	2.48	2.30
	EBIT[3]/ Interest expenses	2.06	3.52	4.02	4.65	4.10	4.62
Industry	Debt	10,507	10,397	12,760	15,684	13,312	14,899
	Debt/ Equity	0.61	0.69	0.75	0.78	0.61	0.68
	Debt/ EBITDA	1.98	1.91	2.07	2.07	1.82	2.02
	EBIT/ Interest expenses	3.99	6.64	6.5	5.71	5.93	5.09
Construction and Real estate[4]	Debt	24,552	32,293	48,324	111,000	138,933	140,364
	Debt/ Equity	1.59	1.93	2.16	3.1	3.08	3.17
	Debt/ EBITDA	5.91	5.71	6.51	11.52	10.83	16.27
	EBIT/ Interest expenses	3.38	2.83	2.79	2.04	1.17	0.52
Services	Debt	34,956	44,505	55,710	91,522	96,941	106,478
	Debt/ Equity	0.89	1.61	1.7	2.52	1.70	1.92
	Debt/ EBITDA	2.08	2.58	2.68	3.58	3.01	3.45
	EBIT/ Interest expenses	3.18	2.67	3.37	2.44	3.23	2.81
Adjustments[5]	Debt	-208	-5,566	-7,943	-11,199	-17,390	-23,245
AGGREGATE TOTAL[6]	Debt	123,966	136,405	167,438	266,198	300,967	311,614
	Debt/ Equity	1.01	1.26	1.27	1.71	1.48	1.51
	Debt/ EBITDA	2.8	2.9	2.9	3.86	3.96	4.17
	EBIT/ Interest expenses	2.63	3.33	3.82	3.29	3.03	2.49

Source: CNMV.

1 Debt/EBITDA based on annualised EBITDA for the first half of 2008.

2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

4 The sample includes Martinsa-Fadesa financial variables as at 31 March, excluding debt which figures at the amount corresponding to the date of application for insolvency proceedings.

5 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.

6 The table does not include 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.

have continued expanding as a result of rising interest rates and more subdued business earnings.

The aggregate debt of non-financial listed companies exceeded €311 billion in mid-2008, representing a leverage ratio of 1.51 times against the 1.48 times of end-2007. The largest risks are lodged with the companies whose debt has climbed fastest in recent years; that is those belonging to the construction and real estate sectors. Their debt was not only almost half that of all non-financial listed companies, it was also 3.2 times their equity as at June 2008. Further, sector EBIT was insufficient to cover the whole of their interest expenses. Companies in other sectors also recorded a rising debt total in first-half 2008, though without abandoning the comfort zone.

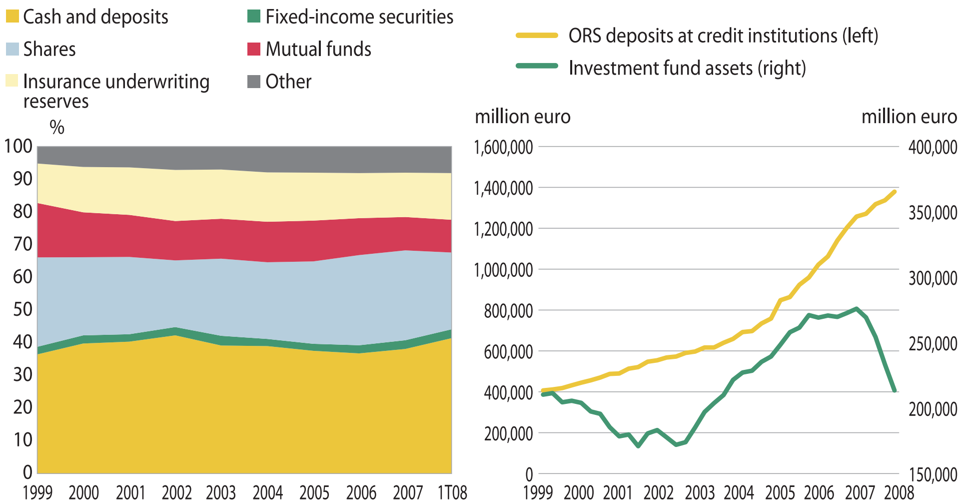
Retail investors let their natural conservatism lead them in the opening months of the year in a climate of growing distrust spurred by economic slowdown and more restrictive credit conditions. Financial information for first-half 2008[14] shows households investing less in financial assets and also reining back their

14 Financial Accounts of the Spanish Economy, Banco de España.

The climate of uncertainty has accentuated households' conservative leanings, as reflected in the gathering shift out of mutal funds into bank deposits.

aggregate borrowings. Specifically, financial asset purchases[15] amounted to 5.8% of GDP prolonging a downward trend in place uninterruptedly since the 10.9% of end-2006. Also, their choice of assets revealed a marked preference for more liquid, low-risk instruments, especially deposits (attracted by the aggressive pricing of financial institutions), contrasting with the outflows from mutual funds and listed and unlisted equity instruments, whose share in household portfolios receded sharply due to rising divestments and fast falling market prices .

Composition of household financial assets and performance of deposits vs. mutual funds FIGURE 4



Source: CNMV and Banco de España.

Debt ratios have stabilised while households have come under increased financial pressure due to higher interest rates and more moderately rising income.

Household borrowings have moved down significantly in the last few quarters as a result of the prevailing supply and demand conditions, from over 12% of GDP in

Investment funds subscriptions and redemptions (million euros) TABLE 6

	Subscriptions				Redemptions			
Category	**3Q07**	**4Q07**	**1Q08**	**2Q08**	**3Q07**	**4Q07**	**1Q08**	**2Q08**
Fixed income[1]	30,581	26,566	37,511	22,581.5	28,983	32,606	35,049	32,357.6
Balanced fxd income[2]	1,142	956	620	315.9	2,050	2,128	2,862	1,891.3
Balanced equity[3]	635	452	279	606.0	999	1,107	1,676	1,245.2
Spanish equity	483	943	415	344.4	1,429	1,683	1,980	733.9
Intern. equity[4]	3,215	2,971	1,867	1,545.7	5,242	5,834	6,457	2,735.1
Fxd-income guaranteed	2,191	2,981	3,286	2,983.5	1,897	1,712	2,086	1,867.5
Equity guaranteed	1,316	3,096	1,089	3,120.4	2,142	4,437	3,648	5,929.2
Global funds	3,046	3,543	1,949	1,953.1	5,906	6,942	8,276	5,302.1
Hedge funds[5]	62.2	243.0	164.1	77.8	0.45	2.1	50.9	26.5
Funds of hedge funds[5]	232.8	215.5	200.1	447.3	11.1	53.2	98.7	234.5
TOTAL	42,610.5	41,508.2	47,016.2	33,450.6	48,647.5	56,448.9	62,032.7	52,061,9

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

15 Cumulative four-quarter data.

2006 to 7.4% in the first quarter of 2008. And this has allowed debt ratios to stabilise to some extent. As with non-financial companies, the biggest risk lies with heavily indebted households who feel the full force of rising interest rates and the consequent increase in financial pressure.

2.3 Outlook

Leading institutions expect growth to recover in the course of 2009. The main risks for this scenario are inflationary pressures and the persistence of today's fragile markets.

The macro and financial forecasts issued by national and international institutions point to a further slowdown of the world economy in the next few quarters, with a chance that some or other developed country may enter recession, then a gradual recovery in the course of 2009. These projections, however, are hedged by uncertainties about the evolution of certain variables. The main estimate risks lie in the fragility of financial markets, the upkeep or intensifying of inflationary pressures and the ability of certain economies to cope with their imbalances (for instance, the US with its high current account deficit). The recent failures in the US investment banking industry and the difficulties of some credit institutions in the United Kingdom have aggravated a crisis of confidence whose macroeconomic consequences are hard to divine. And more of this instability could end up damaging the real economy by interfering with the normal course of the credit-investment-consumption cycle.

Nationally, an added risk is the downturn affecting the construction industry.

The economic-financial outlook for Spain has undoubtedly worsened since the last edition of this report, and the latest forecasts suggest the deceleration phase will last a few more quarters at least. The main downside risks for this scenario are no different from the general risks confronting the economy; namely, the prolongation of financial market turbulence and inflationary pressures. Nationally, an added risk is the downturn in construction and real estate, which is gaining speed and intensity and may end up cutting much deeper than expected. The upside for Spain is represented by the balance-sheet strength of its financial institutions, whose high provisions and capital offer a useful shield against the likely upswing in non-performing loans.

3 Spanish markets

3.1 Stock markets

After a modest rally in April and part of May, Spanish equities are again moving in negative territory...

Spanish stock indices closed both the second and third quarter[16] with sizeable losses after a modest rally lasting through April and most of May, registering year-to-date lows in both cases. The Ibex-35 posted levels unseen since 2006 as a result of worsening macroeconomic prospects and the deepening crisis of confidence on financial markets. Specifically, the select index dropped 9.2% in the second quarter

16 Data to 19 September.

and a further 4.1% to the closing date for this report, while small and medium cap stock indices fell even further (see table 7). Year to date, the Ibex-35 has lost almost 24% of its value, a performance comparable to that of other European bourses and significantly worse than American markets.

Performance of Spanish stock market indices (%) TABLE 7

	2004	2005	2006	2007	I-08[1]	II-08[1]	III 08 (to 19 September) % /prior quarter	% /Dec	% y/y
Ibex-35	17.4	18.2	31.8	7.3	-12.6	-9.2	-4.1	-23.9	-19.9
Madrid	18.7	20.6	34.5	5.6	-12.4	-9.8	-4.6	-24.6	-21.8
Ibex Medium Cap	25.1	37.1	42.1	-10.4	-9.8	-15.0	-8.5	-29.8	-35.7
Ibex Small Cap	22.4	42.5	54.4	-5.4	-13.6	-11.6	-18.9	-38.1	-44.6
FTSE Latibex All-Share	31.0	83.9	23.8	57.8	-10.5	14.5	-21.6	-19.7	-7.9
FTSE Latibex Top	28.1	77.9	18.2	33.7	-6.2	15.8	-18.7	-11.7	-7.0

Source: Thomson Datastream.
1 Change vs. prior quarter.

... with consumer goods, real estate, construction and finance bringing up the rear.

By sector, basic consumer goods and hotels, restaurants and catering were among the biggest losers out of the domestic demand contraction. The shares of real estate and construction firms also fell sharply, reflecting the downturn gripping their respective sectors. Finally, the price run-down affecting financial institution shares, which has levelled off in the third quarter, reflects a growing concern about sector earnings, which goes beyond the funding difficulties caused by the financial crisis to other questions like revenue erosion and the possible losses deriving from loan-book deterioration in today's climate of widespread economic weakness (see table 8).

