I Securities markets and their agents: situation and outlook

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1 Executive summary

- The international macroeconomic and financial setting has experienced some improvement in these last few months. Expansionary measures by governments and central banks and the gradual recovery of world trade allowed almost most advanced economies to pull clear of recession in the second half of 2009. Meantime, the absence of inflationary pressures has kept official interest rates running at lows in almost all areas.
- Forecasts by leading international organisations say that world GDP should grow by around 4% in 2010, thanks to the dynamism of emerging economies and firming recovery among the developed countries. However downside risks persist, to do mainly with the sustainability of public finances and the threat of further deterioration in labour markets. The big upcoming challenge is still how to engineer the withdrawal of stimulus packages.
- Against this backdrop, international equity markets had a somewhat erratic second half, in comparison to the first, as the waters were stirred by announcements hinting at regulatory changes in the United States and evidence of the worsening fiscal situation of certain European economies, Greece in particular. However, volatility died down significantly in the first half of March 2010, helping North American and Japanese indices into positive territory year to date,[1] while European indices continued in losses.
- Government bond markets have performed divergently in the last six months in tune with the newsflow on their economies, their safe haven potential and the degree of deterioration of their public finances, while private fixed-income markets are apparently heading back to a certain normality in financing conditions and issue volumes. The euro, meantime, has gone on losing ground against the dollar, due to the greater relative strength of the U.S. economy and doubts over Europe's public finances.
- Spanish GDP continued to contract, though rather more slowly, in the fourth quarter of 2009 (-0.1%), which closed with a full-year decline of 3.6%. Tensions worsened in the labour market (with the unemployment rate rising to 18.8% of the labour force in the fourth quarter of 2009) and public finances (the public deficit swelled from 4.1% of GDP in 2008 to 11.2% in 2009). Both IMF and OECD forecasts for the Spanish economy point to further growth slippage in 2010 followed by a mild recovery in 2011.
- Spanish deposit-taking entities again had to deal with a complex environment, with weak economic activity taking its toll on income statements through the dual route of falling business and loan-book deterioration. The sum of outstanding loans to companies and households continued to decrease (-0.9% in January), though at a slightly slower rate than elsewhere in the euro area (-1.3%).

1 The closing date for this report is 15 March.

Non performing loan ratios moved higher once more (5.3% in January) though the rate of advance is apparently slowing. Entities were able to fund themselves without too much difficulty in 2009, thanks to the support measures launched by the national authorities and the ECB. However, large differences persist with regard to their financial strength.

- The combined profits of non financial listed companies rose by 14.7% in 2009 to 24.33 billion euros, thanks to an improved performance by real estate and construction firms, which emerged from the heavy losses of 2008. Companies in other sectors, notably industry and energy, reported some degree of earnings decline albeit on a smaller scale than in 2008. Listed company debt rose by 4.6% in 2009 with leverage ticking up from 1.6 to 1.7. The debt coverage ratio increased in the year, while interest coverage came down.
- Spanish equity markets have had a rough start to 2010 (Ibex 35 down 8.2%), with losses cutting deeper than elsewhere in Europe. The price slide extended to all sectors, but were especially intense among financial and telecommunications firms. Stock market turnover showed signs of recovery after the fluctuations of 2009, while issuance activity remained slow, as it has done since 2008.
- Domestic short-term interest rates remained at lows over the opening quarter of 2010, in line with ECB policy, while long government yields moved higher in the first two months before easing back in March. Gross fixed-income issuance was down 19% versus 2009, accompanied by a shift in the mix favouring non convertible bonds and debentures, mortgage bonds and preference shares. Some markets, especially markets in securitised products, have continued to struggle in 2010. In contrast, non government-backed bond issues rose in the period, while Spanish issuers raised more of their funding on international markets.
- Investment fund assets climbed from 167 billion to 170 billion euros in full-year 2009, after a two-year decline driven by unitholder redemptions and portfolio depreciation. Unitholder numbers fell in 2009, while inter-fund mergers reduced the overall number in operation. The proportion of less-liquid assets has stayed more or less constant since mid-2009, at approximately 8.6% of fund portfolios. In this context, the total assets in the care of CIS managers dropped slightly in 2009, while their aggregate earnings were less than half what they were in 2008, with lower fee revenues as the main culprit. The outlook for the collective investment industry looks brighter on the whole, though some risks loom in the shape of the recent upswing in price volatility on financial markets and the increase in redemptions signalled by preliminary data for 2010.
- Real estate investment funds continued to suffer the effects of the property market downturn, compounded by a growing wave of redemption orders. The result is that some funds have been forced to sell off assets, to reappraise holdings and/or to reduce or even suspend redemptions. There is little chance, furthermore, that things will get better until the Spanish real estate market is back on its feet. Meantime, the hedge fund industry has seemingly embarked on a modest recovery, more visibly among funds of hedge funds.
- Investment firms are still weathering their particular storm. The aggregate pre-tax profits of broker-dealers and brokers fell 29% and 54% respectively in 2009. Only CIS managers were able to buck the trend with an increase of 20%. The number of investment firms in losses reduced slightly from 28 in 2008 to 26 in

2009. The sector's solvency levels have held up reasonably well, despite a small decline in the margin reflecting the new rules introduced by CNMV Circular 12/2008 on the solvency of investment firms.

- The wave of defaults in the U.S. subprime mortgage market has driven investors away from securitised products, causing a worldwide demand slump. How well these markets recover will depend on the ability of regulators and industry to lay down a new development framework that mitigates conflicts of interest among the intervening parties, enhances the reliability of rating agencies and makes for simpler, more standard and more transparent products. The search is now on for measures to revitalise the securitisation market, with the involvement of both sides. Its success will hang on striking the right balance between new regulatory elements and new industry practices.

2 Macro-financial setting

2.1 International economic and financial developments

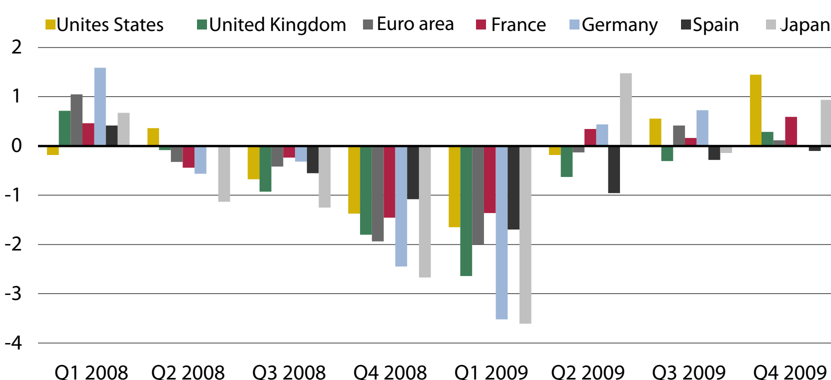
Mild improvement in the macroeconomic and financial setting...

Since the latest instalment of "Securities markets and their agents: situation and outlook" published in the CNMV Bulletin for the third quarter of 2009, the macroeconomic environment has improved to some degree, aided by the gradual normalisation of key financial system components.

... thanks to expansionary measures by governments and central banks, which have helped most advanced economies pull clear of recession.

The expansionary measures taken by governments and central banks and the revival of world trade combined to lift most advanced economies out of recession starting in the second half of 2009. As figure 1 shows, the first to post positive quarter-on-quarter growth rates were France, Germany and Japan (second quarter of 2009), followed by the United States (third quarter) and United Kingdom (fourth quarter). The emerging economies, less directly exposed to the financial turmoil unleashed by the crisis, again outperformed their more developed counterparts albeit with large differences from one region to another. Asia, with China at its head, was the most dynamic of the emerging group with a 2009 growth rate of 8.7%, followed by Latin America (notably Brazil, which has been expanding at rates upwards of 1.0% since the second quarter of 2009). Eastern European economies too showed some recovery, though their progress has been slower.

GDP: quarterly change, % FIGURE 1



Source: Thomson Datastream.

World GDP could expand around 4% in 2010 on the firming recovery of developed economies and a renewed growth spurt among the emerging group.

In view of this nascent recovery across advanced and emerging economies, leading international organisations (see table 1) are now forecasting world GDP growth of 4% in 2010 (vs. the -0.8% of 2008, according to IMF estimates), based on the firming recovery of developed economies and a renewed growth spurt by the emerging group (from 2.1% in 2009 to 6.0% in 2010, again according to the IMF). Among the developed economies,[2] the United States is tipped to see growth of around 2.5% against the more modest projections for leading European economies, from the 1.0% of Italy to the 1.5% of Germany (the exception being Spain, where growth could contract between 0.3% and 0.6%). In any case, forecasts are subject to considerable uncertainty, because much of the upturn owes to transient factors, like fiscal and monetary stimulus programmes or the stock-building cycle.

Gross domestic product (% annual change) TABLE 1

					IMF(*)		OECD(*)	
	2006	2007	2008	2009	2010F	2011F	2010F	2011F
World	5.0	5.2	3.0	-0.8	3.9 (+0.8)	4.3 (+0.1)	-	-
United States	2.8	2.1	0.4	-2.5	2.7 (+1.2)	2.4 (-0.4)	2.5 (+1.6)	2.8
Euro area	3.0	2.7	0.6	-3.9	1.0 (+0.7)	1.6 (+0.3)	0.9 (+0.9)	1.7
Germany	3.2	2.5	1.2	-4.8	1.5 (+1.2)	1.9 (+0.4)	1.4 (+1.2)	1.9
France	2.4	2.3	0.3	-2.3	1.4 (+0.5)	1.7 (-0.1)	1.4 (+1.2)	1.7
Italy	2.1	1.6	-1.0	-4.8	1.0 (+0.8)	1.3 (+0.6)	1.1 (+0.7)	1.5
Spain	3.9	3.6	0.9	-3.6	-0.6 (+0.1)	0.9 (+0.0)	-0.3 (+0.6)	0.9
United Kingdom	2.8	2.6	0.5	-4.8	1.3 (+0.4)	2.7 (+0.2)	1.2 (+1.2)	2.2
Japan	2.0	2.3	-1.2	-5.3	1.7 (+0.0)	2.2 (-0.2)	1.8 (+1.1)	2.0
Emerging	7.8	8.3	6.1	2.1	6.0 (+0.9)	6.3 (+0.2)	-	-

Source: IMF and OECD.

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

Inflationary pressures remain generally muted, allowing official interest rates in almost all world regions to be kept at lows.

Inflationary pressures remain well under control, to judge by the performance of prices in most, though not all economies. Inflation rates in main world economies touched lows in the middle months of 2009, before climbing back up at differing intensities. Although both the United States and United Kingdom have experienced a relatively sharp run-up in prices, especially in the last few months, there are powerful arguments for leaving official rates at their current lows. Firstly, underlying inflation remains subdued, in keeping with a low level of capacity utilisation and high unemployment rates. And secondly, mid-term inflation prospects are well within acceptable bounds. Official rates accordingly held at lows over the first quarter of 2010: 0%-0.25% in the United States,[3] 0.1% in Japan,[4] 0.5% in the United Kingdom and 1% in the euro area, though the central banks of some developed economies, like Australia and Norway, have hiked them on at least one occasion since end-2009, urged by their economic recovery readings and a larger-than-forecast inflation jump.

Some one-off support measures for financial markets and institutions have concluded or are being wound down...

Some of the support measures deployed by governments and central banks to aid financial markets and institutions are now being carefully and selectively deactivated in response to what appears to be a return to normality. But the speed of withdrawal is being timed to fit with the nature of the measure. Hence liquidity provision to financial institutions, the recapitalisation of struggling entities and the guarantees extended for debt financing are all being scaled back considerably; in some

2 IMF and OECD forecasts.

3 Since 16 December 2008.

4 Since 19 December 2008.

cases because the measure had expired, but in many other cases, due to scant (even zero) take-up by the target public. In December 2009, the ECB announced the phased withdrawal of certain extraordinary measures in light of the improvement in financing markets – specifically, that the one-year re-financing operation that same month would be the last of its kind, and that six-month tenders would be discontinued as of March 2010. Meantime, liquidity provision through its fixed-rate full allotment operations would be prolonged until at least the first quarter of 2010, while the covered bond purchase program would be withdrawn around mid-year. Credit institutions are still using these last instruments as collateral for ECB loans in view of languishing demand for asset-backed securities.

Weak activity plus fiscal stimulus and financial sector support measures have pushed up the deficits and public debt of developed economies.

The downturn in activity, allied with governments' strenuous stimulus and support efforts, have caused burgeoning budget deficits and public debt in both developed and, to a lesser extent, emerging economies. The public deficit of the OECD group of countries is projected to reach 8.25% of GDP in 2010, and to stick at around 8% in 2011 in countries like the United States, Japan, United Kingdom, France or Spain. Projections for the OECD countries' public debt expect it to top 100% of GDP in 2011, a full 30 points more than in 2007, before the onset of the crisis. This being so, there is general agreement that maintaining exceptional fiscal packages over any length of time could threaten the sustainability of public accounts. At the same time, the authorities feel there is a need to keep them in place until output recovery looks sufficiently solid.

Equity markets have been in an unsettled mood over the last few months...

International equity markets have performed unevenly in recent months after the strong run-up of the central quarters of 2009. Specifically, the fourth-quarter period saw a rather directionless market, as investors waited in vain for signs of a robust international upturn, which the indicators refused to confirm. The result was a price variation on main European indices that ranged from the -0.1% of the Italian market to the 5.0% of Germany's Dax. Japanese and U.S. indices fared rather better though gains in no case stretched above 8% (see table 2).

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

	2006	2007	2008	2009	4Q 08	4Q 09	1Q10 (To 15 March) % prior qt	%/Dec	% y/y[2]	% low[3]
World										
MSCI World	18.0	7.1	-42.1	27.0	16.9	3.7	1.2	1.2	56.3	71.6
Euro area										
Euro Stoxx 50	15.1	6.8	-44.4	21.1	19.6	3.2	-3.2	-3.2	45.7	58.6
Euronext 100	18.8	3.4	-45.2	25.5	21.6	3.7	-0.3	-0.3	47.2	56.8
Dax 30	22.0	22.3	-40.4	23.8	18.0	5.0	-0.9	-0.9	49.3	59.9
Cac 40	17.5	1.3	-42.7	22.3	20.9	3.7	-1.2	-1.2	43.8	54.4
Mib 30	19.0	-8.0	-48.7	20.7	19.6	-0.7	-2.2	-2.2	53.6	69.4
Ibex 35	*31.8*	*7.3*	*-39.4*	*29.8*	*20.1*	*1.6*	*-8.2*	*-8.2*	*47.5*	*60.7*
United Kingdom										
FT 100	10.7	3.8	-31.3	22.1	20.8	5.4	3.3	3.3	49.0	57.9
United States										
Dow Jones	16.3	6.4	-33.8	18.8	15.0	7.4	2.1	2.1	47.3	62.5
S&P 500	13.6	3.5	-38.5	23.5	15.0	5.5	3.2	3.2	52.1	70.1
Nasdaq-Cpte	9.5	9.8	-40.5	43.9	15.7	6.9	4.1	4.1	65.0	86.2
Japan										
Nikkei 225	6.9	-11.1	-42.1	19.0	1.8	4.1	1.9	1.9	42.0	51.7
Topix	10.2	43.5	1.9	-12.2	-41.8	5.6	3.5	3.5	29.6	32.1

Source: Datastream.

1 In local currency.

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

3 Change vs. 2009 low. The low of the MSCI World index (9 March) is taken as a common date.

... with uncertainty mounting over certain European economies' deteriorating public finances and possible novelties in U.S. financial regulations. In recent weeks, improved agent confidence has sent share prices rising once more.

A number of factors conspired to boost investor risk aversion in January and February 2010, giving rise to instability episodes that pushed down share prices and heightened volatility. Chief among them were the uncertainty generated by announcements in the U.S. hinting at changes in financial regulations, and fears about the grave state of Greece's public finances, which tended to spread by contagion to other European countries. Fortunately, during the first fortnight in March, the easing of tensions in the Greek case after the government's launch of a fiscal consolidation plan plus a set of more positive macro and corporate earnings data sent share prices rising once more. The first quarter of 2010[5] accordingly brought gains in America (from the 2.1% of the Dow Jones to the 4.1% of the Nasdaq) and Japan (from the 1.9% of the Nikkei 225 to the 3.5% of the Topix) and losses in Europe (from the -0.3% of the Euronext 100 to the -8.2% of the Ibex 35).

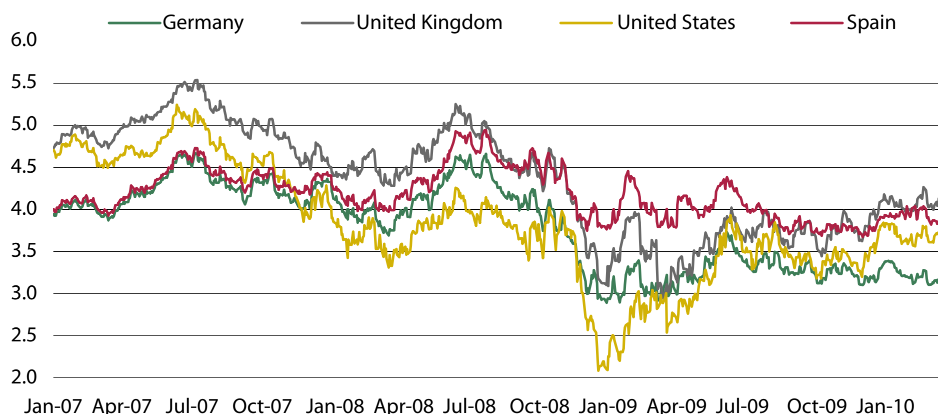
Government bond markets have performed divergently in tune with economic prospects, safe haven potential and the state of each country's public finances.

Public and private debt markets have turned in a divergent performance in these past months, with various factors at work. In the case of government bond markets, the long-term yields of developed countries headed generally higher in the last three months of 2009, in tune with improved macroeconomic prospects. As of the start of this year, yields began turning down in the United States and Germany, probably denoting a new "flight to quality" triggered by the uncertainties mentioned earlier, which has spurred an intense buying round in the government bonds perceived as strongest in solvency and liquidity. In the case of other European economies, concerns over the sustainability of public finances have pushed up their benchmark yields (see figure 2).

5 Data to 15 March.

Ten-year government bond yields (%)

FIGURE 2



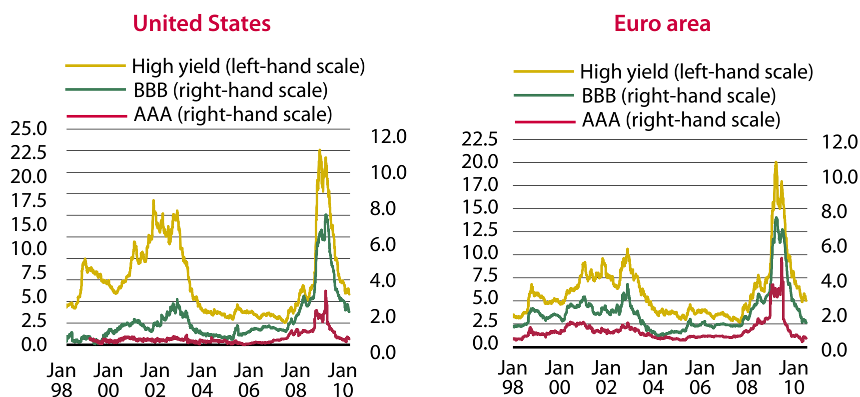
Source: Thomson Datastream. Data to 15 March.

Financing conditions in private debt markets are approaching normality.

In private debt markets, price and volume indicators point firmly in the way of normalisation. On the price front, 2009 brought a sturdy decline in the risk premiums paid by European and American issuers. In fact current levels are, in many cases, similar to those found at times of greater macro and financial stability (see figure 3), even after the small upturn of the last few weeks. As to volumes, net bond issues in international markets rose to 6.3 trillion dollars in 2009, a full 3.3 trillion more than in 2008 and 1.6 trillion more than in 2007. This marks a break with the pattern of the two previous years, when fixed-income issuance fell by 8% and 35% respectively (see exhibit 4 for more details). It seems then that lower issuance costs allied with tougher access to bank finance are driving a shift in entities' financing mix from bank loans to debt (see figure 4).

Corporate bond risk premiums[1] (basis points)

FIGURE 3

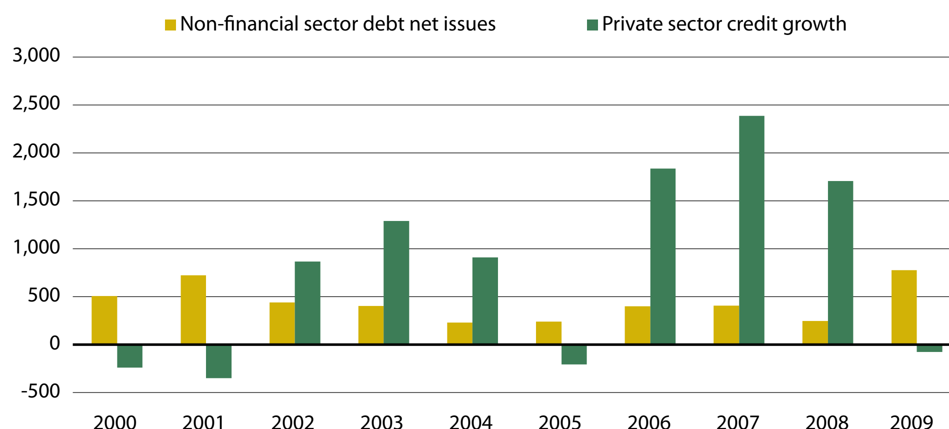


Source: Thomson Datastream (Merrill Lynch, IBOXX indices). Data to 15 March.

