

GUIDE

CNMV information guide

What you should know about

Fixed-income products



This CNMV guide is for investors. It explains the essential terms, helps you to ask the right questions, sets out the information that an investor must request and tells you what to do if you have doubts.

What you should know about

Fixed-income products

This is a CNMV document

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EVERYONE KNOWS THE SIGNIFICANT ROLE ATTAINED BY individual investors over the last decade. The results of the phenomenon known as “popular capitalism” have been privatisations, IPOs and the extraordinary growth of managed funds and of the number of unit holders in mutual funds. This has gone hand in hand with a strong increase in the financial assets of Spanish households.

Financial institutions have shown their maturity by gradually offering more varied and novel products in order to satisfy different needs. On the other hand, however, it has become increasingly difficult for the ordinary man or woman to know the features of these products, understand the returns that can be reasonably expected and the risks associated with them.

Moreover, as well as objective knowledge of the products, investors need to incorporate their own particular selection process based on parameters such as the funds available for investment, the time frame, degree of aversion to risk, etc. As a result, the National Securities Market Commission (CNMV) has decided to contribute to a better understanding of the financial products in the markets that it supervises, so that investors are better able to make the correct choice.

This first guide to investment products looks at fixed-income products. Others will examine equities, mixed products and futures and options.

Although in recent years the relative share of fixed-income in the total financial assets directly held by Spanish households has declined, due to a significant shift into equities, fixed income still plays an

important role in the diversification of portfolios, in other cases to guarantee them and, consequently, they are present in a large number of mutual funds to a greater or lesser extent.

The different guides will give a basic description of the most frequent investment products; they do not aim to be a manual because to be so would require much more information about the complexity of products. We believe that by not being manuals, we will better achieve our dissemination objectives.

In any case our view is that not all products are suitable for all investors and although financial entities must know their customers so that they can provide the right and personalized advice, you are more interested in identifying whether a product is the right one for your specific case. You are the final person responsible for managing your savings, although you may receive advice from your intermediary. Find out about all the features and request as much information as you need before making an investment. As well as being your right, you should remember that part of the commissions that you pay are the counterpart to this service.

OFFERS



Types of financial products

Spanish investors have many financial investment alternatives. The following table summarises as simply as possible the most popular products and sets out the entities authorized to market them and the institution responsible for authorization and supervision.

Financial products

Type	Product	Entities that (trade) them	Supervisor of the product
Bank deposits	<ul style="list-style-type: none"> • Current and savings accounts • Time deposits • Foreign currency accounts 	<ul style="list-style-type: none"> • National credit entities (banks, savings banks and credit cooperatives) • Foreign credit entities (with a branch in Spain and those authorized to operate without a physical presence) 	Bank of Spain
Marketable securities	<p>Fixed income:</p> <ul style="list-style-type: none"> • Public debt (Treasury Bills, government bonds and debt of regional governments and of other public institutions) • Private fixed income (commercial paper, bonds, convertible bonds, mortgage bonds, securitizations, etc) <p>Equities:</p> <ul style="list-style-type: none"> • Preference Shares • Listed and unlisted shares • Subscription rights and free allocation of shares • Units in FIM(1) and FIAMM(2) • Shares of SIM(3) and SIMCAV(4), • Units or shares in foreign IICs(5) 	<ul style="list-style-type: none"> • Brokers and dealers • IIC(5) (6) management entities • Foreign ESIs(7) (entities with a branch in Spain and those authorised to operate without a physical presence) • National credit entities • Authorised foreign credit entities 	CNMV (except public debt supervised by the Bank of Spain)

Financial products (continued)

Type	Product	Entities that (trade) them	Supervisor of the product
Other non-marketable products	Mixed <ul style="list-style-type: none"> • Untypical financial contracts “CFA” 	<ul style="list-style-type: none"> • National credit entities • Authorised foreign credit entities 	CNMV
Derivative products	Traded in regulated markets: <ul style="list-style-type: none"> • Financial futures and options and non-financial ones (“commodities”) • Warrants • Structured products 	<ul style="list-style-type: none"> • Brokers and dealers • Authorized foreign ESIs(7) • National credit entities • Authorised foreign credit entities 	CNMV
OTC derivative products	Products not traded on secondary markets “OTC”(9): <ul style="list-style-type: none"> • Forwards • “FRAs”(10), • Swaps, • Options, 	<ul style="list-style-type: none"> • Brokers and dealers • Authorised Foreign ESIs(7) s • National credit entities • Foreign authorized credit entities 	
Insurance products	<ul style="list-style-type: none"> • Pension plans and funds • Life savings products 	<ul style="list-style-type: none"> • Insurance companies • Credit entities 	General Directorate of Insurance

¹ Capital market mutual fund.

² Money market mutual fund.

³ Investment companies (closed-end).

⁴ Variable capital investment companies (open-end).

⁵ Collective investment institutions.

⁶ Only units of own managed funds sold.

⁷ Investment service company.

⁹ “Over the Counter”.