Performance by sector of the Spanish stock market (%) TABLE 8

	2004	2005	2006	2007	I-08[1]	II-08[1]	III 08 (to 29 August) % /prior quarter	% /Dec	% y/y
Steel	25.3	20.7	81.2	-17.5	2.9	-12.8	-12.2	-21.2	-29.6
Water	31.2	18.1	55.6	-0.8	-13.0	-18.6	-16.5	-40.9	-38.8
Auto	0.6	21.8	171.1	0.0	-14.8	5.3	-9.4	-18.6	-30.1
Food and drink	1.3	10.4	14.6	10.8	-4.9	2.8	-7.5	-9.5	-13.2
Construction and construction materials	28.5	50.4	61.6	-12.0	-13.2	-10.5	-12.9	-32.3	-41.1
Basic consumption	40.0	19.0	12.9	6.9	0.0	-3.4	-3.3	-6.5	-12.2
Discretionary consumption	33.7	24.8	21.2	-7.7	-16.4	-19.4	4.5	-29.7	-38.3
Electricity	19.6	32.9	46.1	16.9	-9.4	-6.6	-0.9	-16.1	-15.3
Financial companies	10.1	22.5	35.5	-10.5	-12.6	-13.0	-4.9	-27.7	-31.7
Hotels	17.3	41.8	27.9	-25.0	-14.1	-19.5	-10.0	-37.8	-56.3
Real estate	29.5	58.9	100.4	-42.6	-7.0	-21.0	-19.9	-41.1	-52.8
Paper	30.2	13.7	36.6	-12.4	-12.5	-18.2	-4.3	-31.6	-48.1
Chemicals	19.2	176.1	-20.4	-58.4	-6.9	-22.2	-3.7	-30.3	-58.7
Tobacco	49.8	13.7	5.0	21.5	0.0	0.1	0.0	0.1	1.0
Telecommunications and media	16.7	-0.7	29.4	26.3	-17.2	-9.9	0.3	-25.2	-10.5
Utilities	21.5	27.2	42.0	18.5	-8.8	-6.7	-2.9	-17.4	-16.7

Source: Thomson Datastream. Monthly data, to 29 August.
1 Change vs. prior quarter.

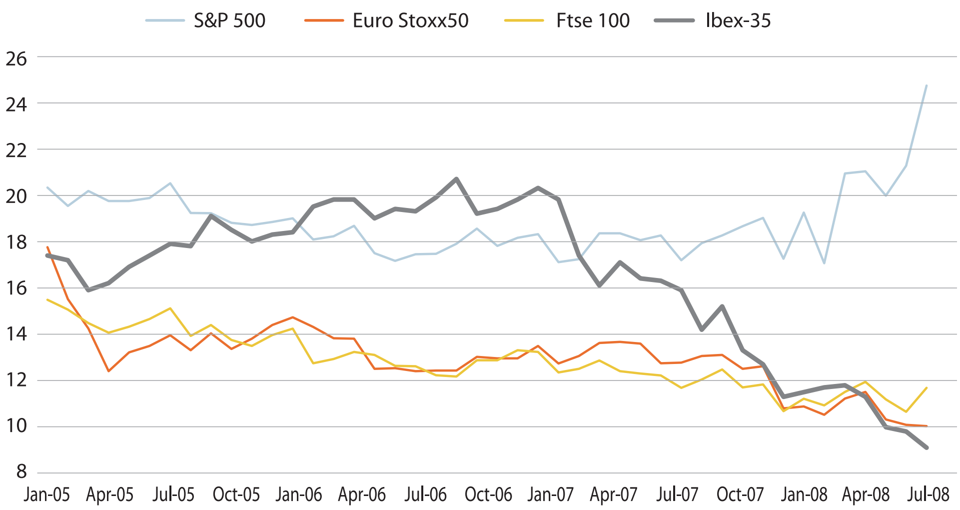
Today's volatile and falling markets have proved an encouragement to short selling, contemplated in Spanish regulation through two operating modalities: margin trading and securities loans[17]. The CNMV has reminded all members of official secondary markets about the ban and penalties affecting naked short selling, and has agreed that any individual or entity holding short positions in the equity securities of twenty listed financial institutions must declare all such positions in excess of 0.25% of their outstanding capital.

Falling markets have proved an incentive to naked short selling, ...

The price-earnings ratio (P/E) of Spanish shares, after stabilising somewhat in the year's middle months, has since fallen back to below 10 times. This is lower than the levels recorded by other European indices, where the downtrend has been less acute, and marks a reversal of the situation over most of 2007, when the multiple was equal to or higher than those of main US stock indices (between 16 and 20).

... and have helped drive down the price/earnings ratio (P/E) of Spanish shares.

Historical P/Es of international indices FIGURE 5



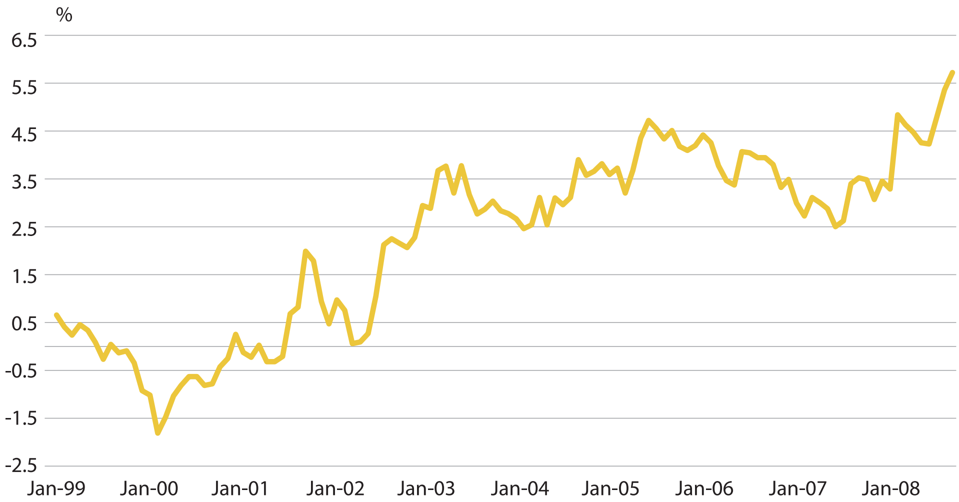
Source: Thomson Datastream. Monthly data, to 29 August.

The earnings yield gap (which reflects the return premium required to be invested in equity versus long-term government bonds) has headed sharply higher due to renewed price falls and, since end-July, a downward trend in bond yields. The latest estimates available put the yield gap above 5%, contrasting with the 2% average registered since 1999.

The uptrend in the earnings yield gap has accentuated further.

17 Margin trading in securities is a variant of the securities loan with its own specific regulation (Ministerial Order of 25 March 1991) which imposes a series of limitations on this practice though not on the general loan transactions provided for in article 36 of the Securities Markets Law. These limitations concern: the securities loaned under margin arrangement, which may only be used for spot sales (ruling out other options such as re-lending); the amount of the transaction, which may be no less than €1,200 euros per sale or buy order; transaction maturity, which may be no more than three months, and collateral requirements, which are set by stock exchange management companies (collateral deposit and execution are likewise regulated). The bilateral securities loans envisaged in article 36 of the Securities Markets Law have no limitations regarding the volume or use of loans, maturities or collateral arrangements, though they are subject to certain restrictions under other legal provisions.
In practice, these differences mean that securities loans under margin arrangement are typical of retail investors while bilateral loans are used by domestic and foreign institutional investors. For this reason, the volume of securities loans (that is, their outstanding balance) is significantly higher than that of margin loans, though note that use of both modalities has been rising sharply.

Earnings yield gap (Ibex 35) FIGURE 6

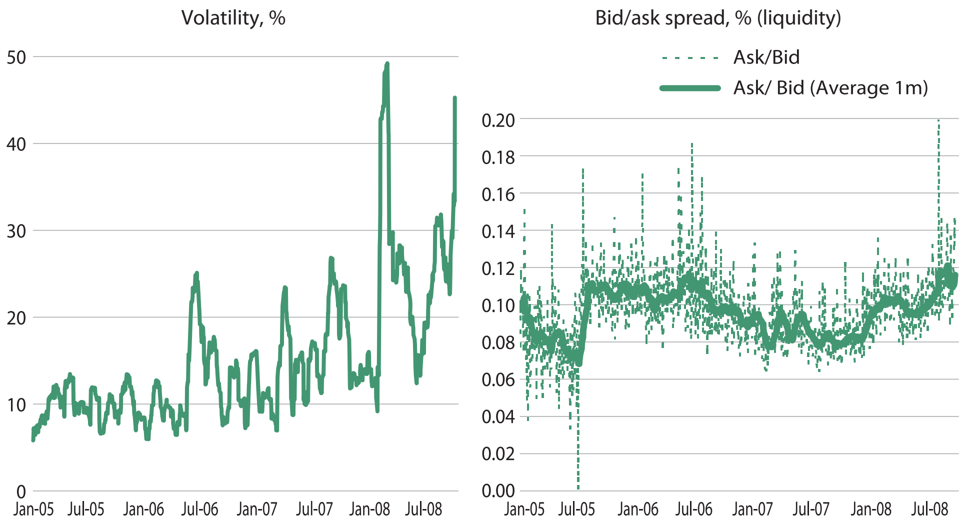


Source: Thomson Datastream and authors. Monthly data, to 1 September.

Market volatility and liquidity take a fresh turn for the worse after the respite of April-May.

Market volatility and liquidity conditions improved somewhat over April and May only to deteriorate once more. Volatility, tracing a rather more irregular course, has reached a second high of nearly 45%, just a little short of the January spike which carried it to 50%. Meantime, Ibex-35 liquidity conditions as measured by the bid-ask spread broke out of the improvement trend in place since mid-2006.

Historical volatility and bid/ask spread (Ibex 35) FIGURE 7



Source: Thomson Datastream and authors. Data to 19 September.

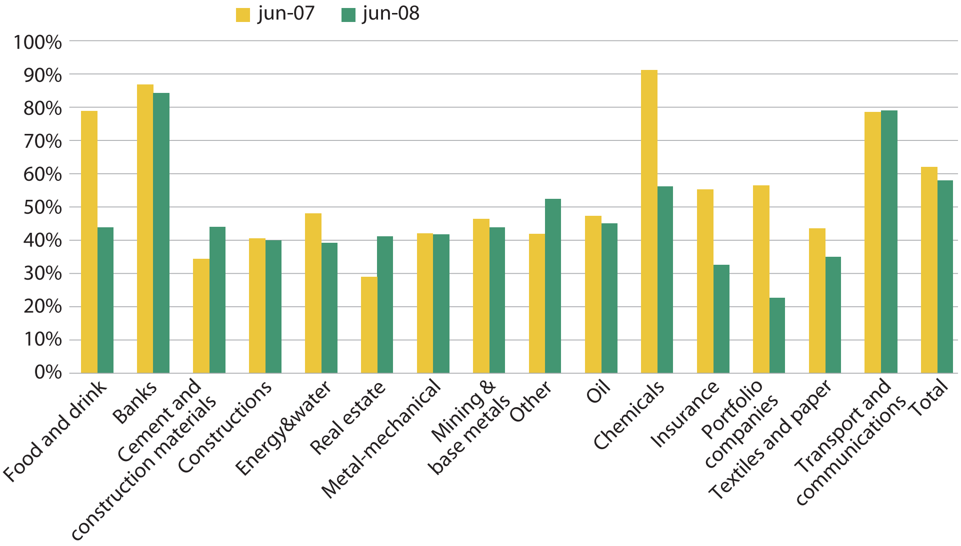
The free-float of the shares traded on the electronic market has continued to decline, though it remains in most cases within acceptable bounds.

An analysis of the aggregate free-float[18] of the companies trading on Spanish equity markets reveals that the percentage of capital changing hands freely is within acceptable levels, though with some decline appreciable over the last year. Specifically, the free-float of shares trading on the electronic market dropped from

18 The percentage of a company's capital that is freely traded on the market. Normally arrived at by subtracting treasury shares and significant holdings from the company's total capital.

62% to 58% between June 2007 and June 2008[19]. The sectors with the highest proportions of free-floating equity are the banks (84%) and transport and communications (79%), with the other extreme (below 40%) occupied by insurance, clothing and paper, and energy and water.

Free-float by sector on the electronic market FIGURE 8



Source: Thomson Datastream and authors.

There is nonetheless justification for some tightening of controls over the distribution of listed company shares.