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

Financing of non financial private companies (billion dollars)

FIGURE 4



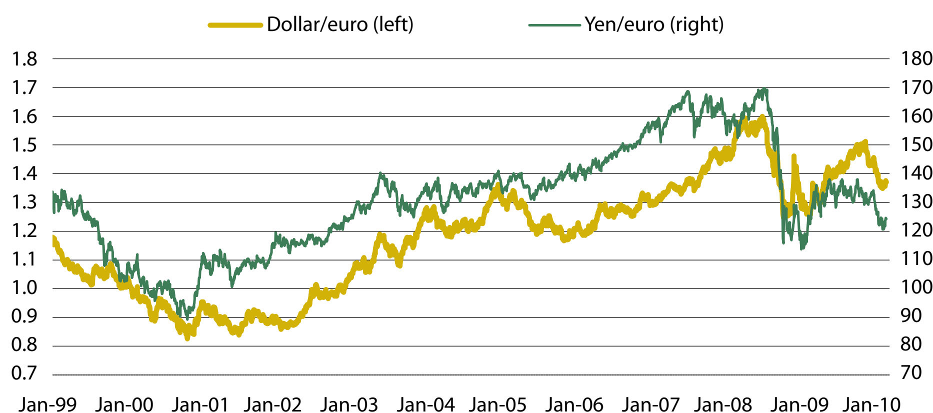
Source: Dealogic and Thomson Datastream. The loans series has been constructed by aggregating the lending to non financial companies series for the euro area and the United Kingdom and resident sector lending series in the United States and Japan.

The euro has lost ground against the dollar since December last, on the greater strength of the U.S. economy and doubts over European public finances.

In currency markets, after a strong run by the euro against the U.S. currency, which took it from 1.25 dollars in March 2009 to above 1.50 dollars in the month of December, the trend has inverted in the last few weeks in view of the relative strength of the American vs. the European economy and concerns over the public finances of some euro area countries. The result has been euro depreciation against the dollar, to around the 1.37 dollar mark[6], and against the Japanese yen (from around 133 yens at end-2009 to the 124 yens of mid-March 2010).

Euro exchange rates vs. the dollar and yen

FIGURE 5



Source: Thomson Datastream. Data to 15 March.

6 By way of an end-February low of 1.35 dollars/euro.

Exhibit 1: Compensation practices in the financial industry: recent initiatives

At the request of the G20, the Financial Stability Forum (FSF) published its *Principles for Sound Compensation Practices* in April 2009, directed at significant financial institutions but also applicable to any large, systemically important firms. They are basically designed to promote prudent risk management by financial institutions that is geared to long-term growth and stability, in place of the short-termism encouraged by pre-crisis compensation practices.

The FSF principles revolve around three main axes. The first is the effective governance of compensation systems, with the recommendation that boards of directors should actively oversee their design and operation. The second involves the obligatory alignment of these systems with the goals of prudent risk management. In particular, compensation policy should consider all the types of risk that employees may take on behalf of the company, and ensure that variable pay is sensitive to the time horizon of the same. The third axis refers to the disclosure of compensation practices and supervisory oversight. The former is a vital input for stakeholders to evaluate the quality of the firm's strategy and risk posture. Supervisors, meantime, must review compensation practices as part of their broader evaluation of the risk carried by the firm.

In September 2009, the Financial Stability Board (FSB), successor to the FSF, published a set of implementation standards for its principles for compensation practices, including specific guidelines on the reform of corporate governance, global standards for pay structure, transparency and the role of supervisors. The FSB also called on the three main international forums for financial sector supervisors to undertake all necessary measures to support the implementation of the standards. This request has already given rise to a number of initiatives. In the banking sector, the Basel Committee on Banking Supervision (BCBS) has set up a Network of Senior Supervisors to exchange experiences on the topic and has developed an evaluation methodology for supervisors to follow in their review of financial institution compensation practices. In insurance, the International Association of Insurance Supervisors (IAIS) is working on a set of supervisory standards based on the FSB principles. And, finally, the International Organisation of Securities Commissions (IOSCO) has centered its attention on the transparency of listed company compensation practices, to decide how the FSB principles can be merged within its own catalogue of *Principles for Periodic Disclosure for Listed Entities*.

The FSB has recently launched a peer review among member organisations to analyse the implementation status of it principles and standards, focusing on the measures planned or deployed by different jurisdictions, and those taken by systemically important financial institutions. It is hoped that this review will be completed by late March 2010.

Looking now at specific national and regional initiatives, the reform proposal Restoring American Financial Stability was sent to the United States Senate in early 2010. The bill includes some radical measures to put a rein on executive pay, among them: (i) the right of shareholders to have an advisory vote on the compensation of company executives ("say on pay"), (ii) the independence of the remuneration committee and (iii) an obligation on listed firms to establish "claw back" policies to recover executive compensation awarded on the basis of inaccurate financial statements.

In the European Union, the Larosière Report, published in February 2009, had already trained its sights on compensation policies, urging that financial sector bonuses should be calculated on a multiannual basis and be reflective of real earnings without being guaranteed beforehand. In April 2009, the European Commission adopted two sets of recommendations on compensation policies. The first of these, aimed at financial institutions, embraces the spirit of the FSF principles, and has been proposed for incorporation into the recast capital requirements directive currently awaiting approval. The second sets out guidelines on the structure and level of the remuneration of listed company directors, with four stand-out recommendations: (i) the placing of limits on severance payments for the early termination of contracts ("golden parachutes"), (ii) a balance between fixed and variable compensation components, with the latter linked to measurable management targets, (iii) bonuses to be designed with a view to sustainable performance and (iv) the return of variable components of remuneration awarded on the basis of misleading information.

In Spain, the CNMV issued a consultation paper in December 2009 proposing to update the Unified Good Governance Code in line with the European Commission's Recommendation of 30 April 2009 on the remuneration of the directors of listed companies. The recast Code is expected to be approved in the third quarter of 2010 for application in companies' annual corporate governance reports corresponding to the same year.

Also, the future Sustainable Economy Law, whose draft was approved by the Council of Ministers on 19 March 2010, will at the CNMV's urging make existing provisions on compensation policies legally binding on all listed companies. The effect will be to enhance the transparency of director and executive pay along with remaining compensation policies and practices. Among its requirements, listed firms will have to submit an annual remuneration statement to the advisory vote of the general shareholders' meeting, with details on the implementation of its compensation policies and an itemisation of payments received by all directors and senior officers.

The new law will also tighten up disclosure requirements for credit institutions regarding the remuneration of employees whose actions may have a material impact on risk exposure. The Banco de España had already called on credit institutions to adopt the FSF principles by 31 December 2009.

Finally, a number of countries are discussing the possibility, temporarily at least, of taxing lavish bonuses awarded at a time of large state aids to the banking industry. The UK, in particular, has imposed a one-off "windfall" tax to run from December 2009 to April this year. France is debating a similar levy, while Spain and Germany have ruled out any such move.

2.2 National economic and financial developments

Spanish GDP declined more slowly in the fourth quarter of 2009 (-0.1%), which closed with a negative growth rate of 3.6%...

Quarterly National Accounts data for 4Q 2009 show that Spain's GDP fell 0.1% in quarterly terms (against -0.3% the quarter before) and 3.1% in annual terms (-4.0% in the third quarter). The result was a full-year contraction of 3.6%. This marks a run of seven quarters of negative GDP growth, though the rate of decline has been gradually slowing since 2Q 2009. Further, a look at the growth mix shows that main components pulled closer into line as the year progressed, with the negative contribution of domestic demand easing from -6.6 points in the third quarter to -5.3 points in the fourth, and net exports dropping back from a positive 2.6 to 2.2 points.

...and a better balanced mix between domestic and external demand.

On the demand side, salient fourth-quarter developments were the recovery of household consumption, which registered a positive quarterly rate (0.3%) for the first time in two years, the quarterly fall in government consumption (-1.7%) and the slower decline of gross fixed capital formation (from -2.4% in the third quarter to -1.0% in the fourth), with equipment investment picking up strongly (from 1.8% to 3.1%) and construction investment braking its fall (from -2.6% to -2.2%). Export growth quickened from 2.1% to 3.0% between the third and the closing quarter, while import growth rose from 1.7% to 2.1%. Finally, household consumption fell by 5% in the full-year period, gross fixed capital formation by 15.3% (-23.1% in equipment and -11.2% in construction), exports of goods and services by 11.5% and imports by 17.9%. The only positive change was in government consumption, which moved up 3.8%.

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

	2006	2007	2008	2009	European Commission* 2010F	European Commission* 2011F
GDP	**4.0**	**3.6**	**0.9**	**-3.6**	**-0.6 (+0.2)**	**1.0**
Private consumption	3.8	3.7	-0.6	-5.0	-0.5 (+0.6)	0.9
Government consumption	4.6	5.5	5.5	3.8	1.7 (-3.0)	2.2
Gross fixed capital formation, of which:	7.2	4.6	-4.4	-15.3	-8.4 (-0.4)	-1.3
Equipment	9.9	9.0	-1.8	-23.1	-6.0 (+3.6)	2.2
Exports	6.7	6.6	-1.0	-11.5	1.3 (+1.2)	3.3
Imports	10.2	8.0	-4.9	-17.9	-2.7 (-0.3)	2.2
Net exports (growth contribution, pp)	-1.4	-0.9	1.4	2.8	1.0 (+0.3)	0.3
Employment	3.2	2.9	-0.6	-6.7	-2.3 (+0.4)	-0.4
Unemployment rate[1]	8.5	8.3	11.4	18.1	20.0 (-0.5)	20.5
HICP	3.6	2.8	4.1	-0.3	1.1 (+0.3)	2.0
Current account (% GDP)	-9.0	-10.0	-9.6	-5.1	-4.6 (+1.7)	-4.2
General government (% GDP)	2.0	2.2	-4.1	-11.4	-10.1 (-0.3)	-9.3

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

1 Eurostat definition.

* Forecasts published in autumn 2009 (with respect to spring 2009), except GDP and inflation forecasts for 2010, published in February (with respect to autumn 2009).

The supply-side contraction of 2009 was strongest in industry and construction branches.

On the supply side, keynote developments were the recovery of industrial output (up from -1.7% in the third quarter to 0.5% in the fourth) and the relative stability of service sector value-added (varying from 0.1% to 0.0% respectively). Meantime, construction value-added declined by 1.2% in each of the last two quarters of 2009. Over the full-year period, the GDP contraction was 14.7% in industry, 6.3% in construction and 1.0% in services.

Annual inflation moved higher from September 2009 ...

Annual inflation moved higher from September 2009 (-1.0%) to January 2010 (1.0%), before easing to a February rate of 0.8%. The run-up was driven by more volatile index components, energy especially, while the underlying rate held more or less flat

... to January 2010, with volatile components in the lead, then eased slightly in the month of February. In general, inflation is expected to stay tame in the absence of demand pressures.

in the interval of 0.1% to 0.3%. Inflation will likely stay low-key through 2010 in the absence of significant demand pressures, though the VAT hike in July and the chance of a renewed rise in commodity prices (again, mainly energy products) could usher in a mild upward trend. Spain's inflation differential vs. the euro area turned negative in December 2008 and dropped as far as -0.9 p.p. in May 2009 before narrowing once more over the year's second half. In 2010 to date, the differential has hovered consistently around the zero mark.

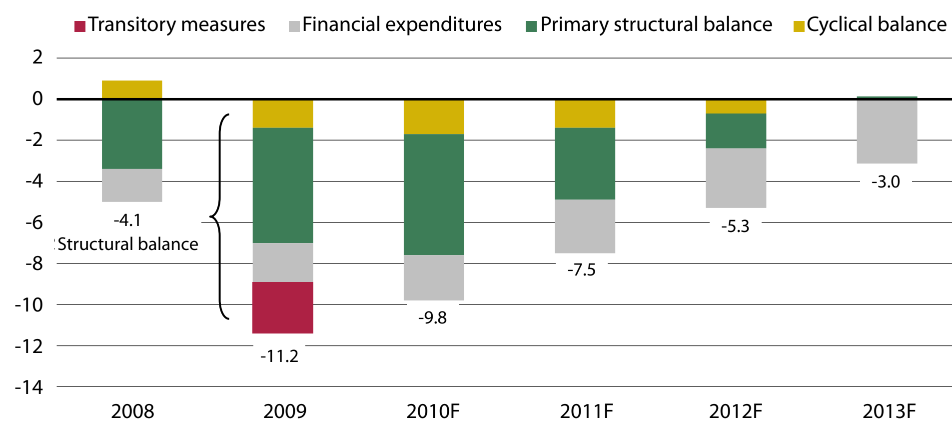
Labour market conditions continued to deteriorate though with tailing-off. Spain ended the year with an unemployment rate equivalent to 18.8% of the labour force.

Labour market data for the fourth quarter of the year point to further deterioration, albeit at a rather slower rate. According to the labour force survey, employment fell by 6.1% in 2009 (by 1,210,000 to 18,646,000) while jobless numbers climbed by around 35% (1,118,000 to 4,326,000). The unemployment rate moved up nine decimal points vs. the previous quarter to 18.8%, while labour force numbers fell by a marginal 0.4%. Preliminary January 2010 data for registered unemployment and Social Security affiliates point in the same general direction.

The public deficit widened from 4.1% in 2008 to 11.2% in 2009 on a combination of economic weakening, extraordinary fiscal measures and an increase in the structural component.

The latest data on Spain's public finances put the 2009 deficit at 11.2% of GDP compared to 4.1% in 2008. Disaggregated totals from the Ministry of Finance for these same years (see figure 6) show that 2.5 points of this 7.3-point jump had their origin in one-off anti-crisis measures, with another 2.3 points due to the cyclical downturn in output, 2.2 points to falling revenues or increased structural spending and 0.3 points to increased financial charges. At the same time, government anti-crisis measures[7] are estimated to have added 1.5 points to 2009 growth. The Stability Programme for 2009-2013 envisages a gradual reduction in the public deficit from the 11.4% of 2009 to 3.0% in 2013. Meantime public debt is expected to go on rising from last year's 55.2% of GDP to 74.3% in 2012 and 74.1% in 2013.

Fiscal balance of the Spanish economy (% GDP) FIGURE 6



Source: Ministry of Economy and Finance. Stability Programme 2009-2013.

The Stability Programme envisages a gradual decrease in the deficit to 3% in 2013 and an upward progression in public debt to the year 2012 (74.3% of GDP).

The envisaged 8-point decline in the public deficit between 2009 and 2013 will be achieved through an upswing in output growth, consistent with the elimination of the cyclical deficit, the withdrawal of one-off measures and, above all, what should be a large reduction in the structural deficit, currently calculated at 5.7% of GDP. This last objective will be secured by means of the consolidation measures set out in table 4.

7 These can be divided into three main groups: 1) extraordinary funds (1.1% GDP), primarily the Local Investment Plan and the Plan to Boost the Economy and Employment, 2) tax measures in support of liquidity (0.7% of GDP) and 3) exceptional deferral of tax liabilities (0.7% of GDP).

Fiscal restrictions (% GDP)

TABLE 4

	Measure	Revenue	Expenditure
2010 Budget	VAT increase	+0.7	
	Increase in excise taxes	+0.3	
	Abolition of €400 personal income tax rebate	+0.4	
	Increased taxation of savings	+0.1	
	Corporate income tax cuts for small firms	-0.1	
	Cuts in current expenditure		-0.8
New measures	Additional spending cuts in 2010		-0.5
	Central Government Austerity Plan 2011-2013		-2.6
	Spending cuts by regional and local government		-0.5
Total revenue		**+1.4**	
Total expenditure			**-4.4**

Source: Ministry of Economy and Finance.

IMF and OECD forecasts for the Spanish economy augur a renewed growth contraction in 2010 and mild recovery in 2011.

The latest forecasts from leading international organisations include a small revise-up in the growth rates of the Spanish economy, which will nonetheless repeat negative growth in 2010 (ranging from -0.3% to -0.6%).[8] This should be followed by a mild upswing in 2011 to the region of 1%. Unemployment rates will stick at around 20% of the labour force, with no firm recovery in sight until 2011.

Spanish deposit-taking entities have continued to operate in a complex environment...

On the financial front, Spanish deposit-taking entities again had to deal with a complex environment, with weak economic activity taking its toll on income statements through the dual route of falling business and loan-book deterioration.

... with the downturn in activity eroding both business volumes and asset quality.

In effect, credit institutions obtained aggregate net profits of 12.96 billion euros in 2009, 29.7% less than in full-year 2008. Improvement in net interest income and gross income (up by 22.4% and 1.7% respectively) could not counter the inroads made by steeper impairment losses on financial and other assets (up by 4.30 billion and almost 6.55 billion euros respectively).

Outstanding loans to businesses and households sank further to January (-0.9% year on year) though improving slightly on the euro area's -1.3%.

The year-on-year change in aggregate outstanding loans to Spanish businesses and households stood at -0.9% in January 2010 against -0.5% one month before and 6.1% in December 2008. The fall was a little deeper in the euro area (-1.3% in January, against -0.6% in December 2009 and 5.8% in December 2008), but with some major differences in the mix. Specifically, loans to businesses in the euro area have decelerated more sharply since April 2009 as far as a year-on-year rate of -3.8% in January 2010 against +1.1% in Spain. Conversely, consumer and home purchase loans to households have held up more strongly, with the latter fighting back from the -0.3% low of September 2009 to +1.8% in January 2010, while the year-on-year rate in Spain has barely budged from 0%. Consumer lending, meantime, has been registering annual growth rates close to zero for several months now, compared to annual falls in Spain since mid-2009 of between -2.6% and -3.1%.

Non performing loans continue to advance (5.3% in January) though at a rather slower pace.

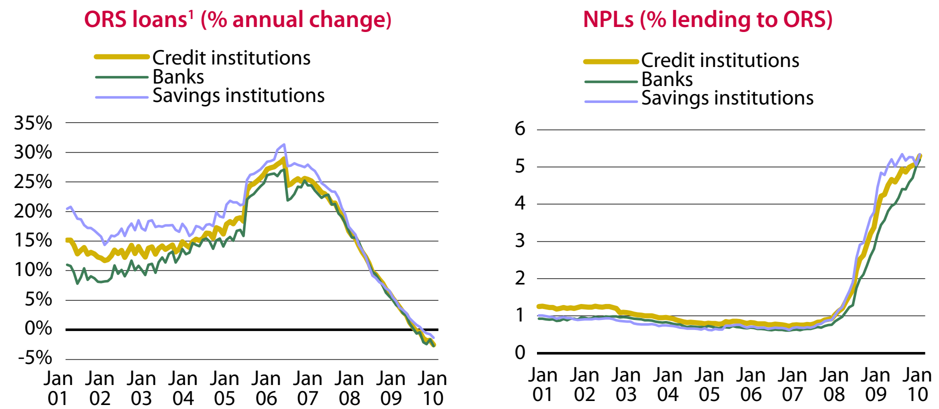
In this complex landscape, the non performing loans ratio of Spanish entities continued the advance initiated three years back though at a rather more moderate pace (see figure 7). In January 2010, the ratio stood at 5.3% (5.2%for the banks and 5.3%for the savings banks) compared to the 3.9% of the same month in 2009, the 1.0% of 2008 and the 0.8% of 2007. The bulk of NPL entries in the past year correspond to loans granted to construction companies and real estate developers, both with a strongly cyclical profile.[9]

8 Source: IMF, OECD and European Commission.

9 The NPL ratio for construction and real estate business was 9.6% in December 2009, against an overall ratio for productive activities of 6.2% at the same date.

Deposit-taking entities; loans and NPLs

FIGURE 7



Source: Banco de España. Data to January.

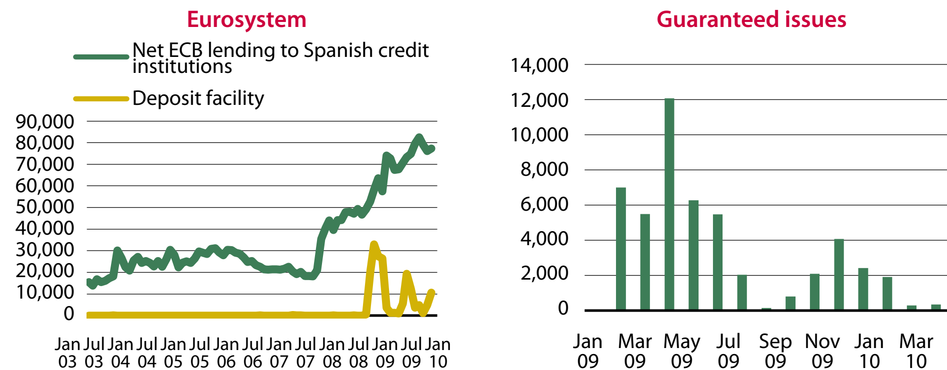
1 ORS = Other resident sectors.