¹⁰ “Forward rate agreement”.

There are relatively unknown products that have, nevertheless, significantly penetrated retail investors, such as Preference Shares or Non-typical Financial Contracts. The return on Preference Shares is based on a company generating a certain profit, while Non-typical Financial Contracts combine the features of a time deposit and a derivatives product (usually an option on listed shares). The latter are high-risk products, whose return is higher than that of traditional deposits, but also they can generate losses in the capital invested.

In order to be sure that an entity has been duly authorized, and so be able to find out about the product in the official registries, and check that this information coincides with the features, you should consult the following supervisors:

- The CNMV in the case of fixed income, equities, derivatives and mutual funds.
- The Bank of Spain, for deposits, current accounts etc, that are contracted with Spanish and foreign commercial banks, savings banks and credit cooperatives.
- The General Directorate of Insurance and Pension Funds, for pension plans and funds and life savings product.



2 Points to bear in mind

Although the features of financial products are very different, there are two parameters, which cannot be overlooked: **the return and the risk**.

There are performance measures that grant a classification to the simultaneous evaluation of the return and the risk, enabling comparisons to be made between the different assets and the past performance to be measured.

These methods are based on relating the return of an asset, which has a certain risk, with another one that is considered to be risk-free (often the yield on a one year Treasury Bill issue). The Sharpe, Jensen, Modigliani M2 ratios, etc. are ways to measure the performance and are increasingly found in information about products.

a. The return

In its simplest form the return is the quotient between the net yield of the investment and the amount of money invested, expressed in percent. However, the calculation is in practice more complex.

First, one has to consider the **net returns**, ie, the revenue received less the costs incurred. On the costs side, one has to take into account both the expenses derived from the operation — commissions for carrying out purchase and sale orders, subscription or repayment (brokerage fees), as well as those that the financial entity subsequently receives for maintaining the investment — deposit and administration costs (also called administration and custody fees).

Second, one has to bear in mind the tax impact on the return. For the investor the important thing is the **return net of taxes**. Tax treatment of the same product can be different depending on the personal circumstances of each investor. The tax impact can change for two reasons: modifications to laws which mean changes in the way a product is taxed, or modifications to an investor's income or assets that have a different impact to that of this taxation on their personal income tax.

Another factor to bear in mind is the period during which one expects to maintain the investment. In general, fixed-income products generate income — and at times costs — while they are held. In order to compare them one has to know how much these flows are currently worth, in other words their value has to be brought up to date.

The notion that money has a time value is one of the basic concepts of finances. As is generally known, the same capital today has a higher value than obtained in the future. This is because:

- Inflation reduces the purchasing power of capital over time.
- The risk exists, although in some cases it is remote, that the promise to return the capital will not be fulfilled.
- One gives up the possibility of using it for another investment, consuming it or spending it (opportunity cost).

Therefore, in order for there to be an incentive to invest, the expected return must include this rate of interchange to which we are indifferent between having money today or in the future (ie, the price of money, plus an additional premium to cover the uncertainty, known as the risk premium).

The formula that establishes the equivalence between the current value of capital and its future value is*:

$$C_o = \frac{1}{(1+r)^n} * C_n$$

C_o = Current value

C_n = Future value

r = interest rate in percentage divided by 100

n = number of periods (years,..)

If an investor contributes €1,000 at a fixed interest of 4.25% a year, the following year he will have:

$$C_1 = 1,000 * (1.0425)^1 = 1,042.5 \text{ euros}$$

And within 5 years:

$$C_5 = 1,000 * (1.0425)^5 = 1,231.35 \text{ euros}$$

* These formulas are set out in order to explain the concept of the internal rate of return (IRR), and are not needed for the next chapters. If you like, you can continue to read this Guide as of page 15

If the investor can ascertain with certainty that during the whole period there will be no change of interest rate, he or she will be indifferent to having €1,000 today or €1,042.5 the following year or €1,231.35 in five years.

The different methods for evaluating assets are based on the general principle of discounting all that can be expected to be obtained from them in the future at an interest rate or discount rate, in order to know their current value.

- In the case of equities, what one expects to obtain in the future is basically the company's profits, distributed or not in the form of dividends.
- In the case of fixed income securities, the income expected is fixed or variable coupons at different periods.

Reality, however, is more sophisticated because generally fixed income provides a cash flow, which is often known beforehand. Its theoretical price is the current value of the expected payments. In order to calculate it, one needs to know, or estimate if the interest rate is variable, the value of the coupons to be received, their degree of regularity — yearly, half yearly, etc — the repayment value and estimate the discount rate to be applied at each period to the cash flows received.

In general terms, the current theoretical value would be:

$$P_0 = \frac{C_1}{1+k} + \frac{C_2}{(1+k)^2} + \dots + \frac{C_n + P_n}{(1+k)^n}$$

C_n = coupons or interest payments that the bond generates at the end of the period j

n = number of years or periods of life until redemption

k = nominal interest on money in the capital markets

P_n = repayment value

P_0 = current value of the security

In selecting interest rate “ k ” an average market rate is often used for investments with the same maturity, often that of government debt at different maturities.