Levels of free-float decreased across practically all the sectors analysed, most appreciably among food, chemicals and insurance firms, with only construction and real estate registering a meaningful increase (more than 0.10 percentage points). Among the ten largest listed companies, the twelve-month variation has been either negative or negligible. In any case, too little free-float means the market cannot function properly and is more exposed to price manipulation. It is also an obstacle to the correct valuation of listed securities. For these reasons, it is appropriate to strengthen controls over the distribution of listed company shares through amendments to the Stock Exchange Regulations.

Exhibit 3: Listing conditions vis à vis distribution of shares to the public in leading European markets

EU law requires that companies applying for stock market trading meet certain minimum requirements regarding capital and the distribution of share ownership. However it makes no similar demands once firms are admitted. Thus, article 43 of the Consolidated Admission and Reporting Directive (CARD) states that the foreseeable market capitalisation of the shares for which admission to official listing is sought or, if this cannot be assessed, the company's capital and reserves, including profit or loss, from the last financial year, must be at least one million euros. And article 48 of the same text requires that a sufficient number of shares must be distributed to the public in one or more Member States not later than the

19 Source: Thomson Datastream and authors.

time of admission, a condition deemed to be met when the shares so distributed represent at least 25% of subscribed capital.

CARD allows Member States some flexibility in applying these two conditions. This means they may, for instance, permit the admission to trading of firms with a lower capital, providing the shares are deemed to have a wide enough market. They can also impose higher thresholds of capitalisation in cases where the country in question is home to "another regulated, regularly operating, recognised open market" where the Directive threshold does apply. As regards share distribution to the public, the threshold may be set lower than 25% when, "in view of the large number of shares of the same class and the extent of their distribution to the public, the market will operate properly with a lower percentage".

Community legislation in this respect is completed by the Directive on Markets in Financial Instruments (MiFID), which takes on board the CARD requirements while leaving regulated markets free to set their own admission and listing rules, providing they are clearly expressed and transparently applied. Indeed most leading European markets have applied stricter capitalisation requirements than those envisaged in the CARD, though the difference is only truly substantial in the Italian case. Regarding ownership distribution, additional conditions refer to the determination of the 25% minimum. Though note that both the United Kingdom and NYSE Euronext establish most lasting requirements in this respect.

The conditions applying in main European markets are summarised below:

- United Kingdom. While the main continental EU countries have transposed admission and trading directives with few variations, leaving the fine-tuning to the markets themselves, the UK regulator has opted for an active approach. The FSA operates a different system of admission and listing requirements for firms of British (Primary List) and foreign (Secondary List) nationality. In both cases, it sets the capital threshold at GBP 700,000. On the question of share distribution, however, it stipulates that significant holdings (board members and equity stakes above 5%) may not compute towards the 25% and also makes this a permanent condition for British companies, while adhering to the CARD terms for foreign issuers.

- NYSE Euronext. This market requires a minimum capital of 5,000,000 euros and adopts the 25% threshold for distribution of shares to the public. It also goes further in imposing a minimum distribution threshold of 5% in order for companies to stay in trading.

- Borsa Italia. The admission threshold is set at a considerably higher 40,000,000 euros. Likewise, stringent conditions are imposed regarding the 25% threshold for distribution to the public, with director holdings and those over 2% excluded from the calculation. In both cases, these rules apply to admission only.

- Germany. The German exchange's capitalisation and distribution rules coincide with the minimum requirements of Community legislation.

In Spain, the regulator has made only minor adjustments to directive requirements. Royal Decree 1310/2005 implementing the admission conditions set out in the Securities Markets Law sets the foreseeable capitalisation threshold at 6,000,000 euros and adopts the CARD criteria for share distribution. The rules, in both cases, are for admission only, i.e., they cease to apply once firms are in trading.

The Spanish stock exchanges will shortly be developing their own internal rules. Meantime, the aforementioned RD 1310/2005 provides that Chapter V of the Securities Exchange Regulations will stay provisionally in force in all respects not at odds with the new legislation. These regulations, tracing to 1967, must be updated as soon as possible.

Falling prices and tougher financing conditions have taken a year-long toll on stock market turnover, with average daily trading fading progressively from the €6.18 billion of the first quarter to the €4.22 billion of the third.

...Market turmoil and worsening economic prospects have caused a climate of uncertainty that has borne down on stock market trading volumes.

Turnover in the Spanish stock market

TABLE 9

Million euros	2005	2006	2007	I 08	II 08	III 08[1]
All exchanges	**854,145**	**1,154,294**	**1,667,219**	**383,254**	**318,939**	**185,865**
Electronic market	847,664	1,146,390	1,658,019	380,935	317,051	184,862
Open outcry	5,899	5,318	1,154	44	25	15
of which SICAVs[2]	4,864	3,980	362	6	3	2
MAB[3]	-	1,814	6,985	1,966	1,646	883
Second Market	26	49	193	3	18	6
Latibex	557	723	868	306	199	99
Pro-memoria: non resident trading (% all exchanges)						
	57.1	58.2	61.6	na	na	na

Source: CNMV and Directorate-General of Trade and Investment.
1 Cumulative data to 31 August.
2 Open-end investment companies.
3 Alternative equity market. Data since the start of trading on 29 May 2006.
na: data not available on the closing date for this report.

Equity issues and public offerings[1]

TABLE 10

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

1 Issues filed with the CNMV. Initial and supplemental filings.
2 Available data: 31 August 2008.
3 Excluding amounts recorded in respect of cancelled transactions.
4 Including all transactions registered, whether or not they eventually went ahead.

The squeeze on borrowing and the unsettled state of markets also explain the dearth of new equity issues in the second and third quarter of the year. Capital increases in the period were a bare €400 million[20] while public offerings were entirely absent. Accordingly the main event was the first ever issue of savings bank *cuotas participativas*, conducted by CAM in the month of July (for a description of these instruments, see exhibit 4). A total of 50 million *cuotas* were placed on the market, equivalent to 7.5% of CAM's equity.

Exhibit 4: Savings bank *cuotas participativas*

Cuotas participativas[1] had their first mention in an aborted piece of legislation dating from 1988, then reappeared briefly in the guise of *cuotas asociativas* (subscribable only by *Cajas* themselves) in a 1998 issue by savings banks federation CECA. Subsequently, Financial Law 44/2002 amended Article 7 of Law 13/1985 to regulate these *cuotas*, a provision later repealed by Royal Decree 302/2004 on the Participation Quotas of Savings Banks. This new text brings them partly within the regime laid down for shares in the Public Limited Companies Law, while making their issuance subject to the Securities Markets Law and its implementing regulations.

Cuotas participativas are marketable securities that can only be issued by savings banks (*Cajas de Ahorro*) and represent monetary contributions of an indefinite duration. They are configured as a pure equity instrument (similar to shares though rather more complex) without voting rights attached and forming an integral part of the issuer's core capital, and may only be traded on an organised market.

In payment priority, they stand behind the *Caja*'s ordinary and subordinated creditors, and even the holders of preferred stock, with the same claim as the community welfare fund. *Cuotas* outstanding may not exceed 50% of the saving bank's equity. Direct or indirect control by a single investor is capped at 5% and any breach of this limit will result in the suspension of all economic rights.

Each *Caja* can choose to establish a *cuota*-holders syndicate to act as its interlocutor and to defend the interests of investors.

Cuotas may be applied to offset savings bank losses in the same proportion and order as the endowment fund and reserves and, in extreme cases, may be used up entirely in the process.

In order to issue *cuotas*, the savings bank must first calculate the economic or market value that will serve to establish the issue premium. For first-time issuers, this internal valuation must be cross checked against an external report in cases

1. Reform of Art. 7 of Law 13/1985 of 25 May on the investment ratios, own funds and reporting obligations of financial intermediaries, later implemented though Royal Decree 664/1990 of 25 May on savings bank participation quotas.

20 As against €21.69 billion in 2007 and 2.56 billion in 2006.

where the placement is via a public offering with a minimum of 20% going to qualified investors. The sale price of the *cuotas* will comprise their face value plus the issue premium, which will then be split between the issuer's general reserves (*Caja* funds) and the Reserve Fund of the *cuota*-holders (investors' funds). The issue of cuotas will thus give rise to three funds or account captions on the *Caja*'s balance sheet:

- Participation Fund, equal to the sum of *cuotas'* face value, and only distributable among *cuota*-holders in the event of an issue redemption or the liquidation of the savings bank.

- The *Cuota*-holders Reserve Fund, summing: a) a percentage of the *cuota* issue premium and b) subsequently, the part of the unrestricted surplus of *cuota*-holders that is not paid out in cash or apportioned to the Stabilisation Fund. This fund may only be distributed with the authorisation of the Banco de España.

- The Stabilisation Fund, a voluntary option which the *Caja* can fund out of *cuota*-holders' unrestricted surplus. Available for distribution to investors to smooth out excessive fluctuations in *cuota* remuneration.

The holders of *cuotas* enjoy the following economic rights:

- A variable, non cumulative remuneration from the institution's unrestricted surplus (net profit for the year) pro rata with their equity holding. The *Caja*'s General Assembly votes each year on the distribution of this surplus, which is freely available after meeting capital requirements .

- A pre-emptive right in the issue of new *cuotas*, unless the General Assembly votes to suspend it.

- Receipt of the corresponding net asset value in the event of *Caja* liquidation.

- The right to sell cuotas to the issuing *Caja* at their current market value in the event of a merger.

Cuota-holders' share in profit and loss is calculated as a proportion of *cuotas* outstanding over the *Caja*'s book equity plus the amount of *cuotas* outstanding. The formula for deciding the current share-out between *cuota*-holders and the rest (*Caja* general reserves and the community welfare fund) is based on total *cuota*-holder funds as a percentage of the *Caja*'s book equity. Hence if *cuota*-holders receive a proportionally greater share of cash remuneration than the community welfare fund, their weight in earnings distribution will progressively decline. Since this adjustment is a function of the *Caja*'s book equity rather than its market value, this declining weight may also signify a progressive dilution in *cuota*-holders' allocation of unrealised capital gains. In other words, they will gradually lose ownership of the unbooked portion of the *Caja*'s real value.

The fact that the return of *cuotas participativas* can be affected by discretionary actions of the *Cajas* makes them a more complex instrument than public limited company shares. Their market prices must therefore factor not only expectations of the *Caja*'s future earnings, but also the policy of cash payouts to *cuota*-holders and the community welfare fund decided discretionally by the General Assembly and any other of its decisions affecting capital gains not taken to the income statement. This is why CNMV instructed CAM to exercise maximum caution in placing its product among retail investors, including the requirement to run a suitability test on prospective buyers.

Note, however, that article 9.1.2 of the framework Royal Decree allows issuers to attenuate the effects of differences between the cash remuneration of *cuota*-holders and allocation to the community welfare fund on the formers' earnings share. Applying this adjustment mechanism, which was not used in the CAM operation, could reduce some of the complexities of *cuotas* and make them more like conventional shares, to the benefit of future issues.

3.2 Fixed-income markets

The June run-up in corporate and government bond rates following the ECB's change of stance has since given way to a period of stabilisation.

After the falls of the opening quarter, short-term rates in domestic markets resumed an upward course. This movement intensified in early June, as elsewhere in Europe, due to changing expectations for ECB monetary policy, since when both government and corporate bond yields have traced a relatively stable course. Interest rates rose across all maturities, albeit more sharply in the 12-month term and in private fixed-income instruments. In particular, the interest rates on commercial paper climbed well ahead of 5%.

Long bond yields headed lower after their second-quarter spike, accompanied by a sharply widening spread between governments and corporates...