Financing conditions stayed relatively comfortable thanks to support measures of the national authorities and ECB …

Financial institutions enjoyed fairly relaxed financing conditions throughout 2009 thanks to the help received from official quarters in the shape of state or ECB guarantees for debt financing, the extraordinary liquidity provided from the outset of the crisis and, more recently, the purchase programme for covered bonds. In effect, government-backed bond issues amounted to 48 billion euros in 2009, while recourse to Eurosystem credits held more or less stable, ranging from 75 billion to 82.50 billion euros since August 2009 (see figure 8). As to other debt instruments, securitisation markets remained virtually shut, while entities wishing to strengthen their capital turned increasingly to preference shares and, more recently, convertible bonds. Improved access to wholesale debt markets through 2009 also enabled a small resurgence in non guaranteed issues, particularly among the larger operators.

Financing of Spanish credit institutions (million euros)

FIGURE 8



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

...amid a general move to strengthen institutions' capital adequacy. However, large differences persist with regard to their financial strength.

The capital adequacy of Spanish deposit-taking entities strengthened further in the first half of 2009. The BIS ratio was 11.7% in June 2009, well clear of the 8% minimum requirement and also 46 basis points higher than one year before. The tier 1 ratio for this same month was 9% (against the minimum requirement of 4%), 86 basis points more than in 2008. This improvement, moreover, extends to a large number of entities as regards both the total and core capital ratios, though note that levels vary widely in tune with their respective financing strategies and borrowing capacity.

Aggregate profits of non financial listed companies grew 14.7% in 2009. Leading the upside were contractors and real estate developers, which shook off the heavy losses of the previous year.

The aggregate net profits of non financial listed companies climbed 14.7% vs. 2008 to 24.33 billion euros. As table 5 shows, this increase was entirely due to the better relative performance of firms engaging in construction and real estate activities, which fought back from aggregate losses of over 7.10 billion euros in 2008 to just over 1.15 billion profits in 2009. That said, economic weakness continued to take its toll. Hardest hit were industry sector firms, which scraped combined 2009 profits of just over 300 million euros (against more than 900 million in 2008) and those in the energy sector, whose profits dropped by 27% to 11.80 billion. The profits of retail and service companies also declined, though by a rather more moderate 3.6%, to an aggregate total of 11 billion euros.

The number of companies with minor losses was a little higher in 2009, while the number slightly in profit fell. The general story, however, was of some moderation in profits decline.

Breaking down listed companies in terms of their net profit for the year (see figure 9, panel a), we find that the number reporting minor losses (between -100 million and zero euros) rose between 2008 and 2009, while the number just slightly in profit (between zero and 100 million euros) fell. The smaller numbers reporting heavy losses (above 500 million euros) reflected the improved performance of real estate companies. Finally, among the companies in profit over both these years (see figure 9, panel b), we can see that earnings slippage has moderated to some extent.

Earnings by sector[1]: non financial listed companies

TABLE 5

	EBITDA[2]		EBIT[3]		Net profit	
Million euros	2008	2009	2008	2009	2008	2009
Energy	26,899	29,043	18,174	18,385	16,118	11,797
Industry	3,309	2,797	1,828	1,274	912	303
Retail and services	30,390	29,022	18,867	17,454	11,449	11,042
Construction and real estate	1,920	4,749	-1,101	1,634	-7,127	1,168
Adjustments	-439	-270	-251	-94	-137	+24
AGGREGATE TOTAL	**62,079**	**65,341**	**37,517**	**38,653**	**21,215**	**24,334**

Source: CNMV.

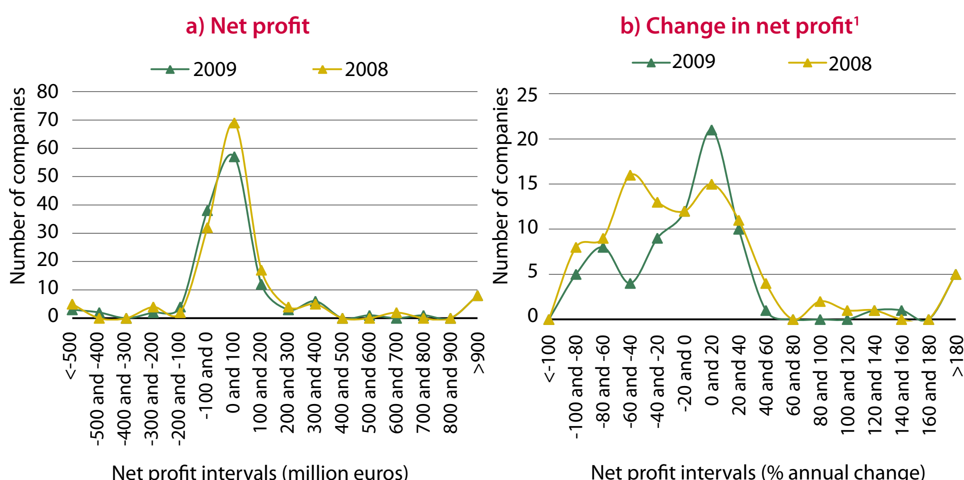
1 Year-to-date earnings.

2 Earnings before interest, taxes, depreciation and amortisation.

3 Earnings before interest and taxes.

Non financial listed companies by:

FIGURE 9



Source: CNMV.

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

Listed company debt rises by 4.6% in 2009 while leverage ratios tick upwards.

The debt of non financial listed companies was 323.7 billion at the 2009 close, 4.6% more than at end-2008. The largest increase corresponded to companies in the energy sector, whose combined debt swelled by almost 18 billion euros in the course of the year, due basically to Unión Fenosa's takeover of Gas Natural (see table 6). The debt of remaining sectors reduced in year-on-year terms, with construction and real estate (-12.7%) and retail and services (-6.3%) leading the downside. Financial leverage –the ratio of debt to net equity – edged up from 1.6 in 2008 to 1.7 in 2009, with all sectors except retail and services sharing in the increase.

The debt coverage ratio increased in 2009, though this was accompanied by some improvement in companies' interest coverage.

The debt coverage ratio, measuring the years needed to repay existing debt assuming constant EBITDA, rose from 4.6 in 2008 to 5 in 2009 for the sample as a whole. Construction and real estate companies were again to the fore with a drop from 32 to 22 years. Meantime, lower interest rates and more resistant earnings secured a general improvement in interest coverage ratios (EBIT/interest expenses up from 2.0 to 2.4). However sectoral differences loomed large, with retail and services and construction and real estate faring considerably better, against the worsening performance of industrial and energy firms (see table 6).

Gross debt by sector: listed companies TABLE 6

Million euros		2005	2006	2007	2008	2009
Energy	Debt	58,586	59,191	69,172	82,608	100,573
	Debt/ Equity	0.9	0.9	0.8	0.9	1.1
	Debt/ EBITDA[1]	2.4	2.2	2.5	2.8	3.5
	EBIT[2]/ Interest expenses	4.0	4.7	4.1	3.7	3.4
Industry	Debt	12,760	15,684	13,312	15,645	15,115
	Debt/ Equity	0.8	0.8	0.6	0.7	0.9
	Debt/ EBITDA	2.1	2.1	1.8	2.7	5.4
	EBIT/ Interest expenses	6.5	5.7	5.9	3.4	1.5
Construction and real estate	Debt	48,324	111,000	138,933	119,788	104,593
	Debt/ Equity	2.2	3.1	3.1	3.8	4.1
	Debt/ EBITDA	6.5	11.5	10.8	31.9	22.0
	EBIT/ Interest expenses	2.8	2.0	1.2	0.0	0.3
Retail and Services	Debt	55,710	91,522	96,941	112,322	105,289
	Debt/ Equity	1.7	2.5	1.7	2.1	1.8
	Debt/ EBITDA	2.7	3.6	3.0	3.6	3.6
	EBIT/ Interest expenses	3.4	2.4	3.2	2.9	3.4
Adjustments[3]	Debt	-7,942.0	-11,199.0	-17,391.0	-20,802.0	-1,907
AGGREGATE TOTAL[4]	**Debt**	**167,438**	**266,198**	**300,967**	**309,561**	**323,663**
	Debt/ Equity	1.3	1.7	1.5	1.6	1.7
	Debt/ EBITDA	2.9	3.9	4.0	4.6	5.0
	EBIT/ Interest expenses	3.8	3.3	3.0	2.0	2.4

Source: CNMV.

1 Earnings before interest, taxes, depreciation and amortisation.

2 Earnings before interest and taxes.

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

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

Household indebtedness has receded further while ...

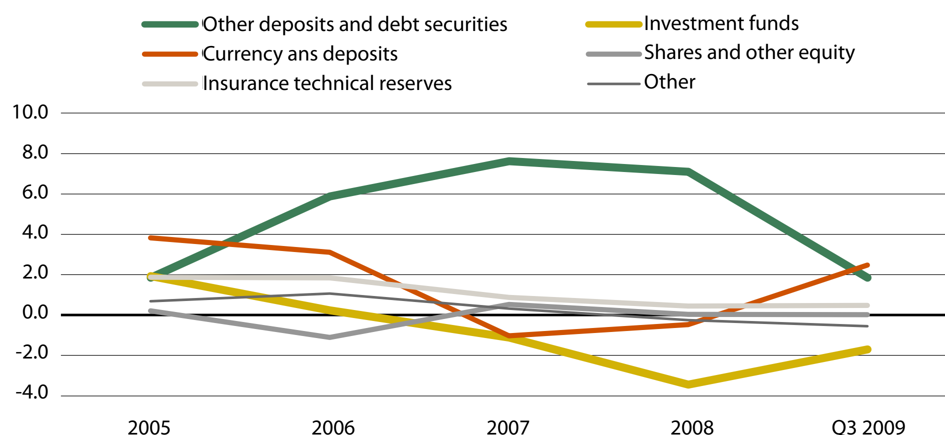
Household asset indicators for the third quarter of 2009 offered more of the same: namely, a continuing increase in the savings rate (to above 18% of gross disposable income) and a decrease in indebtedness ratios (to around 125% of gross disposable income). Where we can see changes emerging is in household wealth, whose appar-

ent stabilisation after the run-down of 2008 and first-half 2009 is a product of two opposing forces: the rising prices of financial assets and the depreciation of real estate. In all, households' net financial asset purchases climbed to around 3.5% of GDP in September 2009 (cumulative four-quarter data), almost one point higher than in June. By instrument, investment funds have made a significant come-back, while we can detect some reallocation towards cash vs. term deposits on the liquid side of the investment mix (see figure 10).

... increased savings rates have encouraged more funds into collective investment at the expense of term deposits.

Households: financial asset acquisitions (% GDP)

FIGURE 10



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

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

TABLE 7

Category	Subscriptions				Redemptions			
	1Q09	2Q09	3Q09	4Q09[8]	1Q09	2Q09	3Q09	4Q09[8]
Fixed income[1]	18,299.3	15,572.6	19,696.6	20,150.3	19,963.9	19,433.2	20,089.9	21,710.4
Balanced fxd income[2]	361.9	515	1,081.7	3,309.0	806.2	549.3	576.6	792.3
Balanced equity[3]	71	156.3	541.5	366.6	493	284.4	554.2	264.9
Spanish equity[4]	362.1	489.3	589.2	743.2	751.4	515.9	455.6	734.9
Intern. equity[5]	390.8	598.4	775	1,165.3	506.3	592	457.5	609.5
Fixed-income guaranteed	3,180.6	3,783.2	2,544.8	2,246.8	3,587.1	3,300.3	4,046.6	4,070.5
Equity guaranteed[6]	636.5	1,369.3	1,683.7	1,899.6	2,372.5	2,944.0	3,100.5	2,574.1
Global funds	600.6	971.5	389.4	792.9	1,538.5	588	141.6	280.5
Passively managed[7]		62.1	204.4	269.0		307.8	164.3	235.9
Absolute return[7]		567.8	1,256.4	2,221.5		627.3	924.6	1,672.1
Hedge funds	23.5	72.2	66.5		108.3	18.1	24.5	
Funds of hedge funds	35.5	9.2	170.1		294.6	79.8	57.5	
TOTAL	**23,961.8**	**24,166.9**	**28,999.2**	**33,164.3**	**30,421.8**	**29,240.1**	**30,593.5**	**32,945.1**

Source: CNMV.

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

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

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

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

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

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

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

8 Estimated data.

2.3 Outlook

Leading forecasters augur a return to robust growth in 2010 and 2011, led by the emerging economies. However, this scenario faces a series of downside risks...

The forecasts of leading international organisations (IMF and OECD) augur world growth of around 4.0% in 2010 and slightly more in 2011, confirming expectations of an international upswing. The consensus is that growth will be led by the emerging economies, with the Asia group strongly to the fore, and a firming recovery of economic activity in developed economies, especially the United States. However, improvement to date has relied heavily on the one-off stimulus measures approved by governments,[10] and it is hard to know how well it will withstand the phasing-out of these extraordinary aids.

...chiefly related to the labour market and public finances. The big upcoming challenge is how to engineer the withdrawal of stimulus packages.

The main downside risks for macrofinancial projections have to do with the sustainability of public finances in various advanced economies, additional labour-market deterioration, with the risk of an upturn in structural unemployment, the persistence of global demand imbalances and, finally, the possibility of crisis after-shocks in certain markets or institutions. In these delicate moments, the challenge for economic policy is how to withdraw extraordinary stimulus packages and, even more so, the timing of that withdrawal.

Forecasts for the Spanish economy are rather more pessimistic.

Current projections for the Spanish economy suggest recovery will lag that of other advanced economies. According to the latest IMF forecasts, issued in January 2010, Spain will be the only major developed economy to remain in recession through 2010, though labour-market and fiscal deterioration should begin to gradually revert as of 2011. The risks for this scenario, again according to the IMF, start with the prospect of deeper labour-market deterioration as government measures targeted directly on mitigating unemployment begin to be phased out. A case in point is the Local Investment Fund, which will be allocated five billion euros in 2010 against the eight billion paid in 2009. Another worry is how the country will cope with the burgeoning public deficit of 2009. A large and sustained increase in public sector borrowing requirements could bring pressures to bear on financing conditions with a knock-on effect in the private sector. Finally, the financial industry is still a focus of concerns regarding the further impairment of real estate sector assets and the eventual scale and success of its restructuring process.

3 Spanish markets

3.1 Equity markets

Most equity markets have recorded losses year to date...

Most Spanish exchanges have registered heavy losses since the start of 2010,[11] the exception being trading platforms for Latin American shares. Volatility, however, has remained fairly subdued, despite a recent upturn and the tightening of liquidity conditions – otherwise notably better than one year back.

...with concerns over European public finances and talk of new financial regulations as contributory factors.

The Ibex 35 has started the year with a price slide of 8.2% on the heels of the 30% gain of 2009 (see table 2). Factors at work included the skepticism abroad about

10 For G 20 countries, the IMF (*World Economic Outlook*, October 2009) estimates the growth boost deriving from discretionary fiscal stimulus measures at between 1.2 and 4.7 points in 2009 and 0.1 and 1.0 points in 2010. The cost of these measures for the same group of countries is reckoned at 2.0% of GDP in 2009 and 1.5% in 2010.

11 Data to 15 March.

European public finances after the troubles besetting Greece, and the uncertainties caused by a string of U.S. government announcements hinting at new fiscal and regulatory measures with a potentially large impact on the nation's banks. After quickening losses since the end of January, the index managed to reverse the trend in early March.

Trading platforms for Latin American securities (Latibex) outperformed the Ibex 35 all last year and up to the present date (the FTSE Latibex All-Share index practically doubled its value in 2009). Small and medium cap indices, meantime, have dropped back 3.7% and 0.6% respectively since the start of 2010, after more modest 2009 advances than remaining national indices (17.6% and 13.8% respectively).

Trading platforms for Latin American securities and small cap firms are proving the most resilient.

As table 8 shows, most sectors have shed some of their value in 2010, with financial institutions leading the downside, followed by telecommunications, energy producers and suppliers (oil, gas and utilities) and construction and materials. Insurance too has had a rougher ride this year, while real estate losses have been fairly contained compared to the price tumble of the last three years. Among the risers, the only truly solid gains belonged to non banking entities providing financial services and companies in the discretionary consumer goods sector. In figures 11 and 12, we can see that financial sector prices have been dragging on the Ibex 35 since early 2010, and also that the correction has been steeper among companies taking most of their income from foreign markets. This is the reverse of the story from March to December 2009, when companies with an international presence, principally in Latin America, fared better than their more home-market oriented peers.

Most sectors have shed some of their value, with financials and telecoms leading the downside.

Performance of Spanish stock indices (%) TABLE 8

							1Q09 (to 15 March)		
Index	**2006**	**2007**	**2008**	**2009**	**3Q09[1]**	**4Q09[1]**	**% prior qt**	**% Dec**	**% y/y**
Ibex 35	31.8	7.3	-39.4	29.8	20.1	1.6	-8.2	-8.2	43.5
Madrid	34.5	5.6	-40.6	27.2	20.9	1.0	-8.5	-8.5	41.3
Ibex Medium Cap	42.1	-10.4	-46.5	13.8	11.7	-5.9	-0.6	-0.6	32.0
Ibex Small Cap	54.4	-5.4	-57.3	17.6	17.9	-11.2	-2.7	-2.7	24.8
FTSE Latibex All-Share	23.8	57.8	-51.8	97.2	15.6	14.6	5.4	5.4	75.7
FTSE Latibex Top	18.2	33.7	-44.7	79.3	12.4	17.6	4.2	4.2	77.4
Sector[2]									
Oil and gas	18.3	1.8	-30.8	-20.1	10.6	-5.1	-6.7	-6.7	14.1
Chemicals	-20.4	-58.4	-67.8	3.4	28.3	-15.8	0.8	0.8	23.2
Basic materials	69.3	-17.2	-45.4	23.1	19.1	-5.1	-3.4	-3.4	50.6
Construction mat. and construction	61.6	-12.0	-51.0	25.5	12.0	-5.4	-6.5	-6.5	28.5
Industrial goods and services	28.4	6.9	-41.9	29.3	17.5	0.6	-2.1	-2.1	39.3
Health	40.7	19.2	-45.0	17.7	4.6	-7.9	0.2	0.2	24.0
Utilities	42.0	18.5	-31.0	-7.8	16.4	2.1	-6.0	-6.0	14.2
Banks	27.6	-4.5	-47.9	46.3	26.7	1.3	-11.9	-11.9	75.8
Insurance	44.7	-13.3	-25.0	19.8	31.2	-4.3	-5.4	-5.4	72.1
Real estate	100.4	-42.6	-58.6	-43.8	33.3	-25.8	-0.5	-0.5	-22.9
Financial services	91.1	-35.6	-44.3	20.8	9.8	-7.3	6.8	6.8	57.1
Telecommunications and media	29.4	26.3	-31.4	23.5	17.1	3.2	-8.8	-8.8	19.7
Discretionary consumption	21.2	-7.7	-39.2	37.0	18.8	7.3	4.8	4.8	77.4
Basic consumption	12.9	6.9	-22.5	-8.4	12.0	-0.8	0.8	0.8	18.0

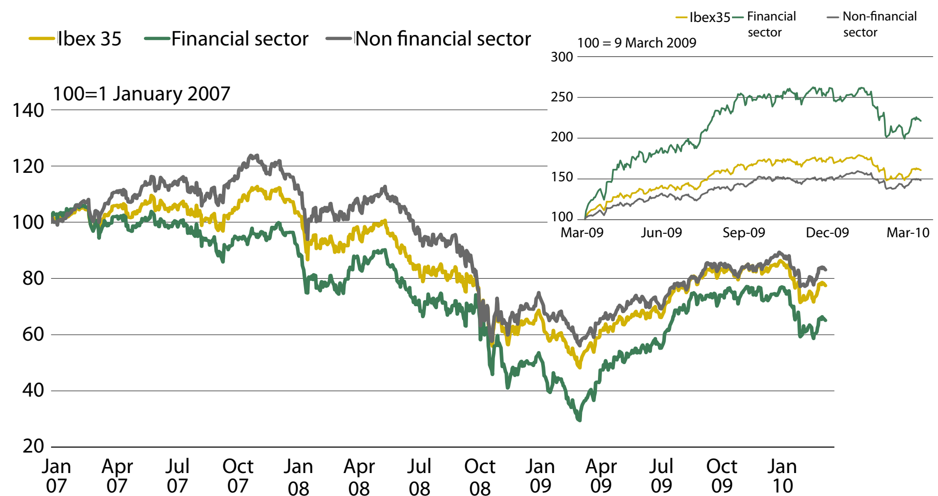
Source: Thomson Datastream.