Example: Theoretical Value of a Bond

Mr. ZZZ decides to invest in a bond with a nominal value of €10,000, with an annual coupon of 5% over three years. If the average market interest rate for investments of the same maturity were 5.25%, what would be the price that should be paid today?

$$P_0 = \frac{500}{1+0,0525} + \frac{500}{(1+0,0525)^2} + \frac{500+10.000}{(1+0,0525)^3} = 9,932.23 \text{ euros}$$

Using this same calculation method and at a same date, some investors would buy and others would sell the same bond. The reason is that there is never a single current theoretical price because there are different interpretations — subjective — of future discount rates — future interest rates — and/or of the amount of the next coupons, when they are variable. The logical thing would be to apply a different discount rate for each period. The result is that for everyone this asset today has a different theoretical value. If it is higher than the market's value investors would buy and if lower sell.

There is a single discount rate, average effective rate, which is equal to the price of a bond with the flow of payments generated by it. This is the **internal rate of return (IRR)**, which sums up the yield of a security in the form of an average and is very useful for comparing different products.

$$\text{IRR} : P_0 + \frac{C_1}{(1+r)} + \frac{C_2}{(1+r)^2} + \dots + \frac{P_n}{(1+r)^n} = 0$$

This operation is easily done with a calculator or spreadsheet, and you can ask your broker about the method of calculation.

But it is not always possible to calculate these returns in advance. In fixed interest securities, the investor knows with certainty what is the income and costs associated with the investment, and can calculate exactly the return if they are bought in the primary market and held until maturity. However, in variable interest rate products, especially in both cases, if the investor sells before maturity and/or acquired the securities on the secondary market, the calculation *a priori* is an estimation.

When operating in the **secondary fixed-income market**, and especially **short term**, you have to consider the risk of an increase in interest rates, the more so the longer there is for the asset to mature. In these cases, **a rise in interest rates in the short term can produce capital losses**.

b. The risk

Financial risk is a series of factors that can determine whether an investment provides a return higher or lower than the one expected. Risk means uncertainty and, financially speaking, obtaining 20% more or less than the expected return incorporates the same risk. Logically, an investor is only worried by the second case, that is 50% of the total risk or only the probability that the return may be lower than initially envisaged.

In this aspect there are substantial differences, Simple fixed-income products that entail little risk generally have low returns, although this is not always the case.

A fixed-income asset can accumulate different sources of risk. The calculation is not the sum of them but a lower figure that takes into account possible correlations:

- **Interest rate and price risks.** An investor is subject to one or other depending on the time frame of the investment in relation to the maturity period of the asset acquired and the changes in interest rates that take place during this period.

When an investor acquires an asset with a maturity longer than its period of investment, at this date it has to be sold in the secondary market. If during this period interest rates have risen the investor will obtain a lower than expected return and, depending on this variation, there could be a capital loss. Clearly, a drop in interest rates will provide a return higher than initially envisaged.

It is easy to understand how interest rates affect the prices of fixed-income assets in the secondary market. When the interest rates of new issues rise, the prices of those already in existence fall as investors are only prepared to buy the old ones if their price comes down and so guarantee the purchaser a return equivalent to that of the new issues. On the other hand, when interest rates fall, the price in the secondary market of old issues will rise. In both cases, it is movements in the IRR which adjust the price. The IRR enables one to homogenize the return of each issue in order to compare it with market rates.

The sensitivity of price to interest rate changes depends on the number of coupons pending, their distribution, amount, and the rest of income to be received. This sensitivity is measured through the **life** of the asset. The longer it lasts the greater the risk because, in the face of interest rate rises or falls, the price of the product will fall or rise to a greater or lesser extent.

This is why the effect of a change in interest rates on the price of a fixed-income product is greater the longer the life until amortization.

As well as a risk measurement, the duration is the moment in the life of a bond when the value of all the payments already received is the same as those to be received, all of them valued at this date. The investor must know that when buying a bond, interest rate risk can be eliminated – eliminate the impact of its swings, regardless of its amount – if it is sold during the duration.

The duration can thus be interpreted in two ways.

Example: 10-year bond at 4%. IRR = 3.5%. Duration = 8.47¹

If the IRR rises by one percentage point, ie from 3.5% to 4.5%, the price of the bond will drop 8.47%. and the opposite if there is a drop of one percentage point. In both cases, the

¹ Corrected duration. For simplicity the convexity effect is not taken into account.

movements will be offset over time so that in the year 8.47 the return will be at least the IRT initially envisaged, assuming that the rest of the parameters remain constant.

- On the other hand, if the asset acquired has a life lower than the investment horizon, at its maturity another one must be bought until this period is completed. This situation produces a **risk of reinvestment**, because at this date the return on the assets could be lower than those initially offered at this maturity.
- **Exchange-rate risk.** This is the risk of a variation in exchange rates, and it only affects non-euro denominated assets.
- **Credit risk or risk of insolvency.** This is the risk that the issuer of a security cannot meet payments – both coupons as well as repayment of principal, or that there is a delay in making them. The issuer can be a company, a financial entity, a State² or another public institution.