In the medium and long segment, private fixed-income and government yields moved substantially higher in the second quarter of 2008. The increase was almost one full point in governments (depending on the term, see table 11) and around a point and a half for corporates, resulting in a widening of the spread. The more stable markets of July sent yields heading lower once more. Spreads

Yields of medium- and long-term government bonds and private fixed income[1] TABLE 11

%	Dec 05	Dec 06	Dec 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
Private fixed income[2]								
3 year	3.15	4.04	4.59	4.35	4.59	4.21	5.79	5.35
5 year	3.48	4.14	4.65	4.42	4.65	4.41	5.97	5.42
10 year	3.89	4.26	4.94	4.68	4.94	4.82	5.94	5.60
Government bonds								
3 year	2.91	3.74	4.07	4.09	4.07	3.50	4.69	4.18
5 year	3.06	3.77	4.14	4.20	4.14	3.62	4.67	4.21
10 year	3.36	3.81	4.27	4.37	4.27	3.87	4.80	4.51
Spread[3]								
3 year	25	30	52	26	52	71	110	117
5 year	42	37	51	22	51	79	130	121
10 year	54	45	67	31	67	94	114	109

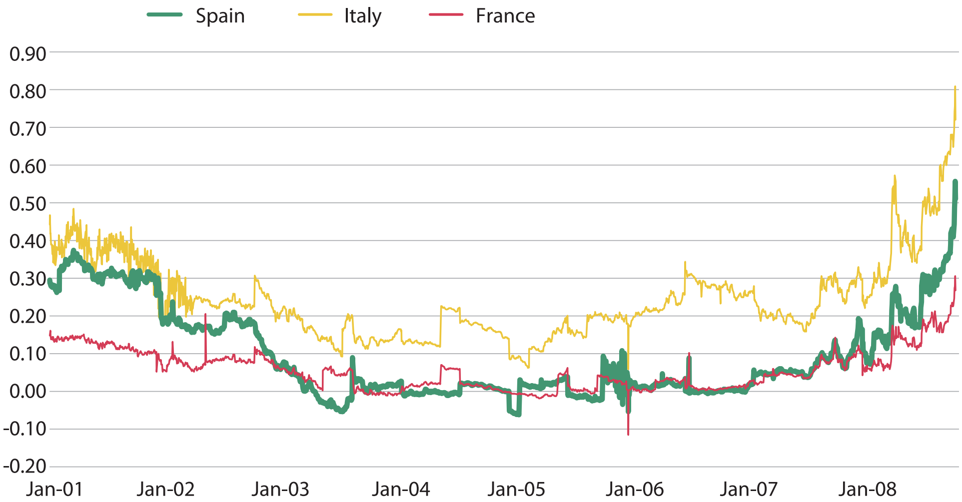
Source: Thomson Datastream y AIAF.
1 Average daily data. September data from 1/9 to 19/9.
2 Bonds and debentures in outright trades on the AIAF market.
3 In basis points

tightened slightly in response but remained at relative highs in comparison to recent years.

... and also between Spanish and German public debt.

The spread between the Spanish 10Y government and the German benchmark also widened further in the period. After holding round the zero mark in 2004, 2005 and 2006, the spread began to pull higher in mid-2007 and by mid-September 2008 was moving upwards of 50 points (see figure 9). This pattern, which has repeated with differing intensities throughout the euro area, reflects changed perceptions of the country risk associated to each economy.

Yield spread vs. the 10Y German benchmark FIGURE 9



Source: Thomson Datastream. Data to 19 September.

Perceptions of Spanish issuers' credit risk improved notably in April and a large part of May, taking credit spreads down by around 100 bp on average (based on 5-year CDS). From this point on, worsening economic conditions and bad debt problems sent risk premiums rising higher once more to a mid-September high of around 180 bp for the universe of Spanish issuers (see figure 10).

Fixed-income issues were thin on the ground, though with signs of recovery in concrete segments.

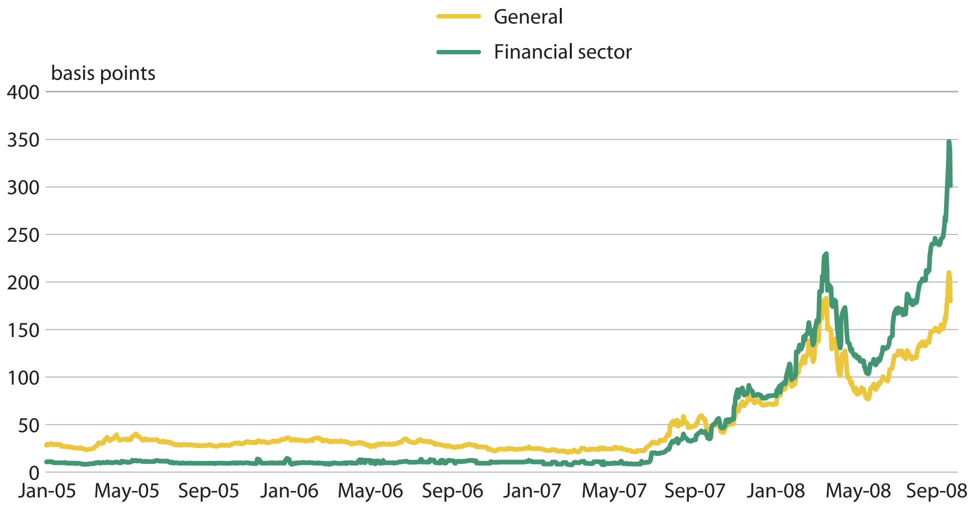
Financing constraints also left their mark on the number and amount of fixed-income issues registered with the CNMV (see table 12). Issuance volumes to date are trailing those of 2007 and are still mainly bunched in commercial paper (69% year to date[21]) and asset-backed securities (24%), though we can see a timid recovery in certain segments of the mortgage bond and bond and debentures markets[22]. Asset-backed securities were again mainly acquired by the originating entities, in order to stock up on assets for use as collateral against Eurosystem funds.

21 To 31 August.

22 In fact, a large portion of these entities' long-term fixed-income issues was placed abroad. Between 1 January and 31 July 2008, the face value of foreign sales of such long-term issues (bonds, debentures and asset-backed securities) summed over €29 billion, with the sum of short-term issuance even higher at over €33 billion euros.

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

FIGURE 10



Source: Thomson Datastream and authors. Data to 19 September.
1 Simple average.

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

TABLE 12

				2008		
	2005	2006	2007	I-08	II-08	III-08[3]
NUMBER OF ISSUES	**263**	**335**	**334**	**74**	**94**	**56**
Mortgage bonds	21	37	32	11	20	6
Territorial bonds	3	6	8	7	0	0
Non convertible bonds and debentures	93	115	79	7	22	18
Convertible/exchangeable bonds and debentures	4	1	0	0	0	0
Asset-backed securities	54	82	101	18	30	20
Commercial paper facilities	80	83	106	27	21	10
Securitised	3	3	3	0	1	0
Other commercial paper	77	80	103	27	20	10
Other fixed-income issues	1	0	3	0	0	0
Preference shares	7	11	5	4	1	2
FACE VALUE (million euros)	**414,254**	**523,131**	**648,757**	**117,527**	**134,468**	**67,779**
Mortgage bonds	35,560	44,250	24,696	1,250	10,120	1,610
Territorial bonds	1,775	5,150	5,060	1,020	0	0
Non convertible bonds and debentures	41,907	46,688	27,416	604	3,744	4,215
Convertible/exchangeable bonds and debentures	163	68	0	0	0	0
Asset-backed securities	69,044	91,608	141,627	28,657	34,386	14,336
Domestic tranche	63,908	85,100	141,627	28,657	34,386	14,336
International tranche	5,136	6,508	0	0	0	0
Commercial paper[2]	264,360	334,457	442,433	85,900	86,118	47,567
Securitised	2,768	1,993	465	133	48	48
Other commercial paper	261,592	332,464	441,969	85,767	86,070	47,519
Other fixed-income issues	89	0	7,300	0	0	0
Preference shares	1,356	911	225	96	100	50
Pro memoria:						
Subordinated issues	11,079	27,361	47,158	2,313	1,945	943
Covered issues	94,368	92,213	121,608	6,534	7,573	1,115

1 Incorporating issues admitted to trading without a prospectus being filed.
2 Figures for commercial paper issuance correspond to the amount placed.
3 Available data: 31 August 2008

4 Market agents

4.1 Investment vehicles

Financial collective investment schemes[23]

The collective investment industry has been hit hard by market turbulence and competition from the banks. Assets are down,...

Investors' mounting unease over the deteriorating national outlook and stock market turmoil plus fierce competition from financial institutions (see figure 4) are pressing down on the investment fund industry, which has been suffering a drain in assets and unitholders since 2007. In the first two quarters of 2008, the assets in collective investment schemes (CIS) fell by 16% to €214 billion, due to the large volume of net redemptions[24], most notably in global funds, fixed-income funds, international equity and guaranteed equity funds (see table 6). As in previous quarters, the only categories registering net inflows were guaranteed fixed income and, some way behind, the hedge fund collective in its pure and fund of hedge fund variants.

...unitholders are fewer, and ....

Unitholder numbers also declined sharply in the year's first half to a total of just over seven million, more than a million down on the figure for end-2007. Hardest hit in this case were fixed-income funds, which lost around 265,000 members, alongside global funds, guaranteed fixed income and balanced fixed income, with losses ranging from 134,000 to 151,000.

..returns have declined across almost all fund categories.

Fund returns are also being driven down by the fall in equity markets, which left them in negative territory in both the first and second quarter of 2008 (-2.0% and -0.6% for the industry as a whole). The decline was extensive to all fund categories except those with no or little exposure to equities, with losses naturally steepest in pure equity categories (national and international).

Note however that the Lehman Brothers failure had only a modest impact on Spanish CIS. As the CNMV assured in a press release on 17 September 2008, schemes' direct exposure to Lehman counterparty risk, whether through spot holdings or derivative products, was just 0.13% of their global assets (€300.2 million) at 31 July. Of this sum, 242.7 million fell to mutual funds (129) and 57.5 million to SICAVs (330). Half of the mutual funds affected were guaranteed or else specialised in short-term fixed-income products. Here again it is vital for unitholders to be properly informed in a spirit of maximum transparency.

Exhibit 5: Money-market funds: characteristics and recent performance

Money-market funds are the most conservative of mutual fund categories, whose unitholders accordingly seek to minimise the risk of loss. Although most of the money-market funds commercialised in Spain are still generating positive returns,

23 Although this term includes hedge funds and funds of hedge funds, we make no separate reference to them here, since they are the subject of their own sub-section further ahead.
24 Over €33.60 billion euros in the year's first half.

the subprime crisis has brought to light pockets of losses caused by the severe impairment of certain fund assets. There has also been an increase in the number of funds with monthly volatility exceeding 0.1%, the maximum reading the regulator allows[1] for a fund to be considered low-volatility.

Money-market funds are regulated in CNMV Circular 1/2007 on European Union statistical reporting requirements of CIS, which partially amends the earlier Circular 2/1998. They are defined as funds whose portfolio has a duration of under one year and which comply with the following conditions:

- Assets may not have a term to maturity exceeding 18 months except those with floating coupons linked to monetary indices and reviewed at least on an annual basis.

- No more than 40% of assets with a term to maturity exceeding one year.

- Spot holdings may not include either equity assets or derivatives whose underlier is not a fixed-income instrument.

Their conditions, as such, should bar money-market funds from holding significant percentages of long-dated assets or assets subject to credit risk, because this would push their volatility above the tolerance levels of their target public. The CNMV is accordingly considering a review of its Circular 1/2007 to tighten up risk requirements for CIS electing to include themselves in the money-market category. Specifically, the new definition will impose stricter limits on their holdings in assets without assured credit quality or with maturities longer than those of traditional money-market instruments.