1 Change on previous quarter.

2 Classification obtained from Thomson Datastream.

Ibex 35: financials vs. non financials[1]

FIGURE 11



Source: Thomson Datastream. Data to 15 March.

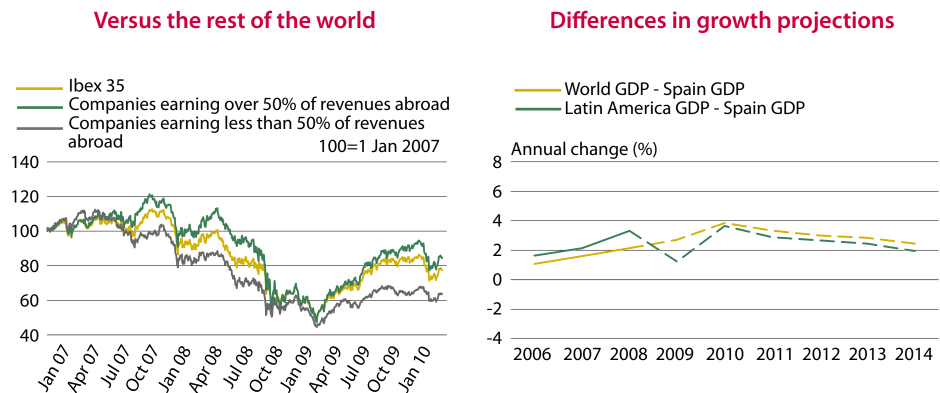
1 Each company is weighted according to the share of its market cap. in the market capitalisation of the Ibex 35 at the close of the preceding year.

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

FIGURE 12

Versus the rest of the world

Differences in growth projections



Source: Bloomberg, Thomson Datastream and IMF. Data to 15 March for the left-hand figure. The IMF revised its 2010 and 2011 forecasts in January this year, but has not yet released its revised forecasts for 2012-2014. October 2009 forecasts are accordingly left to apply for the entire period (2009-2014).

1 In the left-hand graph, each company is weighted according to its share in the market capitalisation of the Ibex 35 at the close of the preceding year. The yardstick used for internationalisation is 2008 operating profits, in the case of credit institutions, and 2008 revenues for all other firms.

Exhibit 2: Proposed disclosure regime for short positions in the European Union

On 2 March 2010, the Committee of European Securities Regulators (CESR) unveiled its model for a pan-European short selling disclosure regime.

The model has been sent to the European Commission with the intention of having it written into a Community instrument of secondary legislation, preferably a new directive or, failing that, an amendment to the Transparency Directive. In the interim, member jurisdictions with enabling mechanisms in their national legal system should start work now on implementing the new regime. Others are urged to adopt the model on a best efforts basis pending the enactment of the new legal norm.

The text was adopted after weighing up the pros and cons of short selling and in view of the felt need to provide a common disclosure system. Short sales can boost market liquidity and serve both to mitigate market bubbles and to facilitate efficient risk management through their utility as hedging instruments. But there is also widespread concern that using them abusively could undermine financial stability and contribute to disorderly markets. The financial sector is especially at risk in view of its trustee role and as a potential propagator of systemic risk, and because the soundness of an institution is often judged by the strength of its share price.

Under the new model, the supervisor should be notified of any short positions in securities listed on regulated markets or multilateral trading facilities in the European Economic Area. Net short positions equal to or higher than 0.2% of the company's issued share capital should be notified to the regulator but need not be publicly disclosed. Net short positions equal to or exceeding 0.5% of share capital should be disclosed to both the regulator and the market. The supervisor will likewise be notified of any 0.1% step-up in ownership after the original disclosure is triggered. The time limit for disclosure is the end of the trading day following the day on which the obligation is triggered (T+1, where T is the day the threshold is breached).

Notices should state the identity of the short position holder, the identity of the issuer on which the position is held, the size of the position and the date on which the position was created or was no longer held.

CESR's view is that market makers should be exempt from any blanket disclosure regime in attention to their particular characteristics and their role as ongoing providers of liquidity. But steps are needed to prevent other participants from trying to elude disclosure obligations by masquerading as market makers. In this respect, CESR understands that a market maker should have no need to take short positions in a systematic manner. By the same token, agents who engage in proprietary trading, i.e. acting more as investors than liquidity providers, will not be exempt.

CESR will continue working on the technical side of the new model, to facilitate its uniform implementation. Points covered will include: i) a precise definition of "market maker", ii) aggregation of positions in the case of groups, asset managers and fund managers, iii) the mechanics of disclosure to the regulator and the market and iv) calculating net positions in special cases (capital increases, convertible bond issues, etc.).

CESR is also looking at the option of harmonising other aspects of short selling. It will according pursue with urgency a common position on whether to accept or ban naked short selling. If an agreement can be reached, the proposal will also be sent to the European Commission, concurrently with the short position disclosure model, in order to secure a uniform treatment of all short selling activity across the European Union.

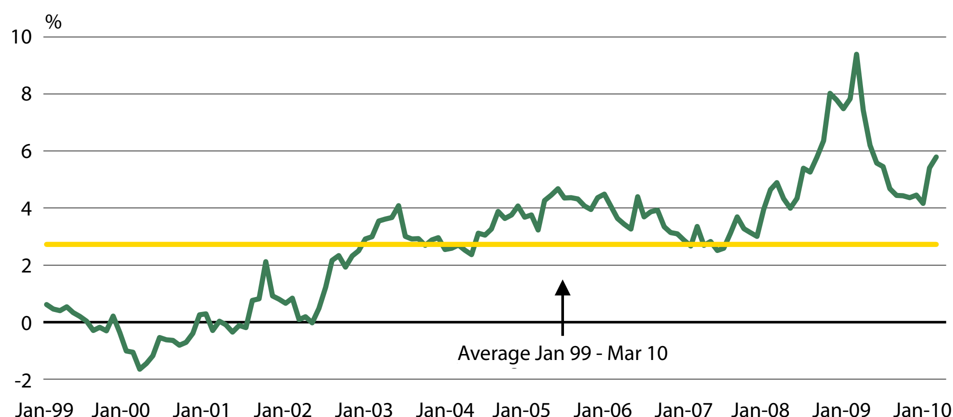
The main differences between the rules currently applying in Spain on the disclosure of short positions and the CESR proposal reside in the thresholds and scope of the disclosure obligation. According to the CESR model, participants must disclose short positions held in all market-traded securities, not just in the shares of financial issuers, as is the case today. Also, the public disclosure threshold for individual short positions will rise from 0.25% to 0.5% of the issuer's share capital, while regulators will have to be informed, for oversight purposes, of all those exceeding 0.2%. Finally, the CESR proposes a minimum step-up of 0.1% for regulator or public disclosure, while current rules specify the reporting or public disclosure of any increase in a previously disclosed position or its reduction to below 0.25% of capital.

The CNMV will study what measures are needed to implement the model in Spain as soon as CESR has hammered out the technical details.

The lower P/E of the Ibex 35 traces mainly to the intervening price correction...

The price-earnings ratio[12] (P/E) of Spanish shares fell to 10.4 from the 12.3 of end-2009 as a result of the intervening price correction and, rather less so, improved corporate earnings prospects. This takes the ratio back to the readings of halfway through 2009. The year-to-date decline has run deeper than in other leading international exchanges, widening the negative differential in their respect. It also caused the earnings yield gap (reflecting the return premium required to be invested in equity versus long-term government bonds) to break out of the downtrend initiated in March 2009 (see figure 13).

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



Source: Thomson Datastream and CNMV.

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

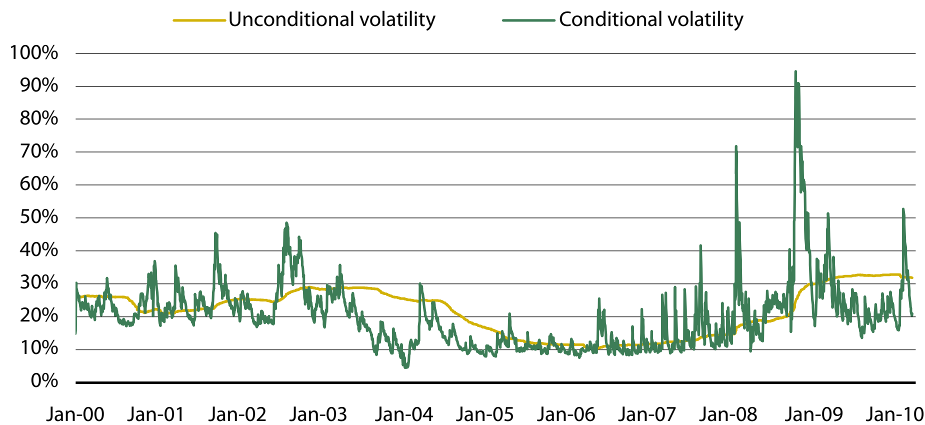
12 On the basis of one-year forward earnings.

...in a period marked by a temporary upswing in volatility and slightly tighter liquidity conditions.

Year-to-date, volatility on Spanish equity markets has experienced a brief resurgence to over 50% before easing back to manageable levels (see figure 14), while the sensitivity of index volatility to falling prices has lessened to some degree (see figure 15). The last month has also brought some slight deterioration in the bid-ask spread capturing equity market liquidity conditions, after the solid improvement registered since March 2009. That said, average monthly spreads continue more or less in line with their pre-crisis levels (see figure 16).

Historical volatility. Ibex 35

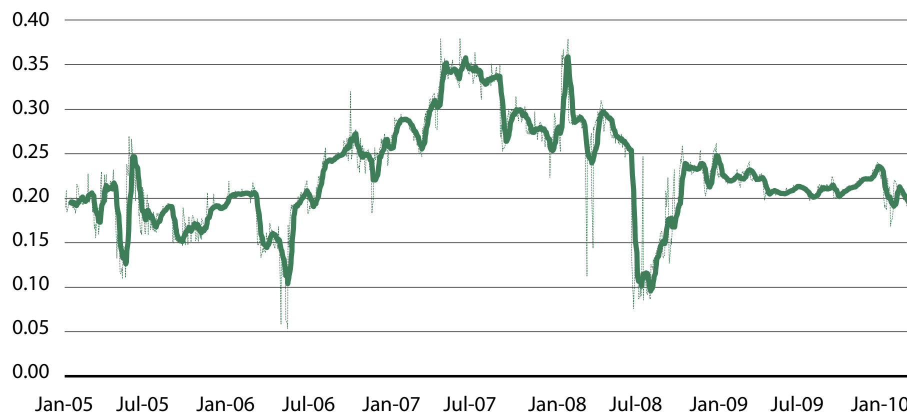
FIGURE 14



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

Volatility asymmetry of the Ibex 35

FIGURE 15



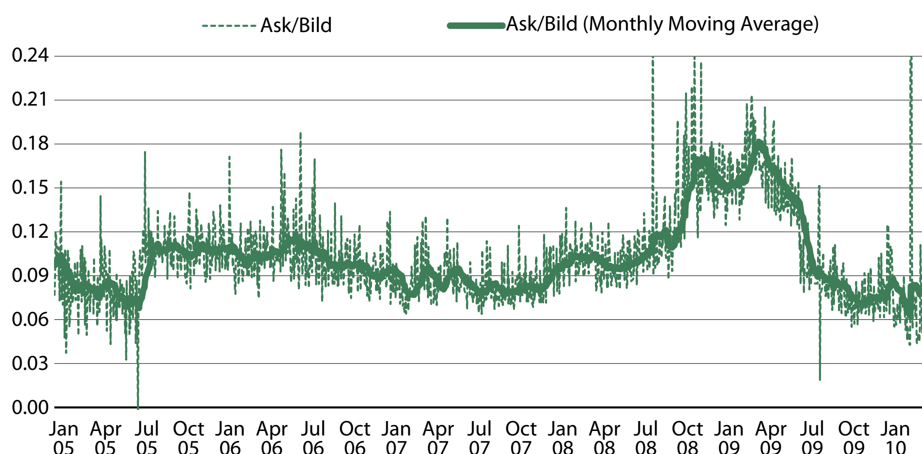
Source: Thomson Datastream and CNMV. Data to 15 March.

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

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

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

Ibex 35 liquidity. Bid/ask spread (%) FIGURE 16



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

After an erratic 2009, stock market turnover appears to pick up tentatively in the opening months of 2010...

Spanish stock market turnover, measured in average daily volumes, staged something of a come-back in the first two and a half months of 2010, after an erratic 2009 performance concluding in a year-long decline of 29%. Average daily trading to mid-March stood at 3.75 billion euros, an increase of 7% with respect to full-year 2009.[13]

Turnover on the Spanish stock market TABLE 9

Million euros	2006	2007	2008	2009	3Q09	4Q09	1Q10[1]
All exchanges	**1,154,294**	**1,667,219**	**1,243,387**	**886,135**	**216,778**	**259,065**	**191,172**
Electronic market	1,146,390	1,658,019	1,235,330	880,544	215,405	257,388	190,135
Open outcry	5,318	1,154	207	73	14	12	10
of which SICAVs[2]	4,581	362	25	20	8	2	2
MAB[3]	1,814	6,985	7,060	5,080	1,249	1,544	899
Second Market	49	193	32	3	0	0	0
Latibex	723	868	758	435	110	120	127
Pro-memoria: non resident trading (% of all exchanges)							
	58.4	61.6	65.5	na	64.9	na	na

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

1 Cumulate data from 1 January to 15 March.

2 Open-end investment companies.

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

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

...though issuance activity remains sunk in lethargy.

The improved price, liquidity and volatility conditions of 2009 were still not enough to get equity issuance moving again. The final issuance tally was 11.39 billion euros, a long way short of pre-crisis totals.

13 In 2009, average daily trading volumes closed at 3.49 billion euros compared to 4.89 billion in 2008.

Equity issues and public offerings[1]

TABLE 10

	2006	2007	2008	2009	2009 3Q09	4Q09	1Q10[2]
CASH AMOUNTS[3] (million euros)	29,436	69,955	16,349	11,391	1,087	2,311	231
Capital increases	26,977	67,887	16,340	11,389	1,087	2,309	231
Of which, rights offerings	645	8,503	292	17	7	10	6
National tranche	303	4,821	292	17	7	10	6
International tranche	342	3,681	0	0	0	0	0
Public offerings	2,459	2,068	10	2	0	2	0
National tranche	1,568	1,517	10	2	0	2	0
International tranche	891	551	0	0	0	0	0
NUMBER OF FILINGS[4]	86	100	54	53	11	19	9
Capital increases	77	91	53	53	11	19	9
Of which, rights offerings	8	8	2	2	1	1	1
Of which, bonus issues	20	19	18	11	4	3	1
Public offerings	14	12	2	1	0	1	0

Source: CNMV.

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

2 Data to 15 March 2010.

3 Excluding amounts recorded in respect of cancelled transactions.

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

Exhibit 3: Changes in the Spanish securities clearing, settlement and registration system

On 15 February 2010, the CNMV issued a public consultation paper proposing a series of changes in the Spanish clearing, settlement and registration system for equity securities, which add up to major overhaul of this all-important market segment. The proposals it contains draw on the thoughts and recommendations set out in *Securities clearing, settlement and registry systems in Europe. Current situation, ongoing initiatives, and recommendations,* prepared jointly by the CNMV and Banco de España at end-2007.

The clearing, settlement and registration of securities trades is a vital part of any financial system. These activities, whose purpose is the correct performance of the agreed cash-for-securities exchange, take in every step in the post-trade process leading up to the handover of the securities and the registration of their new ownership. The effectiveness and legal certainty of post-trade mechanisms, far less visible than their trading counterparts, is accordingly essential to uphold the efficiency, competitiveness and stability of the financial system.

The Spanish post-trade system for equity securities (shares), dating from almost two decades back, was designed to operate in a very different trading and technological landscape, and also exhibits certain singularities with respect to almost all neighbour markets. By and large, we can say that the Spanish system has acquitted itself well, with a degree of soundness and risk control, and an absence of incidents, that can stand comparison with any other front-line international market. It also stands out for its discipline and traceability, though admittedly certain complexities make for a difficult fit with European projects like the Eurosystem's Target 2 Securities (T2S).

The CNMV's proposals are designed to achieve a more efficient, competitive system and, above all, one more closely compatible with those of neighbour countries, and also flexible enough to embrace the changes taking place in

securities markets. Specifically, the CNMV proposes modifying the system along three main lines:

1. Move finality to the point of settlement and enhance system versatility. In the Spanish stock market, transaction finality, understood as the irrevocable, unconditional nature of settlement instructions, is acquired immediately after a trade is closed, when the details are received by Iberclear. In parallel, mechanisms are activated in order to guarantee delivery, ensuring that all trades are settled on their value date. But this is not always achievable in practice, however many cautions these mechanisms incorporate. The proposal, as such, is to move finality to the time of effective settlement –the rule in almost all other European systems– while relaxing the delivery assurance mechanisms currently in place. Another novelty would be to allow different settlement terms, based on the standards operating in other European systems; one of the demands voiced by market participants.

2. Institute a central counterparty (CCP). One way to conserve settlement certainty would be to create a CCP to stand as a buyer to sellers and as a seller to buyers, centralising and organising the credit risk of market participants. This too would align the structure of the Spanish post-trade system with that of other international bourses. The CCP's netting capacity would also boost efficiency by reducing the number of transactions pending settlement at a given time.

3. Postpone the assigning of a registration code until after settlement. At present, all stock market sales must be assigned a registration code before they can proceed to settlement. In future, however, the central depository (Iberclear) would run a prior control of securities balances, maintaining a numerical code that identifies the securities for registration purposes but allowing their a posteriori contribution. This would simplify and speed up process flows, enabling the kind of pared down settlement cycle that will be increasingly demanded in the European Union.

On a practical score, the changes proposed by the CNMV will require the amendment of various provisions, among them the Securities Market Law, Royal Decree 116/1992 on the book-entry system, stock market regulations and Iberclear regulations, as well as new regulations to govern, for instance, the principles of CCP structure and operation.

A Steering Committee has been set up, chaired by the CNMV Vice President and with the involvement of the Banco de España, Bolsas y Mercados Españoles and representatives of sector associations. Its role will be to discuss the groundwork needed for the reform and advise the CNMV accordingly. To aid it in this task, it will receive technical input from two working groups formed by experts and industry representatives. A preliminary paper on the proposed reforms was sent out for public consultation on 12 February 2010.

This discussion will proceed in a spirit of maximum transparency, with all stakeholders invited to have their say, and the results submitted to public consultation. Plans are to have a development blueprint for the reform drawn up by the end of 2010.

3.2 Fixed-income markets

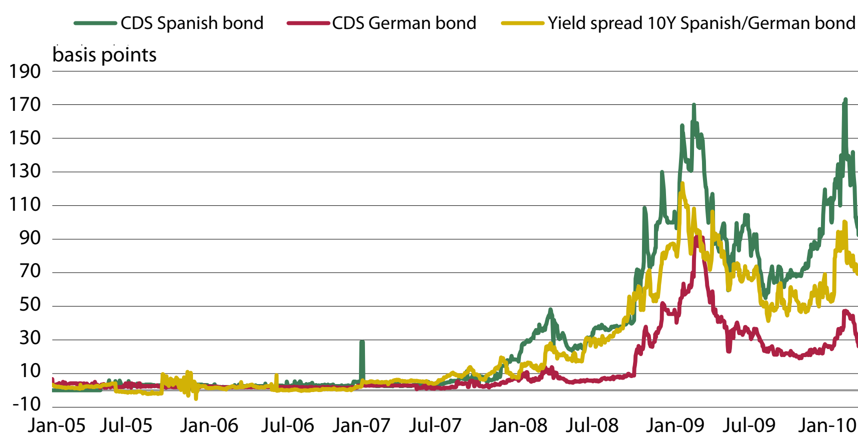
Short-term rates continue at lows in with ECB policy, ...

Short-term rates in public and private debt markets continued at lows, in line with ECB monetary policy. On the public side, the (average) March[14] interest rates of Letras del Tesoro were 0.5% for the three and six month tenors and 0.7% for twelve-month bills. The equivalent rates of private fixed-income instruments on the same date stood at 0.8%, 1.1% and 1.4% respectively.

....while long-term government yields have been straining higher year to date.

In contrast, long-term sovereign yields pulled out of the downtrend initiated in the second half of 2009 and experienced a sharp first-quarter run-up which has begun to lose momentum in recent weeks. The spread between the Spanish and German benchmark stretched to 100 bp on 8 February and is currently hovering around the 72 bp mark compared to the 60 bp approximately of year-end 2009. This profile is rather more accentuated in the case of the Spanish CDS (see figure 17), which climbed from the 113 bp of end-2009 as far as a historic high of 173 bp on 8 February before sinking back to its current level below 95 bp.

Risk premium of Spanish government debt[1] FIGURE 17



Source: Thomson Datastream.

1 Data to 15 March.

Long-term corporate bond yields are holding relatively stable...