The quality of the credit is increasingly taken into account. It is instructive to consult the ratings of the specialized agencies on the credit quality and financial strength of issuing companies, States and public institutions. These ratings can be of the issuer, or in the case of private sector companies, of them and/or each of their issues. The ratings are set out in Chapter II of the Information Prospectus registered with the CNMV.

The main criterion for evaluating the solvency of an issuer tends to be its capacity to generate profits in the future and, consequently, the capacity to meet its payment commitments. Other times the solvency is rated so that a specific issue can offer additional guarantees (such as securitizations). Ratings can be reviewed, suspended or withdrawn at any time by the rating agency.

Where there is the **risk of lack of liquidity**, which refers to a possible penalization in the price of the investment, there is a need to recover the money quickly. In extreme cases, it might be impossible to recover the money at the desired moment.

In some financial products, such as bank deposits with traditional maturities or some guaranteed mutual funds, the amount of penalization in the anticipated repayment is envisaged in the corresponding contract. In others, such as listed shares and warrants, private fixed income traded on stock markets or on the AIAF, futures and options traded on MEFF, it is the market that determines the liquidity and price of the investment.

One also has to take into account that there are products that are not marketable and whose early redemption is not allowed, such as Non-typical Financial Contracts and, if allowed,

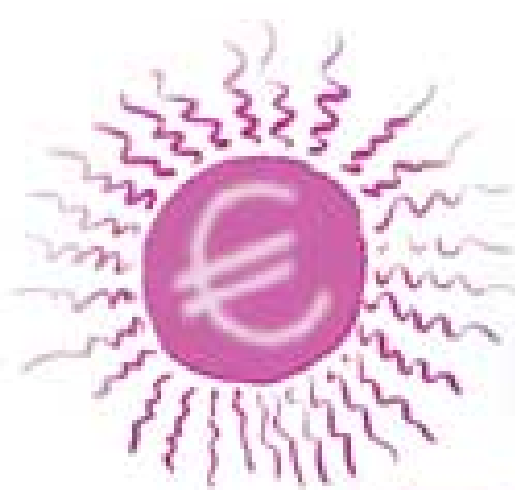
² At times there have been unilateral suspensions of interest rate payments on external public debt issued by developing countries. This risk known as country-risk almost does not exist in Western countries.

the cost of withdrawing the coverage of the associated option is high. In these cases, part of the principal invested could be lost.

There are notable differences in the way organized markets work, as well as significant differences in the liquidity of different products traded on them. And one should not forget that **the lack of liquidity is a cost that is always assumed by the investor.**

Moreover, the prices of financial assets are also sensitive to general expectations on the performance of the economy, the specific performance of certain sectors or companies, etc..

Lastly, there is operational or procedural risk, stemming from the possibility of making **mistakes** when transmitting purchase or sell orders to financial entities. Whereas the other risks can be reduced through adequate diversification or selection of products, this risk is the only one that can be wholly avoided. Carefully revise your orders before transmitting them and then check that they have been executed in accordance with your instructions and the market situation. Subsequently, check the statement of securities from time to time.



What is the best investment for me?

It is impossible to give a universal answer to this question. Generally, the best thing to do is to seek advice from professionals of recognized solvency and, above all, exercise common sense. Fortunately, the wide range of financial products in our markets, with differentiated profitability and risk features, enables us to find adequate investment alternatives.

Before committing your savings, investors should sort out their objectives:

- Determine the amount to be invested
- For how long do you want the money tied up?
- What return do you expect and what risk are you prepared to assume?

Analysing one's age, socio-economic and family situation, degree of aversion to risk and capacity to generate savings, among other factors, will help you to decide the best place for your money, bearing in mind that over a long time frame, the return-risk relation improves.

Meanwhile, you also have to consider the amount and degree of **diversification** of your assets. Diversifying investments — distributing them among different financial products — tends to be an efficient way to limit risk and obtain reasonable returns.

Lastly, you should be aware that not everyone has the same **readiness to accept and manage risks**. It is not just a psychological problem of sensitivity to risk, but also a practical problem of management: the greater the risk that one is prepared to accept, the longer the time and attention needed to monitor investments.

Once you have decided what are your personal needs, all you need to do is select from a wide range of products, after receiving the information of the features of each one. Here are some of the **questions which it is always advisable to ask**:

- Does the investment meet my objectives? Is it adequate for me?
- How does it generate money (through dividends, interest payments, etc)? What is the tax treatment?
- How much will I have to pay in the form of subscription and repayment commissions for management and custody charges or commissions on purchases and sales?
- How liquid is the product? Is it traded on an organized market? Will it be easy to sell if I need the money?
- What are the specific risks of this asset? How large would be my losses in the worst-case scenario?
- Who supervises the product?