Toughening the credit risk conditions of assets eligible for money-market fund investment may lead some schemes to switch to the fixed-income category, with the greater leeway it allows, in which case the number of money-market funds would reduce accordingly.

1. CNMV Circular 3/98.

Market uncertainty accentuates the low-risk profile of collective investment vehicles...

Agent unease has accentuated the low-risk profile that traditionally characterises Spanish collective investment schemes. Hence the weight of more conservative funds (fixed income and guaranteed) in total CIS assets has climbed steadily in the last year, from 66% to more than 71% in June 2008. The distribution of investments has changed in consequence, with a significant shift out of equity, down from 30% of fund assets in June 2007 to 19% one year later, to the benefit of fixed-income instruments (up from 63% to 71% of total fund assets in the same period). The growing weight of short-term fixed-income investment (over 16% of fund assets against 11% one year ago) has also pushed up the share of the domestic vs. the international portfolio.

As explained in the first report on “Securities markets and their agents: situation and outlook” published six months back, Spanish schemes’ exposure to the assets

Main investment fund variables[1]

TABLE 13

Number	2006	2007	2007 III	2007 IV	2008 I	2008 II
Total investment funds	**2,822**	**2,926**	**2,920**	**2,926**	**2,942**	**2,950**
Fixed income [2]	606	600	604	600	609	614
Balanced fixed income [3]	212	204	203	204	203	197
Balanced equity [4]	222	207	216	207	206	205
Spanish equity	118	123	121	123	123	122
International equity [5]	467	481	485	481	477	482
Guaranteed fixed-income	220	251	241	251	256	251
Guaranteed equity	559	590	589	590	592	601
Global funds	418					
	470	461	470	476	478	
Assets (million euros)						
Total investment funds	**270,406.3**	**255,040.9**	**269,907.0**	**255,040.9**	**234,043.9**	**214,251.8**
Fixed income [2]	116,511.9	113,234.1	118,489.4	113,234.1	116,544.0	107,349.4
Balanced fixed income [3]	15,314.5	13,011.9	14,142.3	13,011.9	10,551.0	8,488.5
Balanced equity [4]	10,149.2	8,848.0	9,753.4	8,848.0	6,811.6	5990.9
Spanish equity	10,416.4	7,839.4	8,353.3	7,839.4	5,369.9	4,584.1
International equity [5]	24,799.6	22,698.4	26,453.8	22,698.4	14,962.8	13,433.5
Guaranteed fixed-income	14,484.8	17,674.4	16,291.2	17,674.4	19,253.8	19,841.0
Guaranteed equity	44,796.6	42,042.1	43,365.6	42,042.1	38,521.4	36,633.2
Global funds	33,933.3	29,692.6	33,058.2	29,692.6	22,029.4	18,931.4
Shareholders						
Total investment funds	**8,637,781**	**8,053,049**	**8,467,203**	**8,053,049**	**7,420,379**	**7,023,292**
Fixed income [2]	2,960,879	2,763,442	2,869,191	2,763,442	2,620,712	2,498,451
Balanced fixed income [3]	524,827	493,786	511,811	493,786	434,935	359,904
Balanced equity [4]	357,013	331,214	359,667	331,214	289,184	263,926
Spanish equity	317,386	288,210	343,208	288,210	219,842	204,259
International equity [5]	1,258,426	1,089,868	1,184,871	1,089,868	942,733	907,345
Guaranteed fixed-income	497,540	549,108	540,637	549,108	552,116	542,500
Guaranteed equity	1,783,867	1,715,144	1,754,596	1,715,144	1,639,760	1,575,766
Global funds	937,843	822,277	903,222	822,277	721,097	671,141
Return[6] (%)						
Total investment funds	**5.59**	**2.73**	**-0.15**	**0.10**	**-1.96**	**-0.56**
Fixed income [2]	1.95	2.71	0.63	0.68	0.54	0.57
Balanced fixed income [3]	4.18	1.93	-0.16	0.18	-2.32	-1.29
Balanced equity [4]	10.34	2.69	-1.17	-0.40	-7.56	-2.91
Spanish equity	33.25	8.02	-2.42	2.53	-12.01	-7.66
International equity [5]	14.98	2.13	-2.80	-3.28	-15.06	-2.73
Guaranteed fixed-income	0.83	2.78	1.03	0.84	1.02	-0.01
Guaranteed equity	4.66	2.44	0.13	0.12	-2.56	-1.94
Global funds	4.01	1.47	-0.70	-0.38	-2.56	-0.29

1 Funds which have filed reserved statements (i.e. not including cases of winding-up or liquidation). Subscription and redemption figures are provided in table 5.
2 Includes: Short and long fixed-income, international fixed-income and money market funds.
3 Includes: Balanced fixed-income and balanced international fixed-income.
4 Includes: Balanced equity and balanced international equity.
5 Includes: Euro equity and international equity Europe, Japan, United States, emerging markets and others.
6 Annual return for 2006 and 2007 and non annualised quarterly return for each quarter of 2007 and 2008.

"contaminated" by the subprime crisis is limited in most cases. However the liquidity shortages provoked by the crisis have put new demands on managers vis à vis the complexity of portfolio management and the valuation of assets traded on less active markets. In any event, illiquid products are not too great a problem for the Spanish investment fund industry. In June 2008, the proportion of fund assets

...which maintain only a small share of assets in illiquid instruments.

held in instruments for which no quotes were given in the chosen price communicator stood at 8.4%, as against the 6.3% observed in December 2007 (see table 14). This increase had its origin in the wave of redemptions affecting CIS in the intervening period, which had to be attended via the sale of the most liquid assets in fund portfolios.

Private fixed-income holdings (June 08) TABLE 14

a) Volume and composition of the fixed-income portfolio

Type of asset	Volume (million euros)			% private fixed-income		
	Domestic	Foreign	Total	Domestic	Foreign	Total
Commercial paper	35,776.0	-	35,776.0	38.9%	-	38.9%
Mortgage bonds	3,236.4	-	3,236.4	3.5%	-	3.5%
Structured products	4,229.6	3,321.1	7,550.7	4.6%	3.6%	8.2%
Securitisation	9,847.5	6,813.4	16,660.9	10.7%	7.4%	18.1%
Other private fxd income	3,449.4	25,257.7	28,707.1	3.8%	27.5%	31.2%
TOTAL	56,538.9	35,392.2	91,931.1	61.5%	38.5%	100.0%

b) Percentage of assets with and without market quotation

Type of asset (% portfolio)	Bloomberg price	No Bloomberg price
Mortgage bonds	1.5%	-
Structured products	1.7%	1.8%
Securitisation	5.1%	2.8%
Other private fixed income	9.8%	3.8%
TOTAL	18.1%	8.4%

Source: CNMV.

Managers must make doubly sure they are applying appropriate valuation standards.

Finally, for as long as liquidity problems persist and redemptions go on growing, fund managers will have to take regular and careful checks on the depth of the financial markets where they operate, and be sure to apply appropriate standards in valuing less liquid instruments.

Real estate collective investment funds

Real estate funds are also losing assets...

Real estate funds served up a similar first-half performance to the rest of the collective investment industry. Fund assets closed the period at 8,753 million euros, 8% down on the peak levels of August 2007, with outflows reflecting the sharp rise in net redemptions. Fund returns remained in positive territory (0.9%) with some small erosion versus previous quarters.

Main real estate fund variables TABLE 15

					2007		2008	
	2004	2005	2006	2007	III	IV	I	II
FUNDS								
Number	7	7	9	9	10	9	9	9
Shareholders	86,369	118,857	150,304	145,510	151,916	145,510	144,197	141,037
Assets (million euros)	4,377.9	6,476.9	8,595.9	8,608.5	8,905	8,608.5	8,563.8	8,394.0
Return (%)	6.65	5.35	6.12	5.30	1.53	1.26	1.16	0.89
COMPANIES								
Number	2	6	8	9	9	9	8	8
Shareholders	121	256	749	843	661	843	839	839
Assets (million euros)	56.4	213.9	456.1	512.9	504.3	512.9	349.0	359.2

Source: CNMV.

The downturn in Spanish real estate is gradually making itself felt in this fund segment. Uncertainties about the scale and duration of the adjustment remain the biggest risk facing real estate funds. And here too the importance of appropriate valuation methodologies cannot be emphasised enough.

...and their performance remains contingent on the scale and duration of the real estate downturn.

Hedge funds

The youngest segment of the collective investment industry (taking in hedge funds and funds of hedge funds) has gone on expanding through successive waves of market turmoil, and was, along with fixed income, the only category to register net fund inflows in the first half of the year. The number of funds of hedge fund on the market reached an end-June total of 39, eight more than at the start of the year, while unitholder numbers practically doubled (see table 16) to more than 8,500. Fund assets, meantime, climbed from €1 billion to €1.39 billion in June 2008. Hedge funds also expanded, though to a rather modest extent, with numbers up to 23 in June (versus 21 at the 2007 close), 1,429 unitholders against the 1,335 of the year's outset and funds under management up from €446 to 604 million.

The hedge fund segment keeps up its expansion...

The rollout of hedge funds in Spain has coincided with a time of financial turbulence, and this has certainly got in the way of their normal development. Among the obstacles, we can cite market liquidity shortages and possible difficulties raising the finance they need to carry forward certain strategies. In effect, these are the main clouds hanging over the sector's near-term development.

... despite having to contend with a period of market turmoil that has complicated certain strategies.

Main hedge fund variables TABLE 16

	2006	2007				2008	
	IV	I	II	III	IV	I	II
Funds of hedge funds							
Number	2	2	22	30	31	38	39
Shareholders	2	26	1,456	3,142	3,950	5,488	8,582
Assets (million euros)	0.6	9.5	600.2	829.2	1,000.6	1,129.6	1,389.6
Return[1] (%)	ns	-0.55	1.08	-2.14	1.22	-2.31	2.20
Hedge funds							
Number	5	6	9	17	21	25	23
Shareholders	21	108	183	251	1,127	1,335	1,429
Assets (million euros)	24.4	119.9	152	210.2	445.8	546.3	603.9
Return[1] (%)	ns	1.26	3.18	-2.2	-1.31	-1.95	1.48

1 Non annualised quarterly return.
ns: not significant.

4.2 Investment firms

The investment firms exercising important financial market functions...

Investment firms perform a series of functions in regard to securities markets, including order processing and execution, issue placement, securities custody, portfolio management, CIS subscriptions and redemptions and investment guidance.

...have experienced a profits slide attributable to the downturn in market trading and the current listlessness of the CIS industry.

The decline in financial market turnover, the standstill in primary market issuance and the apathy gripping the investment fund industry conspired to drive down brokers' and broker-dealers' first-half earnings with respect to the same period in 2007.

The decline extends to both ordinary and extraordinary income lines, while firms have simultaneously been stepping up provisions...

Broker-dealers obtained aggregate pre-tax profits in 1H 2008[25] of €174.8 million, a long way short of the €458.2 million of first-half 2007 (see table 17). The causes, in this case, lie with lower inflows at both ordinary (fee income) and extraordinary income lines, along with increased provisioning in the period.

Of the three items making up gross income (net interest income, results on securities transactions and net fee income), only the first recorded year-on-year growth in broker-dealer income statements. Securities transactions generated over €11.5 million losses, while net fee income from recurrent business (provision of investment services) was 30% down on the 2007 figure at €307 million. By fee category, falls were steepest in order processing (17%), consistent with the downturn in equity market trading, and fund subscriptions and redemptions (39%), reflecting cooler demand for this kind of investment vehicle.