Long-term corporate bond yields have held more or less flat since year-end 2009. The average rate on three-year bonds dropped from 3.19% to 2.95% in March 2010, against the 8 bp and 3 bp increases in five- and ten-year maturities as far as 4.11% and 4.99% respectively (see table 11).

14 To 15 March.

Interest rates on corporate debt[1]

TABLE 11

%	Dec 06	Dec 07	Dec 08	Dec 09	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10
Short term: commercial paper[2]									
3 months	3.78	4.97	3.45	0.89	1.70	1.28	0.95	0.89	0.83
6 months	3.91	4.91	3.54	1.17	1.86	1.52	1.22	1.17	1.13
12 months	4.00	4.85	3.68	1.43	2.10	1.80	1.45	1.43	1.41
Medium and long-term[3]									
3 years	4.04	4.59	3.79	3.19	3.24	3.40	3.22	3.19	2.95
5 years	4.14	4.65	4.17	4.19	4.00	4.46	4.31	4.19	4.11
10 years	4.26	4.94	4.73	5.02	4.76	5.24	5.14	5.02	4.99

Source: AIAF.

1 Average daily data. Data for March correspond to the average level from 1/3 to 15/3.

2 Traded on private fixed-income market AIAF.

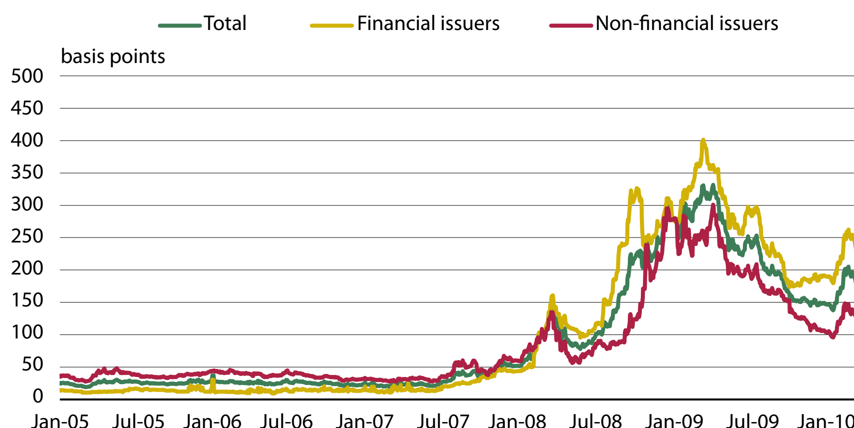
3 Bond and debenture trades to maturity on AIAF.

...while the rising CDS of Spanish corporate issuers are more about the contagion effect of heightened sovereign risk.

In contrast, the CDS spreads of Spanish corporate issuers have gained 30 bp since the start of the year, although with some levelling-off since the middle of February. Specifically, average spreads widened from the 148 bp of year-end 2009 as far as an 8 February peak above 200 bp then headed downwards to the 178 bp of mid-March. One reading is that the varied pressures felt by Spanish sovereign debt are being relayed to the general body of corporate borrowers regardless of their sector (see figure 18 and exhibit 5).

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

FIGURE 18



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

1 Simple average.

Falling issue volumes in 2009 were accompanied by a shift in the mix in favour of non convertible bonds, mortgage bonds and preference shares.

The volume of fixed-income issues registered with the CNMV fell by 19% in 2009 compared to the 27% slide of the previous year. This rather better outcome was accompanied by sizeable changes in the mix. Gaining ground were non convertible bonds and debentures (up from 2.2% of total issuance in 2008 to 16.1% in 2009), mortgage bonds (3% to 9.2%) and, to a lesser extent, preference shares (0.3% to 3.3%), in contrast to the fading share of commercial paper (65.5% to 49.4%) and asset-backed securities (28.4% to 21.1%). This six-fold rise in non convertible bonds and debentures owed to the popularity of government-backed financing, which accounted for 77% of total issue volumes, while the 149% increase in mortgage bonds was presumably driven in part by the ECB purchase programme launched in June 2009.

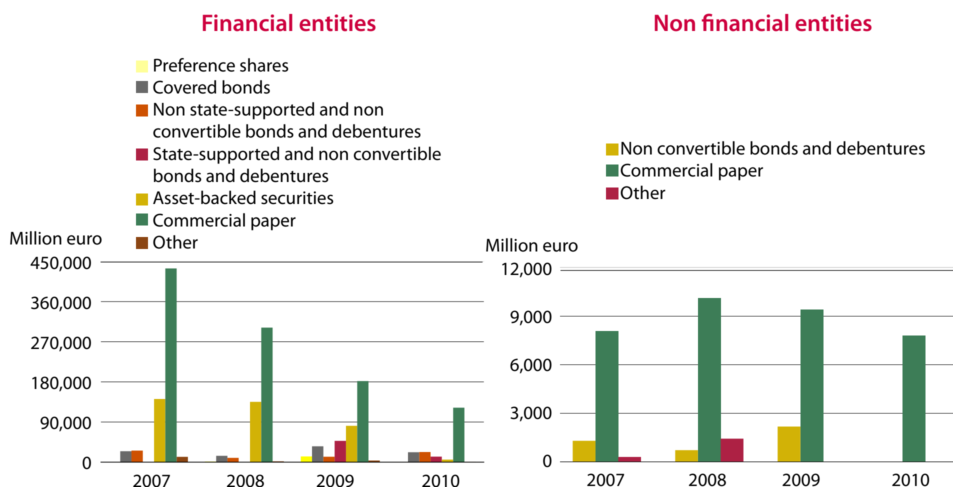
This year to date,[15] total issuance has reached 39.8 billion euros, well short of the 95.5 billion of the same period in 2009. Indeed the year 2010 has got off to a particularly slow start due to the virtual shutdown of securitisation markets. Whereas in recent years this segment has summed around 20% of total volumes, a mere six issues have been registered this year, representing a lowly 3% of issuance. Preferred share issues have ground to a halt after a busy 2009, when they were particularly favoured by financial entities for their role in strengthening regulatory capital. Factors at work could be market preferences for the use of more traditional instruments to evaluate capital adequacy and the weakness of corporate earnings exerting a dissuasory effect on potential investors. What would appear to be a strong surge in commercial paper issuance (67% of the year-to-date total against 49% in 2009) is simply a product of the above declines, and in fact sales of this instrument are just half what they were in the same months of 2009. Issuance of non convertible bonds and mortgage bonds is proceeding along the same lines as last year. In the first case, entities are turning less to government-backed financing (35% of issues to date bear a state guarantee), possibly denoting easier access to capital markets. Mortgage bonds, meantime have benefitted from the fading popularity of asset-backed securities.

Some markets are still struggling in 2010 – securitisation markets being the most obvious case. On the plus side, issuers seem more confident of issuing bonds without government guarantee.

Foreign debt financing partly offset the downturn in domestic issuance during 2009, with commercial paper as the instrument of choice (see figure 19). Borrowers also evinced a notable preference for short rather than long-term paper (41% and 18%, respectively).

Spanish issuers are raising more funds abroad.

Gross debt issuance by type of entity and instrument[1] FIGURE 19



Source: CNMV.

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

15 To 15 March.

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

TABLE 12

	2006	2007	2008	2009	2009 3Q09	2009 4Q09	2010 1Q10[2]
NUMBER OF ISSUES	**335**	**334**	**337**	**512**	**103**	**118**	**57**
Mortgage bonds	37	32	47	75	13	20	10
Territorial bonds	6	8	8	1	0	0	1
Non convertible bonds and debentures	115	79	76	244	51	56	33
Convertible/exchangeable bonds and debentures	1	0	1	6	3	2	0
Asset-backed securities	82	101	108	76	16	13	2
Commercial paper facilities	83	106	88	73	11	26	11
Securitised	3	3	2	2	0	1	0
Other commercial paper	80	103	86	71	11	25	11
Other fixed-income issues	0	3	0	0	0	0	0
Preference shares	11	5	9	37	9	1	0
FACE VALUE (million euros)	**523,131**	**648,757**	**476,276**	**387,476**	**66,722**	**74,199**	**39,842**
Mortgage bonds	44,250	24,696	14,300	35,574	3,870	11,055	4,600
Territorial bonds	5,150	5,060	1,820	500	0	0	125
Non convertible bonds and debentures	46,688	27,416	10,490	62,249	6,138	12,370	7,230
Convertible/exchangeable bonds and debentures	68	0	1,429	3,200	2,200	700	0
Asset-backed securities	91,608	141,627	135,253	81,651	12,956	10,301	1,185
Domestic tranche	30,886	94,049	132,730	77,289	11,751	9,696	1,185
International tranche	60,722	47,578	2,522	4,362	1,206	605	0
Commercial paper[3]	334,457	442,433	311,738	191,342	40,340	39,753	26,703
Securitised	1,993	465	2,843	4,758	953	1,245	870
Other commercial paper	332,464	441,969	308,895	186,583	39,388	38,508	25,833
Other fixed-income issues	0	7,300	0	0	0	0	0
Preference shares	911	225	1,246	12,960	1,217	20	0
Pro memoria:							
Subordinated issues	27,361	47,158	12,950	20,989	4,679	2,254	3,100
Covered issues	92,213	86,161	9,170	4,794	1,450	785	0

Source: CNMV.

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

2 Available data to 15 March 2010.

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

Exhibit 4: Recent trends in international debt markets

The financial crisis had taken a heavy toll on international debt markets. In a first phase lasting until end-2008, it provoked a substantial decline in debt issuance volumes and pushed financing costs to record highs, as evidenced by a generalised leap in credit spreads (see figure 3). The resumption of more normal conditions in 2009 permitted a timid upswing in issuance on certain markets and an easing back of risk premiums.

In this exhibit, we analyse some of the recent trends in primary debt markets in order to explain changes in issue volumes over 2008 and 2009 and the various shifts observable in the issuance mix between instruments, regions and types of borrowers.

1) Issuance by instrument. As we can see from the top panel of figure E4, net issuance of fixed-income instruments in international markets amounted to 6.3 trillion dollars in 2009, an increase of 3.3 trillion dollars versus 2008 and 1.6 trillion versus 2007. Among the first casualties of the crisis was net issuance of asset-backed securities, which was practically wiped out in 2008 after peaking at 2.5 trillion dollars in 2006, and managed only a timid increase in 2009. The volume recovery of 2009 relied on the surge in sovereign debt issuance (from 3.3 billion dollars in 2008 to 5.5 billion in 2009) and a step-up in the issuance of investment grade bonds.

2) Issuance by region. As we can see from the middle panel of figure E4, the issuance shrinkage of 2008 was concentrated mainly in the United States (64% of the total), while the 2009 upswing was spread more evenly across world regions (46% in the United States and 31% in Europe).

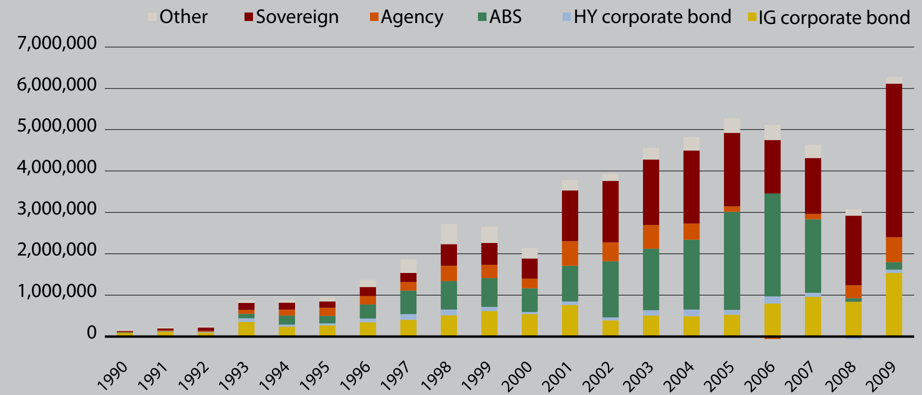
3) Issuance by type of borrower. While the decline of 2008 was all about the reduced issuance of financial institutions (due mainly to the collapse of securitisation), the 2009 recovery was basically led by public sector borrowings (84%) and, to a lesser extent, those of non financial corporations (16%) (see lower panel of figure E4). In all, net financial institution issuance closed the year slightly down on 2008 levels, even allowing for the increase in state-backed financing. Indeed this last trend reflects the deleveraging underway across the financial sector. Among non-financial issuers, the year's salient development was the redistribution of finance sources as firms switched increasingly to debt instruments in place of bank loans in response to the latter's tougher access conditions (see figure E4).

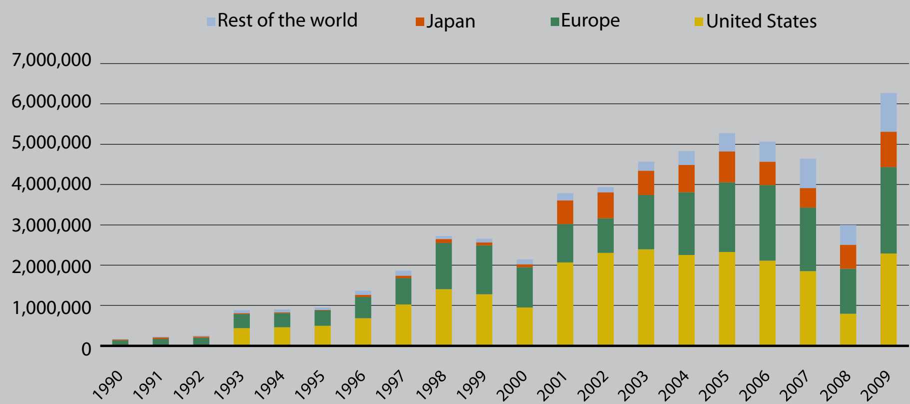
Figures for the first two months of 2010 reveal a renewed increase in annual debt issuance worldwide with the public sector again to the fore.[1]

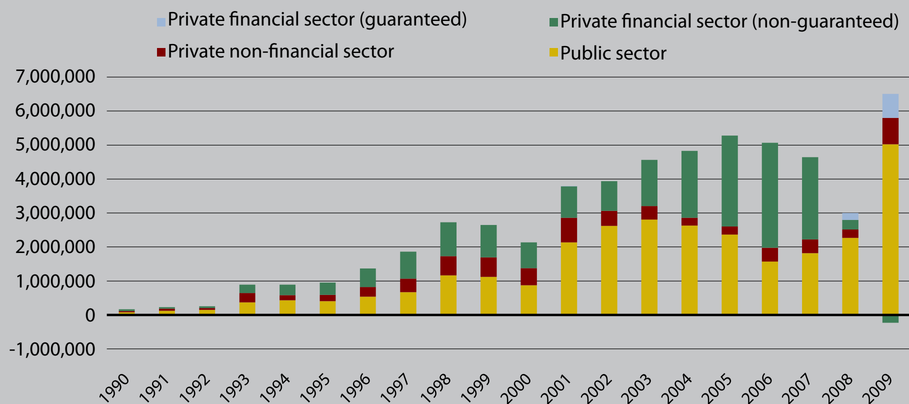
Net international debt issuance (million dollars)

FIGURE E4

By type of instrument, region and type of issuer







Source: Dealogic.

1 In the first two months of the year, gross debt issuance totalled 2.1 trillion dollars, of which 52% corresponded to sovereign issues and 16% to agencies.

Exhibit 5: Recent developments in credit risk valuation

Amid the turmoil unleashed by evidence of the fragile state of Greece's public finances, one phenomenon has stood out in these past weeks: the divergent performance of the CDS and underlying bond spreads of certain European sovereign issuers. This decoupling, which has arisen on different occasions during the crisis in several European countries (see figure), has sown some confusion as well as a degree of controversy over the role of CDS and, particularly, their potentially destabilising role in public debt markets. This exhibit aims to shed some light on the supposedly anomalous conduct of CDS markets, before going on to suggest some courses of action for the relevant economic authorities.

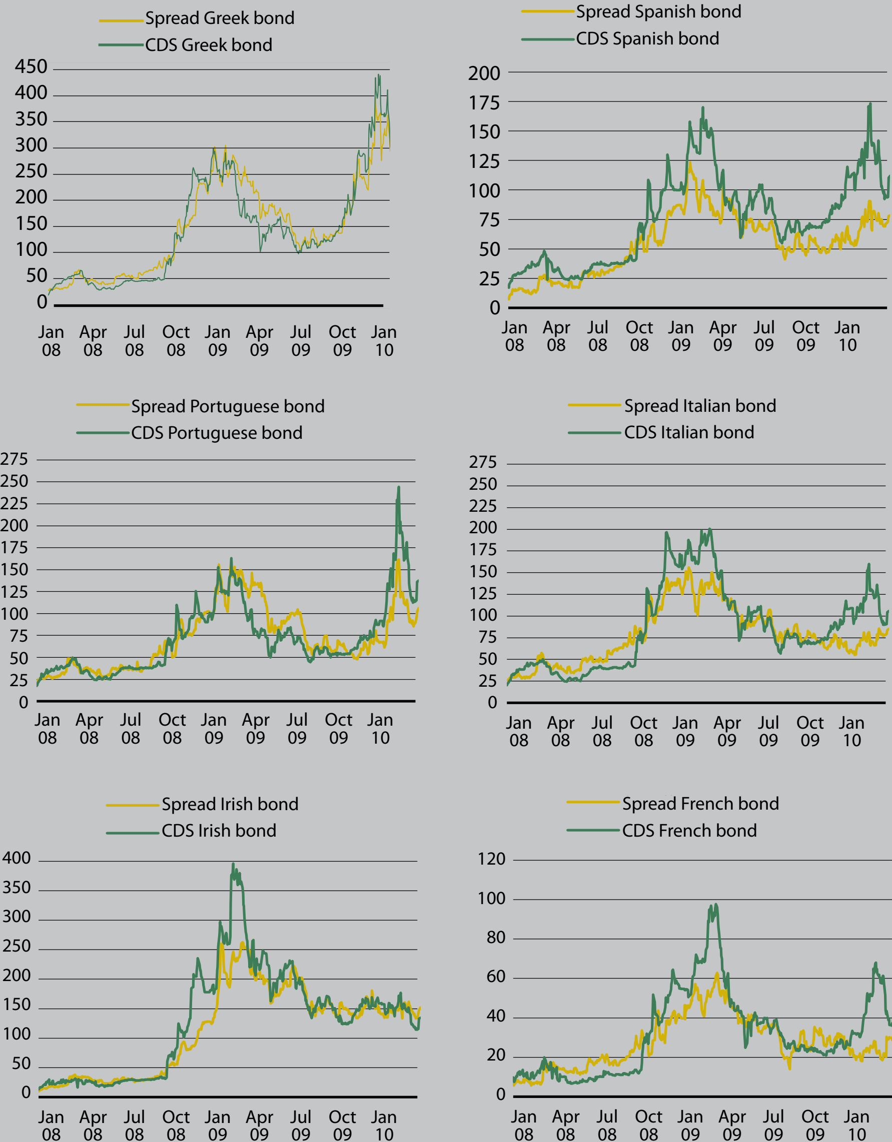
1) The relationship between the sovereign bond and CDS market. According to the theory, bond and CDS spreads should trade more or less in tandem in the absence of major frictions. This near correspondence, based on the non existence of arbitrage opportunities, has been shown to stand up successfully for long time horizons.[1] In the short run, however, gaps can open, as we have seen in recent weeks, when CDS premiums pulled substantially ahead of bond spreads.

This decoupling can have different causes, some to do with CDS demand and others with supply. What does seem clear is that it tends to accentuate at times of mounting debt market tensions.

On the one hand, it is reasonable to assume that part of the demand for sovereign CDS at times of multiple uncertainties is geared to hedging non sovereign, but positively correlated risks for which there is no safe or sufficiently efficient market. In such circumstances, overall demand for CDS will turn more sensitive to changes in the perceived risk of sovereign debt.

On the other, any sudden surge in the popularity of CDS, be it to hedge against sovereign debt credit events or other macroeconomic risks or out of purely speculative motives,[2] can have a magnified effect on product prices if the supply is not there in time. In this respect, the fact that a relatively small number of institutions[3] hold a large percentage of global sovereign CDS could place possible constraints on their availability, thus multiplying short-term price tensions. Also, it could be that the copious public monies transferred to the financial sector have indirectly triggered temporary shortages in CDS supply, by conjuring the spectre of a twin fiscal and banking crisis. Finally, the recent disappearance of some of the most active liquidity providers in CDS markets, like Lehman Brothers and, less so, Bear Sterns, has made further inroads into the global supply capacity of these products.

Credit risk premiums (basis points) FIGURE E5



Source: Thomson Datastream. Bond spreads are referenced to the German bund.

We can see, then, that there are objective factors that at least partly explain the recent deviations between CDS premiums and the credit spreads of European sovereign bonds. As to whether CDS market frictions can impair the valuation of the corresponding bond, this seems unlikely in practical terms given the insignificance of CDS volumes compared to circulating public debt (working out at around 4% for Portugal, 3% for Ireland, 2% for Greece and Spain and 1% for Italy).