What is fixed income?

4

Fixed-income assets cover a wide range of marketable securities issued by companies and public institutions; they represent loans from investors. Fixed income does not confer political rights on the holder, only economic ones, including the right to receive agreed interest payments and the return of all or part of the capital invested at a given date, depending in whether it is simple fixed income or not. A fixed-income investor becomes a creditor of the company that issues the securities, while a shareholder is a partner, owning part of the capital stock. This difference is not a trivial one because:

- If the company is wound down, creditors have priority over shareholders.
- The shareholder has a series of rights the exercise of which requires a greater commitment than that of fixed-income investors: greater tracking of information, taking part in the General Meeting of Shareholders, delegating your vote, etc..

Although traditionally in fixed income the interest on the loan is established exactly from the time of the issue until maturity, there are other more sophisticated possibilities. Often the interest payments are variable and are linked to certain indicators, generally interest rates (Euribor, etc...), stock market indices, or even the performance of a particular share, etc..., bearing in mind other special features.

Fixed-income investors must be familiar with concepts such as:

Issue price

Effective price of each security at the time of subscription. Normally, it is the same as the nominal value, although in some cases it can be lower or higher, depending on whether it is issued at a discount or at a premium.

Redemption Price

This is what is received at the time of repayment and it tends to coincide with the nominal value, although it can be higher or lower. In any case, this is stipulated in the conditions of issue.

Redemption

This is the return of the initial capital at the maturity of the asset. Early redemption can be agreed, either at the option of the issuer or the investor and, in both cases, it can be full or partial. When the issuer opts for an early partial redemption it is done by draw or by reduction of the nominal value of the securities, affecting all investors.

Repayment premium

When at the date of redemption the issuer pays an amount higher than that of the nominal value of the securities, the difference between both is the repayment premium.

Coupons

Amount of periodic interest payments agreed in the issue (quarterly, half yearly, annual, etc). **Accrued interest** is the part of the coupon earned and not paid at a certain date between the payment of two coupons. Its amount is added to the value of the bond when it is bought or sold in the secondary market with ex coupon price.

Zero coupon issues

They are securities whose interest is paid at maturity, along with the principal. Generally, the maturity is short-medium term.

Discounted Issues

These are zero coupon short-term issues, which discount the amount of interest at the time of purchase (for example, Treasury Bills and commercial paper).



Public debt

5

These are securities issued by the State, regional governments and other public institutions.

a. Treasury Bills

These are short-term assets (maximum 18 months) issued by the State through the General Directorate of the Treasury. They are always issued at discount and are represented in the book-entry system. They do not exist in physical form.

The Treasury regularly issues these securities via competitive tenders, as a way to finance the State. The Bills have three maturities: six, 12 and 18 months. You can acquire them, both on the primary and secondary markets, via any financial entity and also from the Bank of Spain via State direct debt accounts.

b. Government bonds

These are medium- and long-term bonds issued by the government. They have an explicit yield. Three and five year bonds are known as *bonos* while *obligaciones* have maturities of 10, 15 and 30 years. They pay a fixed interest rate through annual coupons.

You can acquire them in the primary or secondary markets, in a similar way as for Treasury Bills. The reference market is the book-entry public debt market.

Some long-term public debt issues are issued as strips, where the principle and each coupon of the original bond can be bought separately.

The website of the General Directorate of the Treasury (www.tesoro.es) gives information on all issues of public debt issued by the State and can be used to access auctions and contract debt free of costs.

Spanish state public debt has the maximum ratings from the leading rating agencies.

c. Debt of regional governments and of other public institutions

Regional governments, local governments and various public entities issue short-term (commercial paper) and long-term securities. Their features are similar to those of Treasury Bills and government bonds, respectively.

The Bulletin of the Central Book-Entry Office on the Bank of Spain's website has information on the prices traded and crossed operations (www.bde.es)



Private fixed income

6

These are securities issued by private sector companies. Issuers have to produce and register an information prospectus with the CNMV every time they make an issue for the general public.

a. Commercial paper

These are zero coupons issued at a discount. Their return is the difference between the purchase price and the nominal value of the paper at the date of redemption. They are short term, with maturities ranging from seven days to 25 months, although the usual maturities are one, three, six, 12 and 18 months.

The paper is placed on the primary market either through competitive auctions, which determine the price, or by direct negotiation between the investor and the financial entity.

b. Bonds

These are medium- and long-term securities. Their features can vary considerably from one issuer to another, and even those by the same company. These differences include the date of maturity, interest rate, schedule of coupons, issue price and redemption, clauses of redemption and other conditions, convertibility conditions if they exist, the priority established in the event of liquidation and the guarantees offered.

There are simple bonds, subordinated bonds — which for the purposes of the priority of credits, are behind all other common creditors —, linked, referenced or indexed bonds- whose return is linked to the performance of an index, basket of shares, etc. The investor must bear in mind that if the performance of the references is unfavourable, he might not receive any return or even make a loss.