Aggregate income statement TABLE 17

	Broker-dealers			Brokers		
Thousand euros	1H 07	1H 08	% change	1H 07	1H 08	% change
I. INET INTEREST INCOME	56,641	78,974	39.4	6,884	5,973	-13.2
II. RESULT ON SECURITIES TRANSACTIONS	83,815	-11,556	-113.8	1,120	-1,363	-221.7
III. NET FEE INCOME	435,607	307,088	-29.5	121,236	81,830	-32.5
Fee income (=1 to 9)	573,211	435,954	-23.9	159,500	93,180	-41.6
1. Order processing and execution	365,738	302,749	-17.2	66,060	33,645	-49.1
2. Distribution and underwriting	31,775	25,057	-21.1	1,470	3,010	104.8
3. Securities custody and administration	12,344	11,142	-9.7	1,005	165	-83.6
4. Portfolio management	14,570	9,623	-34.0	14,534	11,916	-18.0
5. Design and advising	38,310	10,264	-73.2	1,119	1,534	37.1
6. Search and placement	9	9	0.0	0	0	-
7. Margin trading	11	7	-36.4	1	0	-
8. Fund subscriptions and redemptions	70,425	42,820	-39.2	37,345	15,609	-58.2
9. Others	40,029	34,283	-14.4	37,966	27,301	-28.1
Fee expense	137,604	128,866	-6.4	38,264	11,350	-70.3
IV. GROSS INCOME (=I+II+III)	576,063	374,506	-35.0	129,240	86,440	-33.1
10. Operating expenses	210,990	190,570	-9.7	75,796	72,225	-4.7
V. NET OPERATING INCOME (=IV-10)	365,073	183,936	-49.6	53,444	14,215	-73.4
11. Depreciation and other charges	10,538	30,947	193.7	4,322	4,139	-4.2
12. Other profit and loss	103,723	21,778	-79.0	15,040	6,409	-57.4
VI. PROFIT BEFORE TAXES (=V-11+12)	458,258	174,767	-61.9	64,162	16,485	-74.3
VII. NET PROFIT	458,258	174,767	-61.9	64,162	16,485	-74.3

Source: CNMV.

Brokers obtained aggregate pre-tax profits of €16.5 million compared to the €64.2 million of 1H 2007[26], an even steeper decline in percentage terms than their broker-dealer counterparts.

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

26 In the case of brokers, comparison of aggregate income statements versus 2007 is distorted by the large number of firms de-registering from the CNMV in 2008 (six to date, three definitively and the other three due to their transformation into broker-dealers). That said, the declines reported at various income lines can be ascribed to the same conditioning factors as those affecting broker-dealers

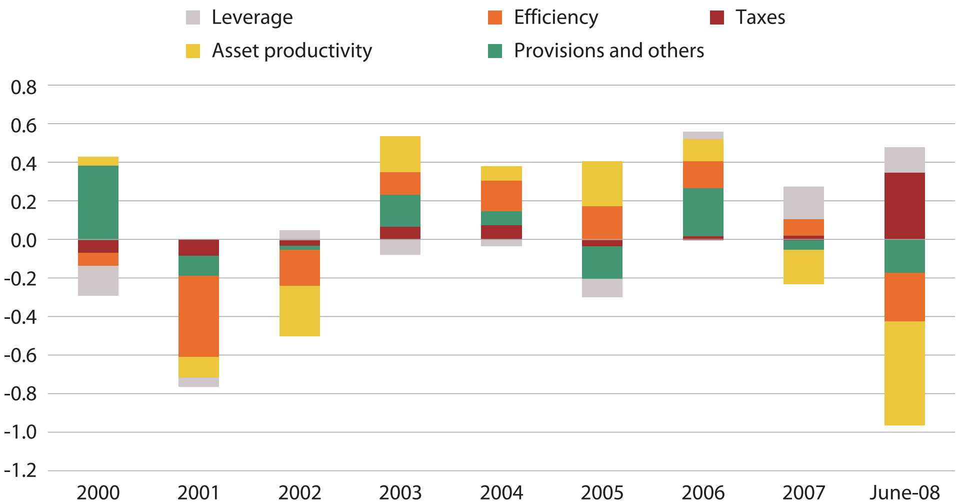
The gross income reported by this group was €86.4 million in June 2008 compared to €129.2 million in 2007 with fee income leading the downside. Brokers cannot engage in proprietary trading so register few inflows at remaining gross income lines. Fees from brokerage transactions (down 49% to €33.6 million) and fund subscriptions and redemptions (down 58% to €15.6 million) performed in line with those of broker-dealers, but brokers also took substantial cuts in other important items such as portfolio management fees.

Lower income plus lower extraordinaries reduced the pre-tax profits of the broker contingent, despite the buffer effect of a small decrease in operating expenses.

The result was to lower the aggregate return on equity (ROE) of these two groups below the levels of end-2007. Specifically, the aggregate ROE of broker-dealers and brokers closed the first-half period at 27.2% compared to the 44% of December 2007[27-28]. An analysis of the components driving this reduction[29] lays the blame on lower asset productivity, a decline in efficiency and a more subdued contribution at extraordinary income lines (see figure 11).

... significantly eroding the profitabilty ratios of both brokers and broker-dealers...

Breakdown of year-on-year change in ROE: brokers and broker-dealers FIGURE 11



Source: CNMV and authors.

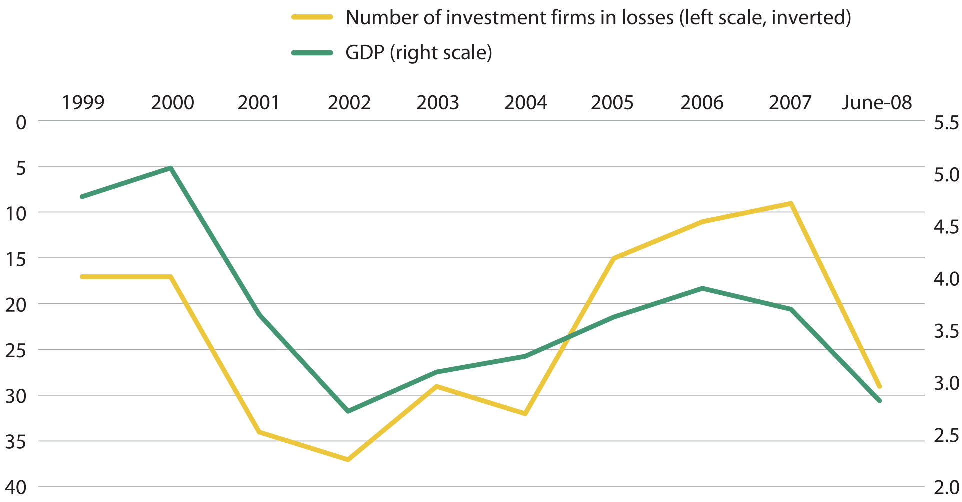
The lull in investment services business has pushed up the number of intermediaries posting (pre-tax) losses, though the proportion remains low. The number of broker-dealers in losses grew from two in December to nine in June, while the number of brokers moved up from 6 to 16 (none of them exchange members[30]). The combined losses of all these firms amounted to 13.5% of

...and an increase in the number of firms in losses, though the proportion remains low.

27 The ROE of broker-dealers dropped from 44% to 28% and that of brokers from 45% to 21%.
28 Results on an annual basis.
29 For a fuller description of change factors for ROE see the exhibit in the first report on "Securities markets and their agents" published in CNMV Bulletin I 2008.
30 Though they are not dealt with separately in this section, note that the number of portfolio managers reporting losses rose from 1 to 4, out of a total of 11.

aggregate earnings. Note however that one firm alone, now under restructuring, accounts for over three-quarters of this total, so though the numbers may be higher, the losses at each are reasonably small.

Number of investment firms in losses vs. GDP FIGURE 12

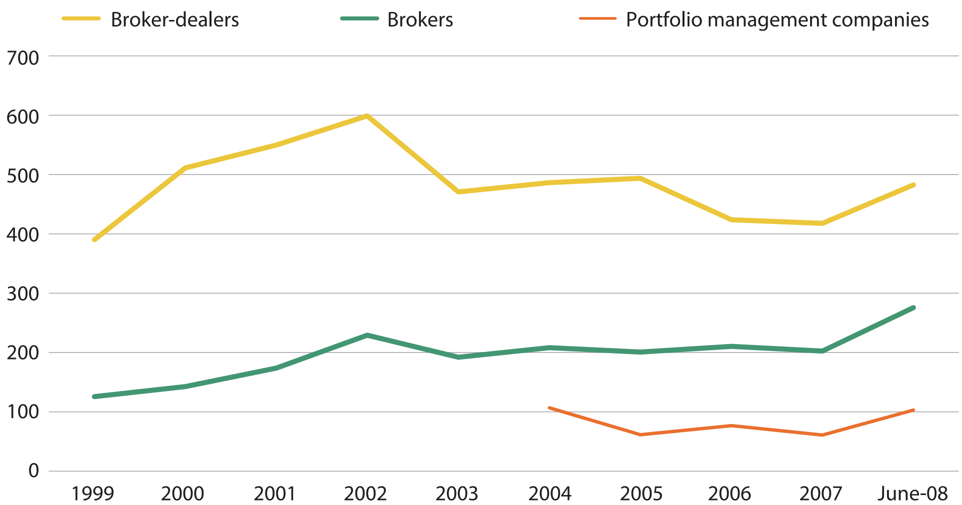


Source: CNMV and authors.

Despite earnings slippage, these financial intermediaries have improved their solvency via the build-up of reserves...

Investment firms remain comfortably compliant with capital adequacy requirements, with no sign for the moment of any knock-on impact from lower earnings. On the contrary, the sector as a whole has reported a significant build-up in reserves that will strengthen its already solid equity position. Hence June 2008 equity was almost six times higher than the minimum requirement in the case of broker-dealers (figure 13), and almost four times above in the case of brokers. Only two firms stood below this threshold (one broker-dealer and one broker) while the number running a tighter margin (less than 50%) actually fell from 14 to 8.

Investment firm capital adequacy FIGURE 13
(surplus of qualifying equity to the minimum requirement, %)



Source: CNMV and authors.

The next few quarters will presumably bring further deterioration in sector income statements. Not only are there no signs yet of a firm recovery in market trading volumes or the collective investment industry, but primary market activity is likely to remain subdued. However, the sector's many resources, including its high standards of capital adequacy, should carry it through the business slowdown in reasonable health. In the meantime, competition will continue to increase and corporate movements cannot be ruled out as firms struggle to position themselves ahead of the implementation of MiFID rules.

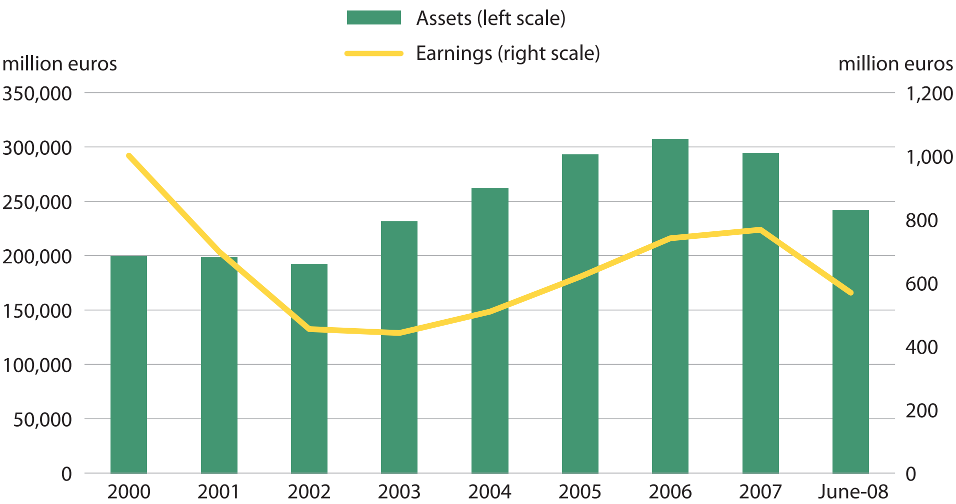
...so are better primed to negotiate this period of greater business difficulties.