Possible courses of action. The debate around these products has indirectly brought to light one of the failures of the CDS market; namely the absence of post-trade transparency, such that transaction prices and volumes are not disclosed to remaining participants. This may muddy the picture for market agents, and even supervisors, to add to the uncertainty that logically follows crisis situations like the present. Also, for most European supervisors (except in Spain, the United

Kingdom and Ireland), these are "invisible" trades that do not form part of the obligatory list for daily transaction reporting. Indeed, it would seem advisable to extend the requirement to provide reliable daily information on the agents and entities offering this kind of hedge against sovereign risk and the conditions of the corresponding contracts (volume, price, type of counterparty, collateral required, etc.). In Europe, consideration should go to including such reporting requirements in the MiFID, taking advantage of its current review.

Supervisors need to have complete, up-to-date information in order to detect abusive or manipulate practices in a timely manner. In Europe, the obvious way to enforce this requirement with regard to CDS markets is to amend the Market Abuse Directive (also under review by the European Commission)[4] in the light of recent experiences.

Finally, another market failure that bears consideration here has to do with the counterparty risk of hedging operations instrumented through CDS. One option would be to strengthen clearing and settlement mechanisms for the CDS contracts most amenable to standardisation by setting up central counterparties.

1 See for instance Haibin Zhu (2004), *An empirical comparison of credit spreads between the bond market and the credit default swap market*, BIS Working Papers N. 160, and Blanco, R., Brennan, S. and Marsh, I.W. "An Empirical Analysis of the Dynamic Relation between Investment-Grade Bonds and Credit Default Swaps", *Journal of Finance*, 60 (2005), pp. 2255–2281.

2 Note however that a recent study by Germany's BaFin (press release of 8 March 2010) rules out speculative motives as the main reason for the spike in Greek CDS spreads, pointing instead to genuine demand for the instrument as a hedge against default risk.

3 According to April 2009 data from the Depository Trust and Clearing Corporation (DTCC), as much as 49% of world supply of CDS was in the hands of the five top suppliers, while the top ten together accounted for 72%.

4 The situation in Spain does not call for significant changes in market abuse regulations or transaction reporting requirements. Participants are already obliged to notify the CNMV of all CDS contracts written whose underlier is a security traded on European markets, while Spanish market abuse provisions already apply to CDS.

4 Market agents

4.1 Investment vehicles

Financial collective investment schemes[16]

Investment funds assets return to growth in the second half of 2009 with falling redemptions…

After two tough years, the investment fund industry has apparently entered some kind of recovery phase, translating as a small increase in assets and unitholder numbers over the second half of 2009 (see table 13). Assets under management edged up 2% from 167 billion euros in mid-2009 to 170.5 billion in the month of December on the back of portfolio appreciation, especially in the third quarter, and a large downturn in unitholder redemptions. More specifically, net outflows, which were running at over 18 billion euros per quarter at some points in 2008, headed steadily lower over 2009. Most encouragingly of all, the industry scraped a positive inflow in the closing quarter (of 220 million euros), when it registered net subscriptions across all categories except guaranteed funds, possibly due to their expiry calendar.

… and higher returns, thanks to the price rally in equities

In full year terms, assets under management in investment funds dropped by just over 5.30 billion euros (-3%), a sizeable improvement on the two preceding years (with falls of 79 billion euros in 2008 and 15 billion in 2007). The decline in assets was exclusively due to unitholder redemptions, which exceeded 12.90 billion euros. In contrast, fund portfolios marked up substantial gains on the strength of recovering equity prices, which restored overall returns to positive territory (5.7% in 2009 against -4.2% in 2008).

Balanced fixed-income and international equity funds are the strongest performers.

Analysis by category is hindered by a regulatory change in fund classification by investment objective[17] enacted in the second quarter of 2009, which led to numerous funds switching categories.[18] But we can safely say that the asset drain was steepest in the fixed-income and guaranteed equity categories, with redemption volumes to blame in both cases. Conversely, balanced fixed-income and international equity funds performed better in the year, thanks to both net investment inflows and portfolio appreciation.

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

17 CNMV Circular 1/2009 of 4 February on collective investment scheme categories as a function of investment objective.

18 These reclassifications particularly affected global funds and the newly created category of absolute return funds.

Main investment fund variables

TABLE 13

	2007	2008	2009				2009
Number				**1Q**	**2Q**	**3Q**	**4Q**
Total investment funds	**2,926**	**2,912**	**2,536**	**2,830**	**2,735**	**2,628**	**2,536**
Fixed income[1]	600	629	582	631	612	598	582
Balanced fixed income[2]	204	195	169	193	190	171	169
Balanced equity[3]	207	202	165	191	181	174	165
Euro equity[4]	247	237	182	235	193	185	182
International equity[5]	357	330	242	304	271	252	242
Fixed income guaranteed	251	260	233	249	253	241	233
Equity guaranteed[6]	590	590	561	586	610	593	561
Global funds	470	469	187	441	208	193	187
Passively managed[7]			69		69	69	69
Absolute return[7]			146		148	152	146
Assets (million euros)							
Total investment funds	**255,040.9**	**175,865.3**	**170,547.7**	**168,829.3**	**167,161.0**	**169,458.4**	**170,547.7**
Fixed income[1]	113,234.1	92,813.1	84,657.2	91,473.0	86,711.3	85,913.9	84,657.2
Balanced fixed income[2]	13,011.9	5,803.0	8,695.5	5,282.6	5,421.8	6,322.4	8,695.5
Balanced equity[3]	8,848.0	3,958.8	3,879.6	3,301.7	3,480.1	3,812.4	3,879.6
Euro equity[4]	16,589.7	5,938.9	6,321.6	4,7781	4,946.0	6,094.1	6,321.6
International equity[5]	13,948.1	4,254.7	5,902.4	3,808.8	4,108.3	5,020.9	5,902.4
Fixed income guaranteed	17,674.4	21,150.3	21,033.4	20,952.0	21,664.1	21,322.7	21,033.4
Equity guaranteed[6]	42,042.1	30,873.7	25,665.8	29,433.3	29,120.6	27,857.4	25,665.8
Global funds	29,692.6	11,072.8	3,872.5	9,799.9	3,350.7	3,400.4	3,872.5
Passively managed[7]			3,216.6		2,714.5	3,066.3	3,216.6
Absolute return[7]			7,303.0		5,643.6	6,647.7	7,303.0
Unitholders							
Total investment funds	**8,053,049**	**5,923,346**	**5,475,403**	**5,626,786**	**5,498,325**	**5,461,473**	**5,475,403**
Fixed income[1]	2,763,442	2,204,652	2,041,487	2,145,607	2,067,091	2,042,556	2,041,487
Balanced fixed income[2]	493,786	277,629	290,151	247,833	241,097	254,599	290,151
Balanced equity[3]	331,214	209,782	182,542	194,064	187,244	184,985	182,542
Euro equity[4]	577,522	377,545	299,353	339,285	270,079	277,093	299,353
International equity[5]	800,556	467,691	458,097	431,575	419,928	434,299	458,097
Fixed income guaranteed	549,108	538,799	570,963	525,387	540,428	550,041	570,963
Equity guaranteed[6]	1,715,144	1,402,948	1,188,304	1,339,367	1,339,321	1,272,792	1,188,304
Global funds	822,277	444,300	88,337	403,668	96,581	79,288	88,337
Passively managed[7]			85,403		91,738	97,399	85,403
Absolute return[7]			270,766		244,818	268,421	270,766
Return[8] (%)							
Total investment funds	**2.63**	**-4.21**	**5.73**	**-0.32**	**2.43**	**2.80**	**0.73**
Fixed income[1]	2.68	2.06	1.91	0.23	0.55	0.88	0.24
Balanced fixed income[2]	2.01	-7.14	6.85	-1.51	3.48	4.18	0.63
Balanced equity[3]	2.79	-22.21	16.47	-5.66	9.86	10.18	1.99
Euro equity[4]	6.05	-39.78	32.41	-13.02	23.34	19.76	3.06
International equity[5]	1.31	-41.71	37.28	-6.60	20.08	15.15	6.30
Fixed income guaranteed	2.80	3.29	3.81	1.14	0.94	1.31	0.37
Equity guaranteed[6]	2.46	-2.61	3.56	1.11	0.85	1.40	0.16
Global funds	1.58	-8.64	10.90	-1.33	4.90	5.18	1.87
Passively managed[7]			-		16.50	12.09	4.61
Absolute return[7]			-		1.54	1.90	0.70

Source: CNMV.

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

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

2 To 1Q09: Balanced fixed income and balanced international fixed income. From 2T09: Balanced euro fixed income and balanced international fixed income.

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

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

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

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

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

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

Unitholder numbers drop by 450,000 in 2009, but the trend inverts in the closing quarter.

The number of unitholders fell by 450,000 to a year-end figure of just under 5.5 million. Not only was the decrease less than in previous years (2008, for instance, when over two million investors opted to withdraw) but the fourth quarter actually brought in 14,000 new subscribers.

Inter-fund mergers reduce overall numbers.

The number of funds held up reasonably well at around 2,900 in the quarters following the crisis onset, then declined to 2,536 at end-2009 after a wave of mergers (448) affecting fixed-income categories especially. In effect, managers used the occasion of the regulatory reclassification by investment objective to reorganise and rationalise their fund offerings, in order to coax out management efficiencies and thereby gain in competitiveness.

Less-liquid assets hold more or less flat at around 8.7% of the total.

Recent analyses of the liquidity conditions of investment fund fixed-income portfolios reveal that the volume of less-liquid assets rose from 14.39 billion euros in September 2009 to 14.87 billion in December (an increase of 483 million), lifting their share of total investment fund assets from 8.5% to 8.7% respectively (see table 14). Exposure to these less-liquid assets varied to differing extents depending on the instrument in question. Specifically, much of the increase owed to less-liquid fixed-income assets (up by more than one billion euros between the third and fourth quarter of 2009), while volumes of less-liquid asset-backed securities decreased by almost 600 million euros. Although the proportion of less-liquid holdings to total fund assets has stayed more or less flat in recent quarters, they are less of a source of anxiety thanks to the improved liquidity conditions prevailing on secondary bond markets through 2009. Also, a significant percentage are in mortgage bonds and covered bond issues, which should be more easily disposed of in the event of a forced sale.

Estimated liquidity of investment fund assets TABLE 14

Type of asset	Less-liquid investments					
	Million euros			% total portfolio		
	Jun 09	Sep 09	Dec 09	Jun 09	Sep 09	Dec 09
Financial fixed income rated AAA/AA	3,504.4	4,008.9	4,637	19.0	19.9	20.7
Financial fixed income rated below AA	4,504.1	4,181.1	4,619	37.4	32.0	31.4
Non financial fixed income	260.7	179.2	190	5.4	2.8	3.9
Securitisations	6,314.4	6,017.4	5,423	78.6	75.1	73.4
AAA-rated securitisations	4,491.1	3,711.0	3,179	76.3	72.3	81.7
Other securitisations	1,823.3	2,306.4	2,244	84.9	80.1	64.1
TOTAL	**14,583.6**	**14,386.5**	**14,870**	**33.6**	**30.2**	**30.1**
% of investment fund assets	**8.7**	**8.5**	**8.7**			

Source: CNMV.

Industry prospects are brighter than before, but some clouds remain.

An increase in assets under management, the rollout of measures to boost management efficiency and an unchanged weight of less-liquid assets in fund portfolios configure a rosier scenario for the investment fund industry, though one that is by no means free of risk. In particular, the recent uneven course of financial markets and a renewed 2010 upswing in unitholder redemptions mean the future is hedged in by numerous uncertainties. In the industry's favour is the increase in household savings, up from around 10% of disposable income at end-2007 to over 18% in the third quarter of 2009, and what seems to be a growing disposition to invest in funds rather than bank deposits (see figure 10). Whether this last trend consolidates will depend on the commercial strategies deployed by management companies and financial institutions, especially those finding it hardest to raise funds on wholesale markets.

Real estate investment funds

The severity of the correction in Spanish real estate and a gathering stream of redemption orders have continued to complicate life for real estate investment funds. The sector first hit difficulties in late 2008, which were prolonged through the opening months of 2009. The surge in unitholder redemption orders and the adverse circumstances of the real estate market meant some entities had problems fulfilling their redemption commitments.

Real estate funds continue to suffer the effects of the property market downturn and mounting redemption orders...

The solution in some cases was the early disposal or reappraisal of assets, while two managers approached the CNMV for permission to suspend redemptions in several funds for a period of two years.[19] This would give them the leeway required to draw up an orderly disposal plan to meet their accumulated redemption orders.

...triggering early asset sales, property reappraisals and, in some cases, the reduction or suspension of redemptions.

In all, assets under management in real estate funds fell by 12.7% to 6.46 billion euros, and unitholder numbers by 14.2% to 83,583 (see table 15). The year closed with eight funds in operation, one less than at end-2008. Of this number, one was being wound up at the 2009 close and three had suspended or deferred their repayments. Aggregate fund returns sank to -8.3% in what was a new low for this type of scheme, in line with the continuing correction in Spanish real estate.

Assets and unitholder numbers declined further in 2009, along with fund returns.

The upshot was that of total fund assets at the 2009 close (6.47 billion euros), 4.69 billion (72.6% if the total) corresponded to funds either in liquidation or with redemptions suspended or deferred. Of the remaining amount (1.77 billion euros), corresponding to fully operational concerns, 586.2 million (33.1%) were in the hands of the fund manager's parent group, in accordance with significant shareholding disclosures. It follows that the assets held by real estate funds not in liquidation, without redemptions suspended or deferred, and held by investors other than the fund manager's parent group came to just 1.19 billion in December 2009 or 18.33% of total real estate fund assets.

Assets held by real estate funds not in liquidation, without redemptions suspended or deferred and held by investors other than the manager's parent group summed just 18% of the total at end-2009.

Real estate investment companies had a similarly rough year, with assets down by 17% to 309 million, shareholder numbers down slightly from 937 to 928 and eight schemes operating at the end of the year, one less than at end-2008.

Real estate companies too endured a full-year decline in assets and shareholder numbers.

It seems safe to say then that real estate schemes are the worst placed in the Spanish collective investment industry with little hope of improvement until the real estate market gets back on its feet. Management measures (as described above), the easing of unitholder outflows in 2009 and the support forthcoming from owner financial groups should improve liquidity conditions in coming quarters or at least stop them deteriorating further.

The sector is unlikely to see any solid improvement until the Spanish real estate market gets back on its feet.

On the regulatory front, the Directorate-General of the Treasury and Financial Policy has put forward a series of amendments to CIS Regulations, now out for consultation. Among their proposals is to repeal the provision whereby the corresponding fund manager can enter all property rights and assets in the Property Registry in favour of unitholders once two years have elapsed from the liquidation agreement. This would avoid situations where unitholders find themselves members of an owners' association without administrative leadership, by keeping the manager on board, with full responsibilities, until all properties have been sold off.

A proposed change in CIS regulations will affect the real estate fund liquidation process, with the aim of keeping managers on board until properties have been fully disposed of.

19 At end 2009, two real estate funds had suspended redemptions (Santander Banif Inmobiliario and Segurfondo Inversión), while another had deferred redemption orders to November 2010 (BBVA Propiedad).

Main real estate fund variables TABLE 15

	2006	2007	2008	2009	2009			
					1Q	2Q	3Q	4Q
FUNDS								
Number	9	9	9	8	9	8	8	8
Unitholders	150,304	145,510	97,390	83,583	95,284	89,461	87,903	83,583
Assets (million euros)	8,595.9	8,608.5	7,406.9	6,465.1	6,758.1	6,547.2	6,494.3	6,465.1
Return (%)	6.12	1.27	0.69	-8.32	-4.50	-1.23	-1.37	-1.45
COMPANIES								
Number	8	9	9	8	9	9	8	8
Unitholders	749	843	937	928	938	937	929	928
Assets (million euros)	456.1	512.9	371.9	308.6	369.1	360.7	313.0	308.6

Source: CNMV.

Hedge funds

The hedge fund industry has begun a mild recovery, with hedge funds per se the first to emerge.

Hedge funds and funds of hedge funds appear to be mounting a tentative recovery, like traditional funds before them, after several quarters in decline. The upturn was earlier and more intense among hedge funds per se, while funds of hedge funds have had to fight harder to cope with the fallout from the crisis – particularly problems of liquidity and asset valuation due to restrictions imposed by foreign investees. They also faced added difficulties with the redemption wave that swept through most sectors of the fund industry, because some of their underlying funds were concurrently imposing restrictions or suspensions.

Funds of hedge funds lost assets and unitholders in 2009, which closed with half their number in liquidation.

Funds of hedge funds finally closed the year 2009[20] with 830 million euros in assets against the 1.02 billion of one year before, while unitholder numbers dropped from 8,151 to 5,411. The number of schemes closed at 41, one more than in 2008, though by then more than half had either formally entered liquidation or signalled their intention to do so to the CNMV. That said, assets and investor numbers appear to have recovered slightly since mid-2009, though the quarterly data are inconclusive.

Conversely, hedge funds enjoyed a certain expansion in all these variables, as well as achieving robust returns in the year's middle months.

Hedge funds, meantime, closed with 611 million in assets, almost 72 million ahead of the 2008 figure (see table 16), after growth in every quarter but the first. Unitholder numbers climbed from 1,589 to 1,839, broadly in line with assets under management, while the 28 schemes in operation at the 2009 close represented four more than in 2008. By the middle of the year, funds were earning a healthy return in aggregate terms (8.1% in the second quarter and 5.2% in the third) which turned only slightly negative in the closing stretch (-0.13%).

The outlook for hedge funds is far from clear, but there is a good chance they could return to growth in a less volatile market setting.

As we write, the prospects for the hedge fund industry are subject to numerous uncertainties. On the one hand, it seems to have resumed growth in assets, unitholders and even returns. And yet the large number of schemes being wound up will mean a large asset outflow in coming months. On balance, it seems reasonable to expect a return to expansion in 2010 on the strength of the ongoing normalisation of international markets and assuming redemption orders continue to abate, as they have done in other fund categories.

20 October data at the closing date for this report.

Main hedge fund variables

TABLE 16

	2006	2007	2008	2008 4Q	2009 1Q	2Q	3Q	4Q[1]
FUNDS OF HEDGE FUNDS								
Number	2	31	40	40	40	40	40	41
Unitholders	2	3,950	8,151	8,151	5,646	5,577	5,303	5,411
Assets (million euros)	0.6	1,000.6	1,021.3	1,021.3	775.2	709.5	846.8	830.3
Hedge funds								
Number	5	21	24	24	26	26	27	28
Unitholders	21	1,127	1,589	1,589	1,551	1,768	1,778	1,839
Assets (million euros)	24.4	445.8	539.4	539.4	451.4	536.9	602.6	611.2
Return (%)	n.s.	0.84	-4.82	-3.59	-0.40	8.12	5.21	-0.13

Source: CNMV.

1 Latest data available: October 2009. Monthly return restated on a quarterly basis.

The European Commission's draft directive to regulate alternative investment fund managers, presented in April 2009...

We cannot end this section without reference to developments following the European Commission's presentation of a draft directive in April 2009 to regulate alternative investment fund managers. This name applies to a range of investment modalities (hedge funds, private equity, commodity funds, real estate funds, etc.), whose vehicle is a company or asset pool owned by a more or less large body of investors and entrusted, in most cases, to professional managers. Where they differ from traditional collective investment schemes is in the fact of being unregulated in certain jurisdictions and being marketed above all to institutional and professional investors. Some of these vehicles, like hedge funds or private equity funds, had attracted the gaze of regulators prior to the financial crisis for their potential impact on systemic risk, primarily via the use of leverage.

...is now being debated by the Council and the European Parliament.

Taking its cue from G20 recommendations, the European Commission's draft directive seeks to give alternative fund investment managers their own set of regulations. Its scope would extend in principle to all managers administering large pools of assets above a minimum threshold of 100 million euros, rising to 500 million when the scheme is not leveraged and imposes a five-year lock-up period (the case, for instance, of some venture capital vehicles, on the grounds that the potential systemic risk diminishes under such conditions). According to Commission estimates, these thresholds would cover 30% of managers and 90% of net assets under management in hedge funds domiciled in the European Union. The regulation envisaged in the Commission proposal would make managers subject to authorisation procedures and bring them within the scope of transparency rules and standards of conduct. The proposal is now being debated in the Council and the European Parliament.

4.2 Investment firms

Investment firms continued to weather their particular storm. Revenues fell anew in 2009, albeit less steeply than in 2008.

Investment firm activity has continued to buckle under the effects of the crisis. All main business lines generated lower inflows in 2009, although the decline in fee income was significantly less, especially among the broker contingent after a particularly adverse 2008. The number of investment firms in losses reduced slightly from 28 in 2008 to 26 in 2009. The sector's solvency levels have held up reasonably well, despite the more exacting capital requirements introduced in the previous year.[21] There follows a detailed description of the business, earnings and capital adequacy of the different categories of investment firm over the year 2009.

21 Circular 12/2008 on the solvency of investment firms.

The aggregate pre-tax profits of broker-dealers fell by 29% in 2009, with fee income down by 17%.