In these cases, as well as the risk of the interest rate performance affecting all fixed income,, there is the risk of the index to which securities are referenced.

Placement in the primary market is done in accordance with the procedure described in chapter 11 of the Information Prospectus and in the three-page leaflet.

c. Convertible and/or exchangeable bonds

Convertibility enables a financial asset to be transformed into another. Thus, a bond can become a share or another type of bond.

Convertible or exchangeable bonds confer on their owner the right to exchange them for shares at a set date. The difference between exchange and conversion is that, in the former, the transformation into shares is done with the delivery of old shares which are part of the issuer's treasury stock, while in the latter, new shares are delivered.

Until the date of conversion, the holder receives interest through periodic coupons. The number of shares delivered for each bond, the way of determining the prices, as well as the dates of exchange or conversion, are set out in the Issue Prospectus. At the date of exchange, the investor has two alternatives:

Exercise the conversion option, if the price of the shares offered in exchange/conversion is below their market value.

Keep the bonds until the date of the next conversion option or until maturity.

d. Mortgage bonds

These are fixed-income securities issued solely by credit entities, backed globally by their portfolio of loans. By law³, the volume of mortgage bonds issued and not matured cannot be more than 90% of the unredeemed capital of all mortgages of the entity suitable for coverage.

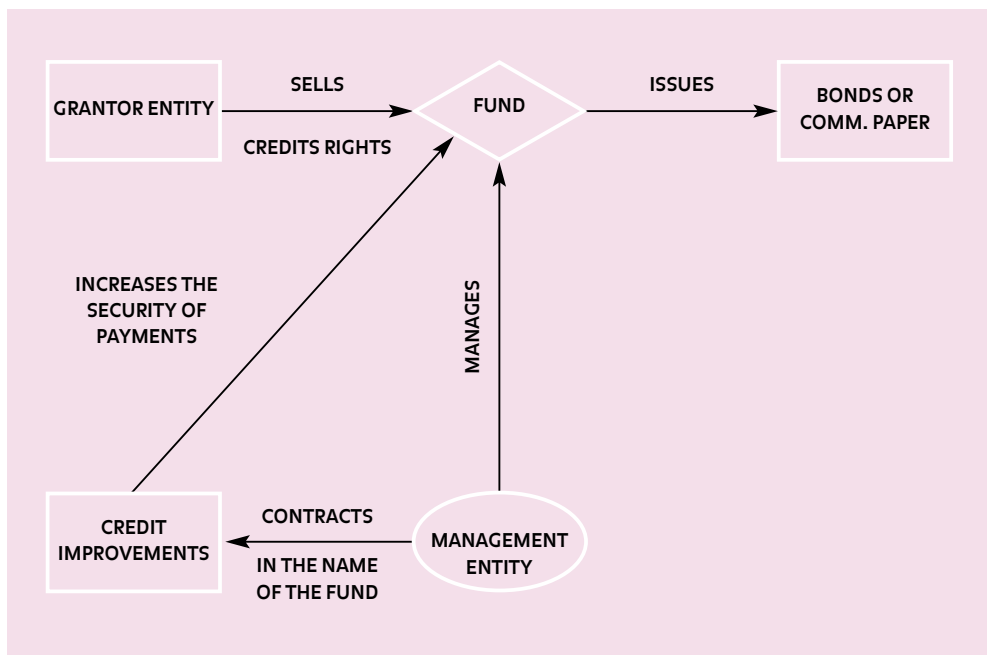
They tend to be medium-term issues and have different interest rate and redemption conditions. The issuer reserves the power to repay early part or all of the issue during its life, in accordance with the law that regulates the mortgage market.

³ Royal Decree 1289 of August 2, 1991 and Royal Decree 685 of March 17, 1982

Issuers tend to inject liquidity into these securities (ie, they provide a purchase or sale counterparty for investors, provided that the volume of securities in their portfolio does not surpass the legal limit of 5% of the volume issued).

e. Securitization of mortgages and of assets

Securitization is a method of financing companies based on the sale or transfer of certain assets, or even the rights of future payment, to a third party who, in turn, finances the purchase by issuing securities that are placed among investors.



In Spain, the method of securitization is as follows. The entity that needs financing — the grantor — sells assets to a **securitization fund**, which does not have legal status and is administered by a fund management entity. The fund, in turn, issues securities that are backed by the assets acquired. When the guarantee consists of mortgages granted by credit entities, the securities issued are acquired by a **mortgage securitization fund**, which issues **mortgage securitization bonds**. When the guarantee consists of other assets, these are acquired by a **fund of securitization of assets**, which will issue **commercial paper or securitization bonds**.

The most noteworthy aspects of securitization include:

1. The securitization fund is configured as separate patrimony so that the securitized portfolio is outside the scope of the creditors of the grantor entity.
2. The securities issued are backed by securitized assets and not by the solvency of the grantor entity. In order to make the payment of the securities issued more secure, neutralize the interest rate differences between the credits grouped in the fund and the securities issued against it, and ease the temporary mismatch of flows, financial operations known as credit improvements are contracted by the fund.
3. The financial risk of the securities issued is always the subject of valuation by rating agencies.
4. The holders of the bonds issued against the fund assume the non-payment risk of the assets grouped in it.
5. The early redemption risk of the fund's assets is transferred to the holders of the securities. At each payment date, the bondholders can support partial redemption.