4.3 Collective investment scheme management companies

Managers are bearing the brunt of the collective investment industry's current difficulties, since their income relies on fund management, subscriptions and redemptions. Aggregate figures for 1H 2008 reveal a sharp contraction in the assets under management in this kind of vehicle; €243 billion at the June close against almost €296 billion in December 2007. Managed assets have been trending lower since end-2006 and are now back to the levels of 2004.

The slowdown in the collective investment industry has made serious inroads into assets under management...

CIS management companies: Assets under management and pre-tax profits[1] FIGURE 14



Source: CNMV.
1. 2008 earnings on an annual basis.

This asset shrinkage has been paralleled by a deceleration in sector management fees which has made notable inroads into pre-tax profits: €572 million approximately in June 2008[31], compared to €791 million at the 2007 close. Declining profitability has been accompanied by an increase in the number of managers posting losses (31 of the 119 registered against just 19 in 2007). Over ten of them, additionally, have declared more or less persistent losses in the last few years.

... with the resulting deceleration of income driving more managers into losses.

31 Annual basis.

Aggregate profitability came down substantially in the first half of 2008...

The aggregate return on equity of CIS management companies dropped from 61% in 2007 to 35% in June 2008[32] with the decline in this case tracing to both lower profits and an increase in own funds (28%).

...and the outlook is not too bright.

The sector's prospects, moreover, are clouded for the moment by fierce competition from the banks to capture investors' savings plus the continuation of market turbulence.

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

Million euros	Pre-tax profits	ROE before taxes
2000	1,005.8	84
2001	701.7	63
2002	457.1	44
2003	445.3	44
2004	512.3	49
2005	622.8	53
2006	744.0	69
2007	790.6	61
June 08[1]	571.9	35

Source: CNMV.

1 Pre-tax profits and ROE on an annual basis.

CIS management companies: assets under management, management fee income and average fees TABLE 19

Million euros	Assets managed	Fund management fee income[2]	Average fund management fee (%)	Fee ratio (%)[1]
2000	200,832	2,869	1.429	63.46
2001	199,427	2,465	1.236	65.78
2002	192,982	2,259	1.171	72.70
2003	232,915	2,304	0.989	73.78
2004	263,369	2,672	1.015	73.58
2005	294,372	2,976	1.011	72.17
2006	308,476	3,281	1.063	71.55
2007	295,907	3,206	1.084	70.22
June 08	243,458	2,528	1.038	71.61

Source: CNMV.

1 Fee expense on fund distribution to fee income from fund management.

2 2008 data on an annual basis.

4.4 Other intermediaries: venture capital

A steady flow of new venture capital entities onto the CNMV register...

A total of 40 venture capital entities (VCEs) joined the CNMV register between end-2007 and 11 August 2008, breaking down 19 companies, 16 funds and 5 venture capital fund managers. And the fact that entries to this voluntary register show no signs of slackening is due in no small measure to the enactment of Law 25/2005 of 24 November regulating venture capital entities and their management companies[33].

32 Annual basis.

33 This law allows for a speedier registration process in the hands of the CNMV. Prior to its enactment, numerous entities engaging in venture capital activities (VCEs) were not entered in the corresponding register. The new

Movements in the VCE register in 2008

TABLE 20

	Situation at 31/12/2007	Entries	Retirals	Situation at 11/08/2008
Entities	**276**	**40**	**4**	**312**
Venture capital funds	76	16	1	91
Venture capital companies	134	19	2	151
Venture capital fund managers	66	5	1	70

Source: CNMV.

According to the CNMV's annual statistics on registered entities, the 2007 assets of venture capital funds totalled €2.72 billion, almost 24% more than in 2006. The breakdown of this sum by type of participant varied little in the year, with the savings banks conserving their lead (22% of assets in 2007 and 25% in 2006) followed by other financial companies, excluding banks (around 18% in both years) and public authorities and non-financial companies (12% and 11% respectively). The assets of first-time registrants in 2007 amounted to €208 million, with some changes in ownership distribution. Specifically, savings banks represented a significantly lower 11.5%, overtaken by the 35% of other financial companies, and collective investment schemes, whose end-2007[34] share of 18% stood in stark contrast to the 0.1% and 2% of 2005 and 2006 respectively.

24% growth in venture capital fund assets in 2007.

Capital risk entities: assets by type of investor

TABLE 21

	VCF		VCC	
Euros	2006	2007	2006	2007
Natural persons				
Residents	208,347,489	237,555,822	103,626,290	181,607,647
Non residents	214,600	182,600	873,485	1,045,943
Legal persons				
Banks	86,242,621	133,527,409	1,130,947,568	1,026,033,294
Savings banks	556,817,092	603,358,750	212,226,190	307,171,769
Pension funds	167,671,947	231,897,998	24,727,335	26,623,865
Insurance companies	42,182,043	66,925,990	47,160,597	17,531,003
Brokers and broker-dealers	-	34,530	5,665,232	3,224,672
CIS	1,866,469	58,859,119	41,507,138	40,439,372
Other financial companies	385,658,361	503,927,684	426,815,331	684,285,762
Non-financial companies	250,210,163	275,802,833	1,919,404,896	2,571,148,263
Public authorities	276,565,233	332,433,991	94,596,270	134,476,084
Academic institutions	-	-	1,860,291	1,217,083
Securities markets	-	-	-	621,683
Others	213,863,034	224,900,047	124,443,428	290,365,431
Available realised capital gains	-	16,916,725	-	-

Source: CNMV.

Venture capital companies (VCCs) had a combined share capital of €5.28 billion in 2007, 28% up on the previous year, of which around half was subscribed by non-

Venture capital companies grow their capital by 28%.

law addresses this problem by establishing a more simplified form of VCE; a more flexible investment vehicle with less protectionist rules for qualified investors. Now, venture capital entities can invest in other VCEs or acquire listed companies to withdraw them from trading. The former option has encouraged the creation of venture capital funds specialising in other VCEs and targeted mainly on the retail public.

34 CIS began investing in VCEs following enactment of Regulation 1309/2005 which expands their choice of investment instruments.

financial companies (49% versus 46% in 2006). Banks remained important players, though their share dropped from 27% to 19%, leaving them a shorter distance ahead of other financial companies, up from 10% in 2006 to 13% in 2007. Savings banks, finally, held around 5% in both years. New VCCs incorporated in 2007 had a total capital of €1.19 billion, breaking down 60% for the banks, 14% for other financial companies, 13% for non-financial companies and 5% for the savings banks. One salient development in both VCFs and VCCs is the dwindling share of pension funds, which held only 0.25% in new-start operators compared to almost 4% among the rest. These percentages will presumably rise in 2008 following the approval of Royal Decree 1684/2007 of 14 December amending pension scheme and pension fund regulations, which gives them more flexible rules for investing in VCEs.

Total VCE assets stood at € 9.76 billion in 2007, of which €6.05 billion were invested in venture capital activities.

VCEs' total assets rose by 26% in 2007 to €9.76 billion euros, with 71% corresponding to companies and the other 29% to funds. The increase traced almost entirely to the assets of new VCEs joining the registers in 2007. At end 2007, entities had €6.05 billion of these assets invested in venture capital activities, compared to just €3.46 billion in 2006. The difference here is because in 2006 they held 18% of their total assets in listed securities, especially repos and government bonds. Again, VCCs account for the lion's share of invested capital; 76% against the 24% of VCFs. This trend was yet more marked among entities registering in 2007, when the split was 94% to 6% in favour of VCCs. Invested capital/total assets rose substantially among the VCC contingent, from 50% in 2006 to more than 67% in 2007. Among VCFs, the rise was a less striking 43% to 50%. Sector leverage eased somewhat in 2007, with the ratio of long-term debt to total liabilities and equity dropping from 5.26% to 2.51%. However these data mask a divergent performance, in that VCCs reduced their leverage from 7.16% to 3.41% while VCFs increased it slightly from 0.17% to 0.35%. Among first-time registrants these ratios were a lower 0.80% for VCCs and zero for VCFs.

ASCRI data for first-half 2008 point to a contraction in sector investment...

Recent data from the industry association ASCRI (including a representative sample of VCEs operating in Spain) reveal a significant drop in sector investment to €1.19 billion in 1H 2008 from €2.02 billion one year before. This decline could reflect the relative scarcity of bank finance, which would translate eventually as a decline in the number of leveraged transactions. In fact, the first six months of 2008 brought only 13 leveraged transactions, a long way short of the 22 concluded to mid-year 2007.

... though the number of transactions has increased.

On the upside, the total number of industry transactions was a little higher than in first-half 2007; a total of 360 as opposed to 300 albeit on a significantly smaller scale. Only two 2008 transactions so far have involved over €100 million investment (Gamesa Solar by First Reserve and Unión Radio by 3i), compared to the five major deals executed in 2007.

Bank credit constraints get in the way of leveraged transactions (LBOs)...

Bank credit constraints tended to favour capital search, with the result that VCEs raised €1.70 billion against €1.31 million in first-half 2007 and €1.56 billion in the same period of 2006.

Divestment statistics too reflect the market mood. Aware that the time was not right, venture capital entities closed fewer sales in 1H 2008, for a total of €328 million compared to €716 million in the first six months of 2007.

Everything suggests that industry investment will go on slowing this year, in view of the unsupportive climate of financial markets. In particular, credit constraints will get in the way of leveraged operations, requiring VCEs to put in more of their own capital. That said, the lesser importance of LBOs in the Spanish context gives local entities a rather better outlook than their European counterparts.

...which in any case are less important in the Spanish market.

5 Initiatives of financial supervisors in response to the subprime crisis

In summer 2007, international markets entered a turbulent period that has persisted to this day, disrupting the world of finance and the progress of the real economy. Lasting distortion in certain wholesale bond markets, the dearth of interbank activity, the worsening expectations being discounted in share prices and the chastisement of credit risk are just some of the more visible symptoms of the crisis.

Market turmoil has prompted a global debate around the regulatory framework...

These developments are largely a consequence of the fading confidence of market participants, which is linked in turn to a lack of transparency on what are frequently essential factors for financial decision-making as well as flaws in the incentive system applying to certain key agents.

In this respect, the crisis has laid bare some shortcomings in the regulatory framework for financial activity, and prompted a series of initiatives to set them to rights; among them, the initiatives drawn up by the Financial Stability Forum (FSF) at the request of the G7 (see exhibit 6), which are currently under discussion in various international forums. In this section, we look at some of the main points being debated among securities supervisors and some of the steps taken by the CNMV.

... and the launch of reform initiatives like those proposed by the FSF.

Exhibit 6: Financial Stability Forum recommendations to improve institutional and market resilience

In October 2007, the finance ministers and central bank governors of the G7 countries asked the Financial Stability Forum (FSF) for an analysis of the causes and weaknesses underlying the recent financial turmoil and recommendations on how to enhance the resilience of both markets and institutions. In mid April, the FSF published a report with the results of this analysis and a set of recommendations which included the following:

- **Strengthened prudential oversight of capital, liquidity and risk management**. Basel II is viewed as the appropriate framework for actions under this head, and priority should go to implementing and strengthening its component measures. There is also a need to review supervisory liquidity guidelines and tighten up the prudential framework for securitisation and off-balance-sheet activities.