Broker-dealers obtained aggregate pre-tax profits of 359 million, 29% less than in 2008 (see table 17) on the heels of the 33% slide of 2007. Companies' fee income dropped back 17% to 781 million euros, with the biggest caption, order processing and execution fees, down by 15% to 549 million euros (-17% in 2008). Fee income from CIS marketing also fell, by 31% (-43% in 2008) to 63 million euros. However investment advising brought in 57 million, an additional 9%, taking up some of the slack from other traditionally significant income lines like issue placement and underwriting in primary debt or equity markets.

Operating expenses declined slower than revenues, while impairment losses moved up substantially.

Gross income, the sum of net fee income and fees from other, non-core business lines, closed at 758 million euros, 21% less than in 2008. The relative stickiness of operating expenses (down 15% to 378 million euros), allied with falling gross income and rising impairment losses, eroded net operating income by a deeper 37%. Finally, higher extraordinary income left pre-tax profits at the -29% stated earlier.

Brokers' aggregate pre-tax profits were 54% less than in 2008. Fee income fell by 16%...

Broker pre-tax profits look worse on paper, in the shape of a 54% decline to 10.5 million euros (see table 17), though this was actually some improvement on the 79% slide of 2008. The fee income of brokerage firms moved down 16% to 144 million euros (-37% in 2008), breaking down -13% from order processing and execution (-51% in 2008), -23% from CIS marketing (-57% in 2008) and -7% from portfolio management (-24% in 2008).

...but operating expenses failed to adjust in the same measure (-13%).

At 130.7 billion, the gross income of the broker group was 19% down versus 2008. Although main revenue items receded less than in 2008, operating expenses failed to adjust in the same measure (-13%), causing further inroads into net operating income and pre-tax profits.

Aggregate income statement (2009) TABLE 17

Thousand euros	Broker-dealers			Brokers			Portfolio managers		
	Dec 08	Dec 09	% var.	Dec 08	Dec 09	% var.	Dec 08	Dec 09	% var.
1. Net interest income	117,783	163,202	38.6	7,977	2,652	-66,8	1,482	341	-77.0
2. Net fee income	674,542	529,792	-21.5	149,874	127,410	-15,0	12,044	10,820	-10.2
2.1. Fee income	943,619	781,555	-17.2	172,344	144,373	-16,2	23,877	21,835	-8.6
2.1.1. Order processing and execution	648,036	548,951	-15.3	62,345	53,988	-13,4	0	0	-
2.1.2. Distribution and underwriting	42,502	25,726	-39.5	4,847	2,989	-38,3	0	0	-
2.1.3. Securities custody and administration	21,198	16,183	-23.7	676	509	-24,7	0	0	-
2.1.4. Portfolio management	17,306	11,543	-33.3	21,137	19,633	-7,1	20,683	18,549	-10.3
2.1.5. Design and advising	52,276	56,966	9.0	4,130	2,571	-37,7	2,484	2,698	8.6
2.1.6. Search and placement	12	10	-16.7	0	0	-	0	0	-
2.1.7. Margin trading	19	14	-26.3	10	28	180,0	0	0	-
2.1.8. Fund subscriptions and redemptions	91,167	63,296	-30.6	31,287	23,966	-23,4	66	18	-73.0
2.1.9. Others	71,103	58,865	-17.2	47,913	40,688	-15,1	644	571	-11.4
2.2. Fee expense	269,077	251,763	-6.4	22,470	16,963	-24,5	11,833	11,016	-6.9
3. Result of financial investments	792,084	43,855	-94.5	-925	1,709	-	-108	92	-
4. Net exchange income	-643,539	22,437	-	20	-265	-	13	5	-58.4
5. Other operating income and expense	17,712	-854	-	3,741	-845	-	-432	-389	9.9
GROSS INCOME	958,584	758,431	-20.9	160,686	130,661	-18,7	13,000	10,869	-16.4
6. Operating expenses	446,356	378,100	-15.3	136,818	118,988	-13,0	11,330	9,142	-19.3
7. Depreciation and other charges	8,572	7,729	-9.8	3,130	2,522	-19,4	512	198	-61.4
8. Impairment losses	69,055	96,855	40.3	415	60	-85,6	0	135	-
NET OPERATING INCOME	434,601	275,747	-36.6	20,323	9,090	-55,3	1,157	1,395	20.5
9. Other profit and loss	68,167	83,343	22.3	2,506	1,438	-42,6	-8	-15	-105.1
PROFITS BEFORE TAXES	502,768	359,090	-28.6	22,829	10,529	-53,9	1,150	1,379	19.9
10. Corporate income tax	137,481	98,631	-28.3	8,423	5,666	-32,7	385	419	8.9
PROFITS FROM ONGOING ACTIVITIES	365,286	260,458	-28.7	14,406	4,862	-66,2	765	961	25.5
11. Profits from discontinued activities	2,292	0	-100.0	0	0	-	0	0	-
NET PROFIT FOR THE YEAR	367,578	260,458	-29.1	14,406	4,862	-66,2	765	961	25.5

Finally, **portfolio management companies**, whose investment service field is narrower than that of their sector peers, obtained aggregate pre-tax profits of 1.4 million, almost 20% more than in 2008. The slide in fee income (-9%) was rather less intense than at brokers or broker-dealers, but what really explained this trend-bucking performance was their successful containment of operating expenses (down by over 19%) and the reduction of depreciation and other charges.

The aggregate pre-tax profits of portfolio management companies climbed by 20% to 1.4 million euros.

Earnings erosion made further inroads into the return on equity (ROE) of the investment firm sector, though here too the decline was more moderate than in 2008 (see figure 20). The ROE of broker-dealers fell from 32.5% in 2008 to 20.5% in 2009 and that of the broker contingent from 17.9% to 10.7%. A look at change factors for ROE in 2008 and 2009 allows some interesting conclusions. As we can see from figure 20 (right-hand panel), the 2008 slide in investment firm profitability was mainly about lesser efficiency and asset productivity compounded by negative extraordinaries.[22] In 2009, however, two other factors were at work (see figure 20, right-hand panel): a decline in leverage and slightly lower efficiency, owing to the year's higher impairment losses. On this occasion, both extraordinaries and asset productivity contributed positively to some extent.

Investment firm returns on equity fell from 32.5% to 20.5% among broker-dealers and from 17.9% to 10.7% among the broker group.

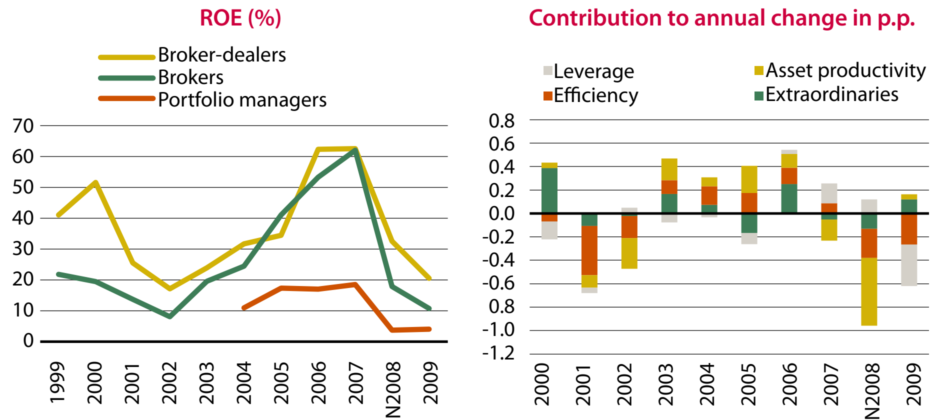
22 The following equation allows us to isolate the effects of changes in each factor contributing to investment firm ROE:

$$ROE = \frac{PBT}{Equity} = \frac{PBT}{Net\ operating\ inc.}(1) \times \frac{Net\ operating\ inc.}{Gross\ income}(2) \times \frac{Gross\ income}{Assets}(3) \times \frac{Assets}{Equity}(4)$$

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

Investment firm ROE before taxes

FIGURE 20



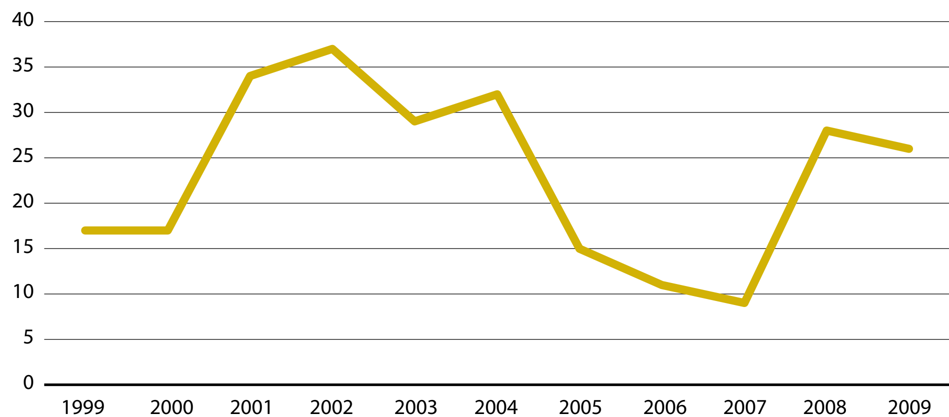
Source: CNMV.

The number of firms in losses fell from 28 in 2008 to 26 in 2009.Four of this number also had a capital deficit at the end of the year.

As we can see from figure 21, the number of firms reporting (pre tax) losses tended to stabilise in 2009 after two fraught years. Of the 26 firms in losses at the end of the year (out of a total of 109 vs. 111 in 2008), 14 were brokers, 10 broker-dealers and two portfolio management companies. The aggregate losses of this group amounted to 25.8 million euros or around 7% of investment firm pre-tax earnings, while four of their number also closed the year with a capital deficit.

Number of investment firms in losses

FIGURE 21



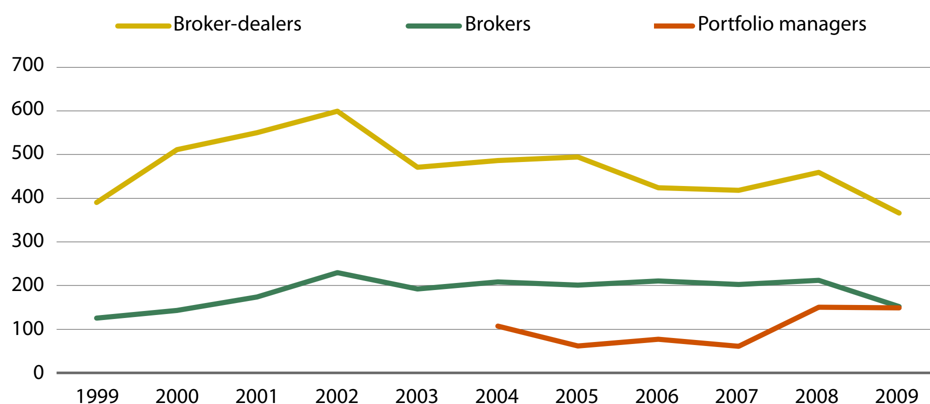
Source: CNMV.

Capital adequacy has held up well despite a small solvency margin downturn; ascribable in part to new rules for its calculation. Six firms reported a capital deficit at the 2009 close.

Investment firms as a rule are comfortably compliant with capital adequacy requirements. The small downturn in aggregate margin in 2009 traces partly to the new rules on investment firm solvency introduced by CNMV Circular 12/2008; particularly the requirement to allocate more funds for operational risk. At end 2009, the equity of brokerage firms was 3.7 times surplus to the mandatory requirement (4.6 times in 2008), while that of broker-dealers stood 1.5 times higher (2.1 times in 2008) and portfolio management companies repeated the prior-year level of 1.5 times the minimum (see figure 22). Six firms ended the year with an own fund deficit (five brokers and one broker-dealer), and the CNMV will follow up their progress in designing the viability plans that the law now demands in this situation.

Finally, one broker[23] posted a significant event notice on 5 March informing that it had started voluntary insolvency proceedings and seeking intervention. The CNMV agreed to this request and to the suspension of the firm's activity, in order to safeguard investors' interests.[24] Bankruptcy proceedings were eventually declared on 23 March last.

Investment firm capital adequacy (surplus of qualifying equity to the minimum requirement, %) FIGURE 22



Source: CNMV.

The general outlook for investment firms is rather more encouraging in view of the gathering normalisation of financial markets evident in these past few months, together with the moderate upswing in collective investment. Confirmation of a revival in stock market turnover and a mild recovery in the investment fund industry should set sector fee income on a more even keel and even allow some timid expansion in certain business lines. Operators could also benefit from what seems to be a renewed preference for debt in the corporate financing mix (see figure 4). That said, the sensation remains one of excess capacity and a degree of restructuring cannot be ruled out.

4.3 Collective investment scheme management companies

Assets under management contract slightly in 2009…

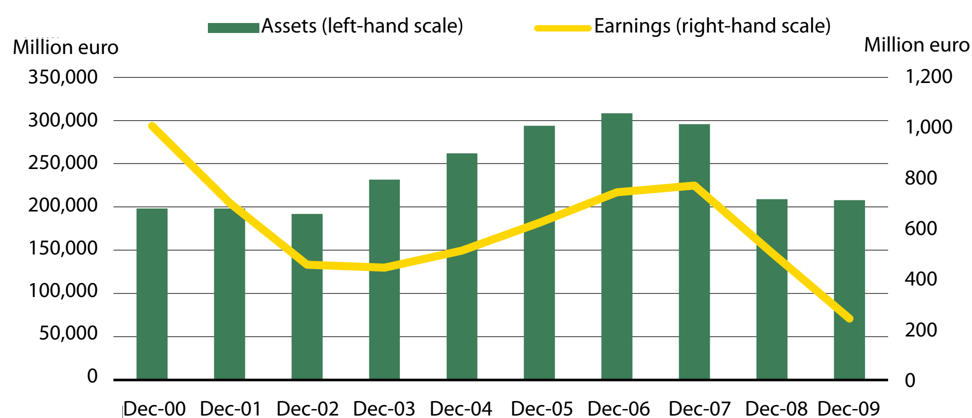
Aggregate full-year figures for CIS management companies put their assets under management at 208 billion euros, one billion less than at end-2008, but improving on the 87 billion fall of the preceding year (see figure 23). This latest result takes managed assets back to the start-out level of the decade.

23 Sebroker Bolsa AV.

24 See CNMV notice of 5 March 2010.

CIS management companies: assets under management and pre-tax profits

FIGURE 23



Source: CNMV. Data to December 2009.

... while the sector's aggregate profits drop by half with fee income as the main culprit.

This mild contraction was accompanied, however, by a sharp slide in companies' pre-tax profits – a combined 243 million euros in the full-year period, less than half the figure for 2008 (see figure 23). Part of this decline owes to the fall in entities' management fees to an average 0.82% of assets compared to 1.1% in 2008 (see table 19).

Aggregate ROE moved down from 35% in 2008 to 17% in 2009, while the number of loss-making entities fell from 34to 31.

Aggregate return on equity dropped from 34% in 2008 to 16.6% in 2009 in tune with the above earnings contraction. The hope now is that the more settled state of the investment fund industry will allow a similar stabilisation in management company income statements and the number of entities in losses. On the last score, loss-making managers numbered 31 at the annual close against 34 one year before, evidencing the sector's efforts to redimension its offering in line with medium-term demand prospects. And sector restructuring could shortly gather pace on perceptions of a certain excess capacity, the re-drawing of the credit institution map and growing use of the Community passport for the fund management activities of foreign groups operating in Spain.

CIS management companies: pre-tax profits and ROE

TABLE 18

Million euros

	Profit before taxes	ROE before taxes (%)
2001	701.7	72.9
2002	457.1	50.1
2003	445.4	50.1
2004	512.2	57.3
2005	622.8	66.2
2006	744.0	68.9
2007	771.1	60.5
2008	503.5	34.0
2009	243.1	16.6

Source: CNMV.

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

TABLE 19

Million euros

	Assets under management	CIS management fee income	Average CIS management fee (%)	Fee ratio (%)[1]
2000	198,280	2,869	1.45	63.5
2001	198,115	2,465	1.24	65.8
2002	192,099	2,259	1.18	72.7
2003	231,458	2,304	1.00	73.8
2004	262,132	2,670	1.02	73.6
2005	293,973	2,976	1.01	72.2
2006	308,476	3,281	1.06	71.5
2007	295,922	3,194	1.08	70.5
2008	209,020	2,302	1.10	70.8
2009	207,999	1,703	0.82	68.6

Source: CNMV.

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

4.4 Other intermediaries: venture capital

The CNMV's register of venture capital entities (VCEs) recorded 19 new entrants in 2009 against 13 retirals. Of the first number, nine were venture capital companies, seven were venture capital funds and three were venture capital management companies. Compare this to 208, when as many as 55 entities entered the fray (25 companies, 21 funds and nine management companies).

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

Movements in the VCE register in 2009

TABLE 20

	Situation at 31/12/2008	Entries	Retirals	Situation at 31/12/2009
Entities	**322**	**19**	**13**	**328**
Venture capital funds	95	7	1	101
Venture capital companies	154	9	10	153
Venture capital fund managers	73	3	2	74

Source: CNMV.

According to 2009 data furnished by the Spanish industry association (ASCRI), investment by venture capital companies sank to 1.62 billion euros, 46.6% less than in the previous year. This was an even worse performance than in 2008 (down 31.6%) and left investment languishing around 2004 levels. Even so, projections based on international data[25] suggest other countries fared a lot worse, with worldwide investment contracting 74% and European investment 67%.

ASCRI data point to a slump in investment by Spanish venture capital companies (-47%).

Company transactions fell by 5.2% on the heels of the 4% decline of 2008. Divestments summed 860 million euros, 20.9% more than in 2008 (when they fell 55.6% vs. 2007), with transactions down by 8.1% to 316 (-11.3% in 2008).

This group also recorded 5% fewer transactions and a 21% increase divestment volumes.

Problems of access to bank finance have increasingly ruled out large leveraged buyouts, and indeed the year's lower investment is mainly a consequence of the drying-up of this kind of operation. Low-volume divestments, meantime, reflect companies'

Borrowing constraints continue to hamper venture capital activity. Sector analysts ...

25 Data for Europe are drawn from *Quarterly Activity Indicator Trends in Q3 2009,* by the European Private Equity & Venture Capital Association (EVCA), November 2009. For world sector performance, the source is *Private Equity 2009* from International Financial Services London (IFSL), August 2009. In both cases data have been annualised in stating year-on-year changes in European and world investment.

... expect recovery to build from the end of this year, though much will depend on the availability of finance.

reluctance to sell off investees at a time of falling valuations, preferring to wait instead for better times. In fact, recognition of capital losses, in many cases due to refinancing difficulties, accounted for 46% of the year's total divestment volumes. The consensus among sector analysts is that activity will pick up at the end of this year in Spain and the rest of Europe, though they warn that it will be a slow road back without a parallel improvement in the availability of finance. That said, 2010 investment is projected to stand at over 2 billion euros, while scheduled securities market placements will offer new opportunities for divestment.

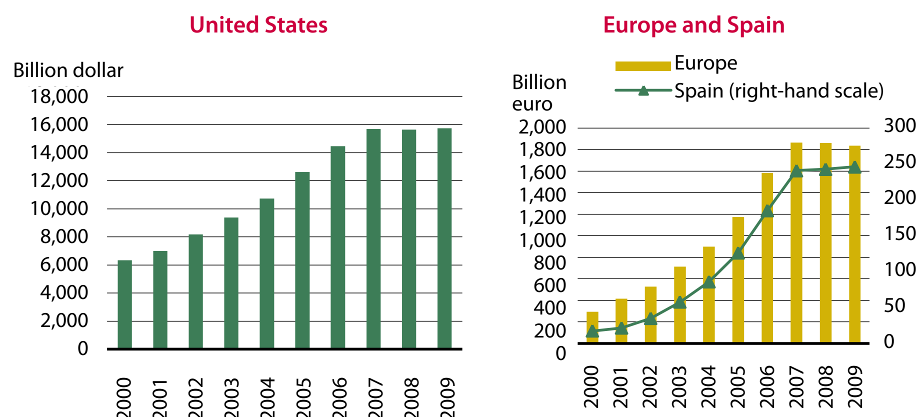
5 Securitisation markets: proposals for reactivation

5.1 Introduction

Mass securitisation is among the most visible products of the intense financial innovation of the last decade.

The mass securitisation of assets is among the most visible products of the financial innovation wave of the last decade. In advanced economies, this financial practice mobilised huge amounts of private credit in the years before the current crisis, by allowing the original owners of credit rights to amplify their traditional range of financing channels. In the years 2000 to 2007, the volume of asset-backed securities rose by 148% in the United States, 534% in Europe and almost 1300% in Spain, as we can see from figure 24 below. Such is the importance of securitisation for the Spanish market, of mortgage loans especially, that Spain is the second country in Europe by volume of asset-backed securities in circulation, surpassed only by the United Kingdom, with an estimated value (including securitised mortgage bonds) equivalent to 24.7% of last year's GDP.