Despite being issues that generally have a very high rating, it can be difficult for retail investors to understand them. Because of their features, they are normally placed among institutional investors.

f. Preference Shares

These are securities that are not contained in Spanish legislation. They are issued by foreign companies domiciled in countries such as the Cayman Islands, and the subsidiaries of a Spanish company which acts as the guarantor. They are different to fixed income securities and shares. Their structure is similar to subordinated debt, but for accounting purposes they are regarded as securities representative of the capital stock of the issuer, which grant to their holders rights that are different to those of ordinary shares, as they do not have political rights and the right of preferential subscription. Their main features are:

They grant to holders a predetermined remuneration (fixed or variable), which is not cumulative and depends on the generation of sufficient profits for distribution by the guarantor company.

Their place in the priority order of credits is ahead of ordinary shares, in the same equality of conditions as any other series of preference shares and behind all common and subordinated creditors.

Preference Shares are perpetual, although the issuer can agree their amortization once five months have passed since their disbursement, after authorization from the guarantor and the Bank of Spain, when necessary.

It is not a traditional fixed-income product and, at this moment, some issues have little liquidity. Before contracting them, you should carefully read the brochure and three-page pamphlet.



Before investing in fixed income ...

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a. What information is there for taking decisions?

The laws that govern transactions in the securities markets are based on a very clear and simple principle: all investors, both institutional and retail, should have access to specific information on investments before making them. In order to achieve this, the CNMV requires issuers to make available to the public all information on the company and the issue, such as the financial situation of the company, etc, at different moments:

A. Information for contracting a product:

- **Issue prospectus.** Their purpose is to give full information on the issuer's situation and the securities offered, so that potential investors can make a sound judgement about the investment proposed to them. The prospectus includes the company's audited accounts, the features of the securities being offered, a description of the company's activities, the results obtained and the business prospects, as well as the main risks related to the offer and the issuer. It identifies the companies authorized to place the securities and underwrite them (with the amount), as well as the tax regime to be applied. **The issuers and financial intermediaries involved in placing securities must make available to the public the prospectus at all points of sale.**
- **Three-page leaflet.** This document summarizes the prospectus and sets out in the simplest way the main figures and risks related to the offer and the issuer. As with the prospectus, the issuer and the financial entities involved in the placement must make the leaflet available to the public at all points of sale. **It is very important that the investor reads the document carefully before contracting a product.**

B. Information for tracking an investment

- **Annual audited accounts**, in accordance with the Law of Limited Companies. The investor must pay particular attention to the possible safeguards included by auditors.
- **Periodic quarterly and half-yearly information** on the company's performance. The half-yearly information contains the individual and consolidated balance sheets and income statements, as well as the business performance (revenues and costs, analysis of the main operations that produced extraordinary results, significant investments and divestments,...). The issuers publish this same information on a quarterly basis, but in less detail.
- **Significant developments**: Companies must immediately inform the CNMV of any development or decision that might significantly affect the share price.

The information can be consulted at the CNMV or via its website ([www. cnmv.es](http://www.cnmv.es)).

b. How do I buy and sell fixed-income products?

Fixed-income products can be subscribed at the time of the issue — in the primary market —, through financial entities, according to the terms set out in its information prospectus.

They can also be bought from other investors — in the **secondary market** —, through financial intermediaries. In this case, the issues of the greatest interest for investors are those listed on the following **markets**:

- The book-entry public debt market mainly trades Treasury Bills and government bonds.
- The AIAF⁴ market trades commercial paper, mortgage bonds and various types of bonds issued by private and public financial and non-financial institutions, as well as preference shares and securitizations.
- Four Spanish stock exchanges – Madrid, Barcelona, Bilbao and Valencia – trade various private fixed-income issues and the debt of other public institutions. Book-entry public debt can also be bought and sold on these markets.

You can find information on the prices of different fixed-income markets in price bulletins and in the specialized daily financial press. Bear in mind that in the case of fixed income

⁴ Association of Intermediaries of Financial Assets.

contracted on stock markets, the prices crossed in the trading sessions are both retail and institutional.

The prices published for securities traded on the book-entry public debt market are obtained from the purchase/sale operations between financial entities. The AIAF prices relate to both bilateral trades between financial entities, between them and their clients, or directly between them. However, by only publishing information on average weighted prices, institutional operations affect prices to a greater extent, because of their larger volume. **These prices are only indicative and, generally, do not coincide with those applied in their operations.**

The price applied to retail investors is directly negotiated between the investor and the entity chosen. This means the prices vary from entity to entity.

c. What questions should I ask about fixed-income products?