- **Enhanced transparency and valuation**. A block of measures is proposed to restore agents' confidence in the markets focusing on the qualitative and quantitative information that participants disclose on their risk exposure, valuation methods, off-balance-sheet vehicles, etc. Other proposals touch on accounting and valuation practices and the quality of financial reporting vis à vis certain instruments. It is seen as vital to improve transparency in securitisation processes and markets.

- **Changes in the role and uses of credit ratings.** Rating agencies should stake steps to improve the quality of the rating process and the management of conflicts of interest. They should also provide differentiated ratings on structured products and improve their analyses of the underlying assets. Finally, measures are proposed to help investors and regulators make better use of rating information.

- **Strengthening the authorities' responsiveness to risk**. Supervisors should make more effort to translate their risk analyses into action in time to have a mitigating effect, and to improve information exchange and cooperation among different authorities. International institutions should enhance the speed, prioritisation and coordination of their policy development work.

- **Robust arrangements for dealing with stress in the financial system**. Central bank operational frameworks should be sufficiently flexible to deal with extraordinary situations. Agreements are needed to help the authorities deal better with weak or failing banks (division of responsibilities between national authorities, cross-border banks, deposit guarantee schemes, etc.).

The FSF will facilitate coordination of these initiatives and oversee their timely implementation, and will report on progress at regular intervals.

5.1 Transparency

Greater transparency on issuers, products and markets is a vital means to restore confidence.

Adequate transparency is one of the surest ways to alleviate crises of confidence. Providing it requires a robust effort in three key respects: transparency on the financial situation of issuers or borrowers, transparency regarding the nature of financial products and transparency on the real supply and demand conditions prevailing on the markets[35]:

5.1.1 Issuer transparency

Exposure to complex products and vehicles should be brought into the open...

There are in fact two main dimensions to this problem: the information available on participants' exposure to the complex products and investment vehicles embroiled in the subprime crisis and the difficulties of valuing products that are traded on less liquid markets.

35 For further information, see the CNMV Monograph 31 "The subprime crisis: some lessons for financial supervisors", authored by Fernando Restoy.

In the past few months, financial institutions have been recognising losses incurred through investment in complex products affected by the market turmoil. And the consensus is that losses due to impairment of assets linked directly to subprime mortgage paper are now more or less out in the open. However, periodic financial reporting has done little to facilitate the *ex ante* identification of materialised risks by investors and even supervisors. The full implementation of Basel II and a more strictly controlled and, perhaps, precise application of international financial reporting standards regarding the consolidation of investment vehicles are the main corrective tools at the system's disposal. At the same time, the IASB, which draws up international accounting standards, is working on a review of itemisation rules, forcing entities to be more explicit about the risks held in non-consolidated vehicles.

... and more rigorous criteria brought to bear on the accounting valuation of assets and liabilities, based on fair value measurement.

As to asset valuation, the liquidity crisis has shown up certain weaknesses in the applicable norms. These oblige entities to state part of their financial assets – particularly those held in trading portfolios – at a fair-value price, that is, the market price or a proxy arrived at using different valuation techniques. Despite the abnormal performance of certain markets, except in exceptional cases lacking a valid benchmark (forced sales, for instance), observed prices are still the best guide to determine how marketable securities are contributing to the balance-sheet – the ultimate end of any financial reporting rules.

A number of agencies are looking at ways to improve the application of current valuation standards.

In any case, the market appears to be looking for guidance on the standards to apply at times like the present – market prices or valuation techniques and, in the latter case, using exactly what inputs. All these points are currently being considered by the IASB. At the same time, the Committee of European Securities Regulators (CESR), after public consultation, has published guidelines[36] to assist listed companies in applying current valuation standards and in knowing what information they must itemise on the valuation procedures used for each asset type.

And this is also a priority concern for the CNMV in its work with listed and supervisee companies.

Spanish entities have suffered next to no losses from exposure to subprime products, and also include investment vehicles in their consolidated accounts as prescribed by international financial reporting standards. The CNMV, even so, is keeping a close watch on compliance with fair-value measurement standards, particularly the way issuers and other companies under its supervision are reflecting market price movements in their asset value.

Valuation methodologies are of course no less vital for other assets such as real estate. In July this year, the CNMV published guidelines for listed real estate and appraisal firms, after several meetings with the sector, to ensure they follow the correct valuation procedures for this type of asset.

5.1.2 Product transparency

More standardised transparency requirements regarding the nature of financial products

Financial innovation and, in particular, the development of structured product markets have brought improvements in efficiency by favouring credit risk

36 "Consultation paper - CESR statement on fair value measurement and related disclosures of financial instruments in illiquid markets" Reference: [08-437].

distribution and a wider choice of investment, while opening up new funding sources for the banks.

However the speed of this process – fuelled at times by regulatory arbitrage – has engendered highly complex products that may be hard to value, causing liquidity problems in the markets they are traded on.

... and improved information on the securitisation process.

This calls for a combined effort by regulators, issuers and intermediaries to enhance the transparency of this kind of product. In fact, this is an area where self-regulation could come into its own. By working towards a greater standardisation of its products, the industry could make them easier to understand and by this means boost their liquidity.

The CNMV has called for a series of improvements in issue prospectuses and is designing a periodic public information system for asset-backed securities.

The FSF recommends that regulators take steps to improve the transparency of the asset securitisation process. The CNMV has already moved in this direction by demanding fuller and clearer information in the issue prospectuses of asset-backed securities, including a declaration stating whether the asset originator intends to subscribe for the issue wholly or in part. It has also taken care to ensure that the prices of issues subscribed entirely by the originator – to use as collateral, for instance, for Eurosystem loans – do not serve as a valuation benchmark for similar instruments. Finally, the CNMV is working on a periodic disclosure system for securitisation funds that will offer improved information on securitised assets throughout their lifespan.

5.1.3 Market transparency

Recent episodes have revealed a transparency deficit in fixed-income markets...

Another shortcoming revealed by the subprime crisis is the lack of data available on transactions closed in structured product markets. European regulations (as contained in the MiFID) impose stringent conditions of transparency on equity market operations, both pre-trade (ask prices) and post-trade (prices and volumes of transactions closed). However no such requirements apply to fixed-income and derivative markets.

Compare this with the United States, where the TRACE system, in place since 2002, provides detailed post-trade data on a large set of fixed-income securities.

...causing European authorities to review their position.

The European authorities have till now taken the view that lack of transparency on fixed-income markets does not constitute a market failure. But this posture is now being revised within the CESR in the light of the FSF recommendations. In any case, the industry itself is taking steps to enlarge its regular information flows. The European Securitisation Forum, for instance, has joined with eight other European associations (among them the European Banking Federation) to publish (July 2008) ten initiatives to boost transparency in European securitisation markets[37].

Spanish fixed-income markets are more transparent than those of most other European countries, but here too there is room for improvement – by disclosing

37 The initial idea was to offer a response to ECOFIN's route map of October 2007, but the end result went a lot further with proposals ranging from a quarterly statistical bulletin on European and American securitisation markets to measures to provide easier access to transaction information, by way of a code of conduct for information breakdown by the issuers of structured products.

trading prices, for example, instead of just the average price at the end of each session. It should also be possible to introduce counterparty mechanisms through the figure of the market specialist, with the added liquidity benefits this would bring. All such changes would, of course, bear in mind the current European framework so they do not impair the competitiveness of Spanish markets.

Although Spanish-fixed income markets can boast above par transparency, there is room for improvement.

5.2 Rating agencies

The transparency deficit regarding the nature of new financial instruments has made the rating agencies key players in the development of structured product markets. And their inability to incorporate the risks materialising in the subprime crisis into their valuation mechanisms has not only helped spread the effects of the crisis but has also contributed to the deterioration of agent confidence.

There is broad agreement that rating agencies have been failing in their work...

Studies carried out by international bodies like the FSF, IOSCO or CESR, and even the agencies themselves, concur in their main findings; namely, that agencies' work has suffered from four kinds of deficiencies: methodological, problems of internal organisation, insufficient transparency and too great a weight in financial regulation.

They also lead to the inevitable conclusion that the self-regulation favoured in the European Union is not doing its work properly, and what is called for its more direct regulation and supervision, as has been the case in the US for some years now.

... above all, that the regulatory framework is in need of tightening.

In this context, the European Commission recently sent a document out for public consultation which includes a proposed Directive or Regulation, and which sets out two alternative authorisation and supervisory models. In the first, applications for authorisation would be directed to the CESR and its members would appoint a national supervisor as the competent authority in the home Member State (following the established home/host system). This supervisor would decide on the rating agency's authorisation, valid throughout the European Union[38], and would be responsible for its oversight.

The European Commission's initiative is undoubtedly a step forward...

The second model would involve a new European agency (or possibly the CESR) with responsibility for authorisation, and for the appointment of a national supervisor as the competent authority in the home Member State[39].

The approach adopted by the European Commission is a necessary response to the absence of controls over these agencies within the EU. But it is also true that the structure of the industry – a de facto global oligopoly – calls for a coordinated system of recognition and oversight on an international scale. Until this can come about, Europe's strategy must rest on a single control system binding on all

...but Europe's authorities could also consider more ambitious options.

38 Remaining national supervisors would not lose their powers to act as and when necessary (in cases regarding the use of a rating in their territory or the relinquishment of the supervisor initially appointed). The CESR would take charge of supervisory coordination and convergence.

39 The appointed supervisor would conduct its oversight functions on the same terms as in the first option, but stepping aside for the new agency (or the CESR) if its members fail to agree on the measures to be taken.

Member States. Otherwise, we run the risk of producing more dispersion in financial regulation, which will only hamper the progress of the single market. The European authorities should accordingly look further than the Commission's options to the possible establishment of a new body to authorise and supervise agencies on an EU-wide basis, or, failing this, assign the CESR sufficient powers and resources to take on these responsibilities, along the lines of the Securities Exchange Commission (SEC) in the United States.

5.3 Liquidity risk

The crisis has highlighted the need for stronger controls on liquidity risk.

The liquidity shortages affecting a number of wholesale markets and their effects on participating entities have prompted an official review of the treatment of liquidity risk in financial regulation.

We can identify at least two regulatory avenues to address this problem in the area of market conduct supervision. Firstly, current financial reporting standards are fairly lax regarding the obligation to offer a breakdown of liquidity positions. For instance, they require entities to disclose the maturity of their liabilities, but there is no parallel requirement for asset maturities, leaving investors uninformed about the liquidity risk deriving from asset-liability mismatches. The IASB should consider a review of the relevant standards.

This invites further reflection on the European rules governing conventional CIS...

A second avenue of interest is liquidity risk management in collective investment schemes. The UCITS Directive, which provides a regulatory framework in Europe for conventional mutual funds, places no limits on positions in assets traded on organised markets by reference to these markets' liquidity. Some countries, Spain among them, have imposed additional controls in their national legislation so managers monitor the depth of the markets on which their balance-sheet instruments are quoted.

... and confirms the wisdom of a redefinition of money-market funds.

In any case, there is a need to review the liquidity requirements applying to investment funds marketed in Europe. These requirements should, probably, be especially strict for the funds labelling themselves "money-market", which, as recent experience has shown, has not stopped them being heavily exposed to products carrying credit and liquidity risk. At the time of writing, the CNMV is planning a review of investment fund categories, one of whose aims will be to tighten the rules on money-market fund holdings so they match the highly conservative vocation of their target investor public (see exhibit 5 on money-market funds in section 4.1).