Asset-backed securities outstanding FIGURE 24



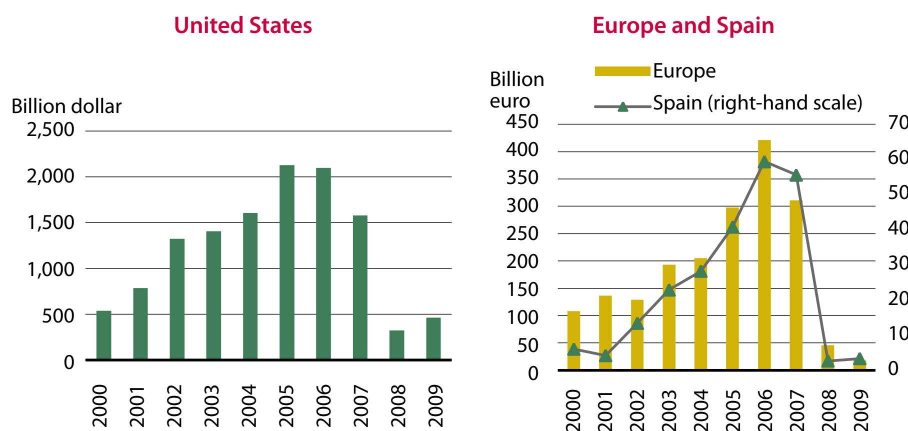
Source: Dealogic.

Defaults in U.S. subprime mortgages eroded investor confidence in structured products triggering a worldwide slump in demand.

However a wave of defaults in the U.S. subprime mortgage sector starting in the first half of 2007 marked a turning point in what until then had seemed to be the unstoppable growth of the country's mortgage loan securitisation. Although the actual amount of subprime defaults was not that large compared to the size of the U.S. mortgage market, the fact that so many of these loans (around 75%) had been securitised caused a slump in investor confidence in this kind of structured product. Within a matter of months, this distrust had spread to practically all types of asset-

backed securities, causing demand to simply cave in. As a direct result of this abrupt withdrawal of investor confidence, new securitisation issues have begun to dry up all over the world (see figure 25).

Gross securitisation issues FIGURE 25



Source: Dealogic.

In this context, it is not hard to understand what doubts have been sown about the whole future of securitisation. On the one hand, asset securitisation holds unquestioned potential as an enhancement tool for credit institution financing and risk management. On the other, the grave problems that the financial crisis has brought to light in the orbit of this practice dictate that any opportunity for its reactivation will depend on the ability of regulators and the industry itself to learn from the lessons of the past and lay the groundwork for a new securitisation framework that is simpler, more reliable and more transparent for the end investor.

The result has been to fuel doubts about the future of securitisation. Whether it can prosper once more will depend on the ability of regulators and the industry to come up with a simpler, more transparent development framework.

The aim of this chapter is, firstly, to identify the vulnerabilities surfacing in securitisation during its years of greatest triumph and, secondly, to describe some of the ideas recently put forward to reactivate the market. It is accordingly divided into four main sections: the problem of incentives in securitisation structures (section 2), the central role of rating agencies in valuing structured products (section 3), the need to progress in the transparency, simplification and standardisation of asset-backed securities (section 4) and ways to improve the functioning of secondary markets (section 5). Finally, section 6 offers some closing reflections.

5.2 Compatibility of incentives in the securitisation chain

The length and complexity of the chain of contracts in any securitisation process ensures that structured products are fertile ground for conflicts of interest between the parties. Two of these potential conflicts merit deeper discussion. The first is the possible existence of opposing interests within rating agencies, in their dual role as calibrators of risk and providers of investment advice, which we will leave until the next section. The second has to do with the lack of incentives for the originator of the securitised loan to act with sufficient care and diligence in assessing the credit quality of the securitised assets.

The length and complexity of the securitisation chain makes it an easy prey to conflicts of interest.

This problem of moral hazard, which arises in a wide variety of financial contracts and products, becomes especially relevant in the case of securitisations, because

of the intrinsic difficulty investors face in deciding the quality of the product. In particular, the vast number of individual loans that may end up in a securitisation pool, and the complexity of the structuring techniques used in product design, stand as a major barrier to external validation of the real quality of the underlying assets. And this, together with burgeoning demand for high-quality assets during the last expansion phase, may have done much to exacerbate the problem of credit institution incentives.

One way to align the interests of originators and end investors would be for the former to retain a certain proportion of securitised exposures.

One recent suggestion to align the originator's interests more closely with those of the end investor is to require all orginators to retain a certain minimum proportion of the risk being transferred to investors. Variations on this idea have already received the blessing of the G20, the United States Government and the European Union.

This idea has received the backing of the G20, ...

In the case of the G20, point 12 of the leaders statement issued after the Pittsburgh summit of September 2009[26] calls for securitisation sponsors or originators to retain part of the risk of the underlying assets, though its does not specify how much.

...the European Union, which amended its Capital Requirements Directive accordingly in May 2009, and ...

In Europe, an amendment to the Capital Requirements Directive (article 122a) approved in May 2009 bars EU credit institutions from investing in securitisation issues in which the originator retains a net economic interest of less than 5% of the securitised exposures. The Directive also stipulates that this net economic interest must be retained on an ongoing basis without resorting to any form or mechanisms of credit risk mitigation. The new norm is scheduled to come into force in 2011.

...the Government of the United States.

Meantime, the United States Government came up with a similar proposal[27] last year in the frame of its financial regulatory reform plan, likewise targeting a minimum retention of 5%. However, the U.S. document contains two points of difference with respect to the European text. The first is that the obligation falls on the originator but not the purchaser. The second is the flexibility allowed in applying the minimum retention threshold, which is greater in the American case, since supervisors would be empowered to adjust it, upwards or downwards, in certain circumstances.

To be effective, its implementation must be balanced and flexible enough to align retention requirements with the real risk of each type of securitisation.

In any event, the imposing of minimum retention thresholds is undoubtedly an attempt, in spirit at least, to reconcile the interests of securitisation chain participants. Its implementation, however, will have to be balanced and flexible enough to ensure that retention requirements square with the real risk profile of each type of securitisation. In Europe, moreover, it is important to apply minimum retention thresholds similar to those envisaged in article 122a of the Capital Requirements Directive to the originators of securitised exposures on the balance sheets of entities other than credit institutions. Otherwise, we risk giving rise to regulatory arbitrage opportunities that favour the build-up of asset-backed securities in the portfolios of institutions exempt from capital requirements.

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26 G-20 (2009): *Pittsburgh Summit Leaders Statement*, 24-25 September 2009. Available from http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

27 United States Treasury Department (2009): *Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation*. Available from http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

5.3 The role of rating agencies

The complexity and, at times, opacity of securitisation transactions ensured rating agencies a key role in their valuation. But the slump in the value of asset-backed securities at the onset of the crisis has called into question the quality of their rating practices.

The complexity of securitisation transactions has put demands on rating agencies that they have been unable to fulfill.

Among the problems faced are the possible conflicts of interest deriving from agencies' dual role as providers of advisory or consultancy services to securitisation issuers, and as valuers of the resulting securities; the risk of strategic selection by issuers (rating shopping) to secure the best possible grade; agencies' limited experience in rating securitisations, especially complex issues for which there are no reliable performance records; and a lack of clarity regarding key factors like the valuation methodology used, the meaning of ratings or the depth and quality of the risk analyses run on underlying assets.

Among the problems detected are possible conflicts of interest arising from their dual role as advisors and valuers.

Regulators and supervisors have come across some of these problems before, and in fact had previously sponsored diverse initiatives based on self-regulation – the case of the IOSCO code of conduct for credit rating agencies (2008)[28]. However, deeper reflection in the wake of the crisis has persuaded them of the need to regulate rating agency activities. In Europe, this need is addressed in the recently published Regulation 1060/2009, which, for the first time, brings rating agencies under an authorisation and supervision system.

After due reflection, the authorities have opted to bring rating agency activities within the regulatory fold. This is the purpose of EU regulation 1060/2009.

Its principal measures with regard to structured financing are summarised below:

- It is prohibited to make proposals or recommendations on the design of structured finance instruments on which the agency is expected to issue a credit rating, i.e. they may not simultaneously provide advisory and rating services.
- Reporting of all assessments undertaken. In order to discourage the practice of rating shopping, agencies shall disclose, on an ongoing basis, information about all structured finance products submitted to them for preliminary rating, whether or not issuers contract with the agency for a final rating.
- Requirements regarding the rating of assets previously rated by another agency. Under the new regulation, agencies may not decline to rate a securitisation issue on the grounds that some of the assets have previously been rated by another agency.
- Organisational requirements. Most of the board members of rating agencies should have sufficient expertise in financial services, while at least two should be independent directors. When the agency issues credit ratings of structured finance instruments, at least one independent member and one other member of the board shall have in-depth knowledge and experience at a senior level of securitisation markets.
- Disclosure requirements. The new regulation specifies as follows: i) agencies shall provide full information about loss and cashflow analyses performed or relied upon and an indication of any expected change in the credit rating, ii) agencies should explain the models and methodologies used, incorporating simulations of stress scenarios undertaken when establishing the rating, iii)

28 International Organization of Securities Commissions (IOSCO), 2008: *Code of Conduct Fundamentals for Credit Rating Agencies*. Available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf.

agencies should clearly differentiate between the ratings of structured products and those of more traditional instruments by displaying an additional symbol that distinguishes the former, iv) agencies should indicate the depth of their analysis of underlying assets, stating whether they have assessed them directly or relied on a third-party assessment, and v) when the lack of reliable data or the complexity of the structure of a securitisation raises serious questions about the reliability of any risk assessment, the agency should refrain from issuing a credit rating or withdraw an existing rating.

The new Regulation seeks to mitigate conflicts of interest while imposing stricter disclosure requirements.

In sum, this new regulatory initiative tackles conflicts of interest within agencies, while imposing considerably stricter disclosure requirements. These two factors –incentives and disclosure– are essential if rating agencies are to fulfil their core function of mitigating information asymmetry between originators and investors. The challenge now is to ensure that they are rapidly and efficiently deployed.

For the moment, the Regulation assigns the oversight of rating agencies to supervisors designated by Member States, though there is agreement that these powers should later be transferred to the European supervisory authority emerging from the transformation of the CESR.

5.4 Measures for the simplification, standardisation and transparency of securitisation

Simplification, standardisation and increased transparency are the keys to winning back investor confidence.

As we stress at the start of this chapter, the global implosion of securitisation markets can only be explained by a sudden collapse in investor confidence. And this collapse was largely due to the complexity and opacity that tend to surround securitised products. Restoring confidence therefore calls for a greater degree of transparency, simplification and standardisation, and this is precisely the aim of the initiatives described below.

IOSCO has published an exhaustive list of disclosure principles for asset-backed securities.

IOSCO recently issued a report[29] with an exhaustive list of disclosure principles for asset-backed securities, focusing on those aspects where transparency is most clearly lacking: the identity, legal situation, functions and responsibilities of each participant in the securitisation chain, and the possible links between them; the securitisation experience of the originator and sponsor; the composition and characteristics of the assets making up the fund and details of individual performance by type (for instance, by cohort of mortgage loans entering the pool); concentration of exposure in a small number of receivables; transaction structure, including the flow of funds, fees and expenses, allocation of excess cashflow, contract termination or trigger clauses, etc.; credit enhancement; the use of derivative products to alter the payment characteristics of cashflows; the nature of risk factors material to the offering; the kind of markets on which the securities are to be traded and relevant tax information.

The Basel Committee on Banking Supervision has reviewed weighting requirements for re-securitisations.

The issue of simplification was tackled by the Basel Committee on Banking Supervision (BCBS) in its recent review of weighting requirements for re-securitisation exposures in the Basel II framework.[30] On the evidence that re-securitisations are among the most complex types of structured products, and also among the most

29 International Organization of Securities Commissions (IOSCO), 2010: *Disclosure Principles for Public Offerings and Listing of Asset-Backed Securities*.The consultation paper is available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD296.pdf.

30 Basel Committee on Banking Supervision (BCBS), 2009: *Enhancements to the Basel II Framework*. Available from http://www.bis.org/publ/bcbs157.htm.

deteriorated on account of the crisis, the BCBS has sizeably raised the corresponding risk weightings. Basel II will thus incorporate a separate weighting scale for these products, specifying increases at times of over one hundred percent, for application starting in the year 2011.

The European Central Bank has sent a proposal out to consultation on keeping detailed records of the loans entering securitisation pools.

A few months ago, the European Central Bank launched a public consultation paper with proposals on a structure for the gathering and upkeep of detailed intelligence on the loans entering securitisation pools, as part of the Eurosystem collateral framework. Its goals are, firstly, to provide rating agencies and investors operating in Europe with access to itemised information on this kind of product and, secondly, to work towards the establishment of a standard data gathering and reporting procedure in respect of euro area securitisations.

The CNMV has taken a lead in Spain by imposing new disclosure requirements on securitisation funds.

Nationally, the CNMV has introduced pioneering new roles to strengthen the periodic reporting requirements of securitisation funds. Further to its Circular 2/2009 of 25 March on account standards, annual accounts, public financial statements, and reserved statistical statements of securitisation funds, all funds operating in Spain are obliged to file public and reserved statements with the Spanish regulator starting in early 2010.

And the industry itself has launched a number of initiatives to boost the transparency and standardisation of key securitisation practices.

Finally, the industry itself is leading a number of initiatives to boost the transparency and standardisation of key securitisation practices. One example is the set of ten initiatives drawn up by the Global Joint Initiative (2008), along with guidance on their implementation, tackling aspects like a standard definition for credit enhancement, the establishment of industry-wide due diligence standards, improvement in third-party valuation and audit practices, or training programmes specifically targeting directors and senior managers whose monitoring duties extend to securitisation products. But the most ambitious industry-led initiative to date is surely the RESTART project (Residential Securitization Transparency and Reporting) launched by the American Securitization Forum (ASF) in 2008 with a view to restoring investor confidence in mortgage-backed securities. This project is split into six phases. In July 2009, the Forum published the final blueprint for the first two, to be implemented in 2010, the aim in both cases being to increase and strengthen disclosure requirements. The first comprises a disclosure package whose purpose is, firstly, to provide substantially more critical data than has hereto be available to investors, rating agencies and other market participants and, secondly, to standardise the presentation of all data to allow investors to easily compare loans and transactions across all issuers. The second deliverable, known as the reporting package, comprises the enhanced and standardised monthly updating of critical pool and loan-level information.

5.5 Proposals for secondary markets in asset-backed securities

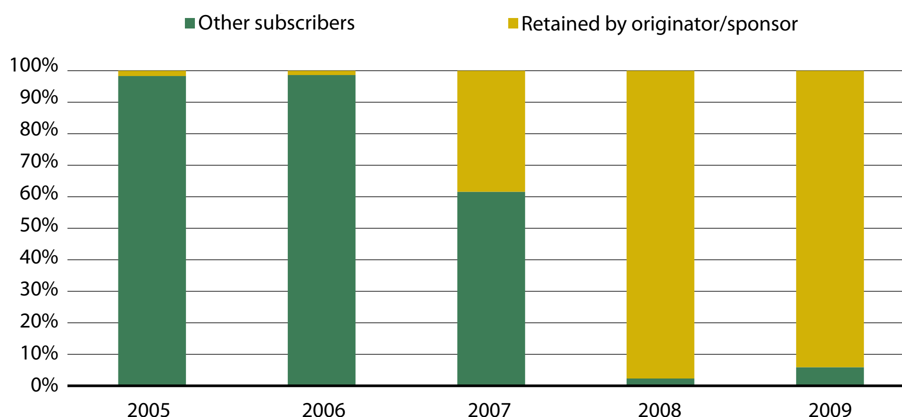
Structured product trading volumes fell substantially during the crisis, causing liquidity tensions in secondary markets...

The strong liquidity enjoyed by structured product markets evaporated when the crisis hit. According to IOSCO, for example, trading in residential mortgage-backed securities fell by 45% in the months following its onset. In Spain's case, although issuance of asset-backed securities held up reasonably strongly, most of the volumes issued since end- 2008 have been retained by originators and used as collateral for Eurosystem loans (see figure 26). Something similar has occurred in the rest of Europe and in the United States, whose Government launched a one-off initiative to revitalise the market at end-2008 specifying that asset-backed securities would be accepted as collateral in Federal Reserve refinancing operations.[31]

31 Ashcraft, A.B., and T. Schuermann, 2008: "Understanding the Securitization of Subprime Mortgage Credit,"

Nominal value of asset-backed securities in Spain by type of subscriber[1]

FIGURE 26



Source: CNMV.

1 According to prospectuses filed with the CNMV.

...which had more to do with agent distrust than with possible failures in market operation.

It must be said however, that the liquidity crunch in asset-backed securities markets, which in the midst of crisis left numerous investors without a counterparty for their trades, had more to do with concern over the quality of underlying assets than any failure of market functioning. Further, the climate of distrust brought on by the crisis was compounded by the narrowness of primary market spreads, denoting a miscalculation of risk at the point of issuance. And this has led to a situation where any increase in asking spreads would of necessity drive secondary market prices well below par.

A series of international initiatives are focusing on ways to boost secondary market liquidity and efficiency.

Hence the search underway for mechanisms to boost the liquidity and efficiency of these markets, led by organisations like CESR and IOSCO. Their interest, for the moment, has focused on post-transparency regimes, i.e., the a posteriori disclosure of trading volumes and prices.

CESR underscores the importance of market transparency, but warns that care should b e taken not to create renewed pressures on liquidity.

A recent CESR report[32] on the transparency of structured finance and credit derivative markets concluded that the lack of post-transparency was not to blame for current liquidity shortages in securitisation markets, while insisting on its important role in market operation as an aid to valuation. That said, it warns that pro transparency measures must be introduced with care to avoid unwanted pressures on liquidity. The best option, it concludes, would be the phased implementation of a harmonised pan-European regime for asset-backed securities of a comparable nature.

IOSCO arrives at similar conclusions.

An IOSCO report drew similar conclusions regarding the relative importance of post-transparency.[33] While admitting that deficient information on past transactions is not a prime cause of illiquidity, it contends that liquidity problems in part reflect a lack of reliable inputs for the valuation of structured products. The organization has also sounded the views of market participants on the pros and cons of a mandatory post-transparency regime. Among the pros, respondents cited the mitigation of information asymmetry between market participants, more efficient pricing, and its usefulness to investors in valuing their portfolios. The main drawback, as they saw

Federal Reserve Bank of New York, Staff Report nº 318.

32 Committee of European Securities Regulators (2009): "Transparency of corporate bond, structured finance product and credit derivatives markets". Available from http://www.cesr-eu.org/popup2.php?id=5798.

33 International Organization of Securities Commissions (IOSCO), 2009: *Transparency of Structured Finance Products*. Available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD306.pdf.

it, was that the complex, non standard, illiquid nature of many asset-backed securities would in any case impair price comparability. Also, as in many other cases, the disclosure of more post-trade information could prove a negative incentive for market participants, by forcing them to reveal data that could give away their strategies.

On balance e, enhanced post-transparency requirements would seem to be a step in the right direction.

On balance, however, it seems clear that some kind of enhanced post-transparency regime would be a step in the right direction, especially at times like these of heightened uncertainty. Any such move must of course bear in mind the idiosyncrasies of secondary securitisation markets, of which the following in particular spring to mind: the degree of liquidity or turnover of each kind of instrument, the original issue volume, whether placement was public or private, the size of the investor base, the extent of securities standardisation, the rollout cost of a post-transparency system, and the wisdom of introducing flexibility in disclosure requirements (for instance, delays in disclosure, reporting of data on an aggregate vs. transaction basis, making minimum trading volumes exempt from disclosure to preserve the anonymity of the trader, etc.)

The next logical move would be to look at ways to increase standardisation in structured product trading rules.

The next logical step after a reform of post-trade transparency in structured product markets would be to broach the possibility of standardising their trading rules, with thought to a common (or broadly similar) regime for at least the main regulated markets.

5.6 Closing remarks

Regulators and industry continue working to the goal of revitalising securitisation markets.

Both regulators and the industry itself are pursuing ways to revitalise struggling securitisation markets. A return to pre-crisis practices can be ruled out, given the greater caution investors will presumably exercise in future, and nor is it especially desirable given the numerous failures that the crisis has brought to light. In this article, we have considered some of the main problems the industry confronts and some recent initiatives to overcome them. Among the former, we have singled out conflicts of interest among securitisation participants, insufficiently robust valuations and incentive problems in rating agencies, the need for more transparent, simplified and standardised products and the lack of post-trade transparency in secondary markets.

The success of these efforts will require a balanced combination of new regulatory elements and new industry practices.

The goals of the industry's pursuit are clear enough: to achieve a sustainable recovery in securitisation markets, on the grounds that, despite the excesses of the recent past, there remains much to be gained from this financial technology, with its enormous potential as an instrument of bank financing and for the pooling of risk. To be successful, however, initiatives must rest on a balanced combination of new regulatory elements and more responsible practices on the part of the industry.