Over the past few years, there has been spectacular growth in the variety of products that investors can find in markets. The most novel products are also the most sophisticated ones, including fixed income. Some of them are difficult to understand and they are subject to an increasing number of sources of risk. Investors can now find fixed-income assets with variable interest rates, early redemption options and other special features.

It is very important that you know all the special features of the product in which you are going to deposit your savings. As well as general questions that it is always wise to ask before acquiring a financial product, we advise you to find out about the following specific aspects:

- **Confirm the interest rate you will receive.** If it is variable how it is calculated and the intervals at which payments are made (remember that they affect the return).
 - If the interest rate is variable, find out what is the reference and the spread that is applied:
 - A certain interest rate (Euribor, etc...)
 - The positive or negative return of an index (e.g. Ibex, Eurostoxx,...) or of a basket of shares, and how the return is calculated, for example if it is the average of the monthly movements over a certain period, etc, or if there is a calculation agent who evaluates these returns.
 - Some interest rates increase or decline over the course of time and according to a schedule established in the conditions of issue.
- **Find out about the forecasts of specialists on the performance of interest rates.** If you are operating short term in the secondary market and interest rates rise, your return will decline and there could be losses.

- **Confirm the issue and repayment prices**

Usually both prices are the same as the nominal value, although they could be different depending on the conditions of issue. It is important to understand this well because in products referenced to the return of indices or baskets, the repayment price can be lower than the nominal value and an unfavourable performance of these references could produce losses.

- **Confirm the date and conditions of redemption**

- It is not the same to invest over three, five or ten years. Furthermore, if you do not want any price or reinvestment risk adjust the maturities to your time frame.

- Confirm if there are early partial or full redemption conditions, at the option of the issuer.

In some cases, the issuer reserves the option of early redemption of the whole issue over a pre-established period. Bear in mind that this same right is not granted to you. If interest rates fall, the issuer will exercise the option of early redemption and you will have to seek earlier than envisage a new investment at a lower interest rate. However, if interest rates rise, the issuer will not exercise the option and you will not be able to redeem the asset until the final date of maturity, and the investment will pay interest at a rate lower than the market's.

Another form of early redemption is partial redemption from the reduction in the nominal value. In this case it is not optional, but it is one of the conditions of the issue. You must weigh up whether an investment of these characteristics meets your needs, because at certain dates you will receive 25% or 50% of your initial investment.

- **Confirm whether there are other series or issues of – preference shares**

Bear in mind that all preference shares have the same equality of conditions in the priority order of credits as their remuneration depends on the generation of profits that can be distributed. Because of this, if at one of several payment dates there are not enough funds to distribute, this will be done on a pro rata basis among all the series of existing shares. In any event, you will know those which the entity has until the date of your investment, but logically not those that will be issued in the future. This information can be consulted in chapters 0 and II of the information prospectus.



NEWS

8%* FIXED
INCOME
AT 10 YEARS

8% the
first year, the REST
of the coupons CORRUPT
0.20, OR 9.29%

Investor advice



The investor is the ultimate person responsible for managing his savings, and so needs to inform himself about fixed-income securities acquired. He can and should seek advice, but remember that the final decision is yours, and that you must be convinced that what you have chosen is the best alternative for meeting your wishes or intentions.

We set out below some recommendations to follow when choosing what to do with your savings:

- Make sure that the issue, except for public debt, has an **information prospectus registered with the CNMV**.
- **Request from the placement entities the information prospectus and three-page leaflet.** Read it carefully for in it you will find all the features and risks relating to the issue and the issuer set out in detail. You can then make a sound judgement on the investment that is proposed.
- **Bear in mind the importance of the information prospectus;** it is the official contractual document that regulates the conditions of the issue. **And ask about anything you do not understand.**
- **Consult the rates of return – IRR – of the issues with similar features, including state debt.** Bear in mind that many issues offer a first coupon with a high interest rate and then for the rest of the life of the issue a much lower rate, making the IRR clearly lower than the initial interest rate.
- Read the **publicity with care.** Because of its very nature it cannot fully reflect the products' features. Don't forget to read the small print of advertisements and other publicity material. The CNMV ensures that the publicity of an issue conforms to the prospectus, supervising each case.
- Do not take investment decisions on the basis of rumours and secrets. Seek advice on the advice and judgements given to you by third parties.
- Diversify your investments and reduce the risk.
- Get information on interest rate forecasts.
- **Remember that you can lose money with fixed-income products.**

INVESTORS ASSISTANCE OFFICE



If I have doubts where can I obtain information?

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If you have any doubts on the specific features of an investment product, seek more information from your financial entity. You can also direct your questions to the CNMV's Investor Directorate, seek information prospectuses, three-page leaflets or periodic information that you want. Through the Investor Assistance Office (Telf: 902 149 200) you can request the other guides published so far by the CNMV.

The CNMV's website also has the full issue prospectuses. In the section on legislation, you can find the regulations governing issues and issuers. The "Investor Page" includes general recommendations and explanations of various aspects of the securities markets.

CNMV

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