Annual Report 2003
Telefónica, S.A.

06

Risk Management

TELEFÓNICA GROUP ACTIVELY MANAGES THE DIFFERENT RISKS TO WHICH IT IS EXPOSED, USING DERIVATIVE FINANCIAL INSTRUMENTS, MAINLY ON EXCHANGE RATES, INTEREST RATES AND SHARES

INTRODUCTION

The Telefónica Group is exposed to diverse risks on the financial market due to (i) its ordinary business, (ii) the debt acquired to finance its business, (iii) shareholdings in companies, and (iv) other related financial instruments.

The main market risks that affect the companies in the Group are:

1. Exchange rate risk.
   This arises mainly due to the international presence of Telefónica, with investments and business in non-euro currency countries (mainly in Latin America), and due to the existence of debt in currencies other than those of the countries where business is carried on, or where the companies that have taken the debt are based.

2. Interest rate risk.
   This is embodied in the variation in (i) the financial costs of variable rate debt (or that with short term maturity, and foreseeable renewal), due to fluctuation in the interest rates, and (ii) the value of the long term liabilities with fixed interest rates (the market value of which rises when the interest rates drop).

3. Share price risk.
   This is due to the variation in value of the stakes that are not consolidated globally or proportionally, of products derived from these, of own shares in portfolio, and of these derived from own shares, or those in other companies in which a stake is held.

Moreover, the Group faces the risk of liquidity, which arises due to the possibility of imbalance between the needs of funds (due to operating and financial expenses, investment, debts that have matured, dividends committed) and the sources of these (revenue, divestments, financing commitments with financial institutions, operations on capital markets).

Lastly, one must emphasise that the so-called "country risk" (mixed with market and liquidity risks) that consists of the possibility of loss of value of the assets or decreased flows generated or sent to the parent company, due to political, economic and social instability in the countries in which the Telefónica Group operates, especially in Latin America.

The Telefónica Group actively manages the risks mentioned, in order to stabilise:

- The cash flows, to facilitate financial planning and taking advantage of investment opportunities.

- The Profit Account, to facilitate its understanding, and investor prediction.

- The value of the equity, protecting the value of the investment made.

In cases in which these objectives are mutually excluding, the financial management of the group will evaluate which must prevail.

In its risk management, Telefónica uses derivative financial instruments, mainly on exchange rates, interest rates and shares.

Exchange Rate Risk
The fundamental objective of exchange risk management is to compensate (at least partially) possible losses of value of assets related to the Telefónica business, caused by depreciation of the exchange rate to the euro, with lesser savings in euros on the debt in currency (when this is depreciated).

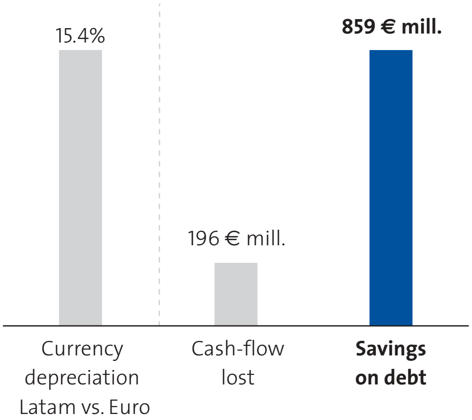
To that end, the aim has been set for the decrease in EUR value of the debt in currency to cover the flows lost over two years due to the lower value of the Latin American currency. Our estimates show that the loss in value of the Latin American currencies throughout 2002 and 2003 (in comparison to the levels of 2001 in relation to the euro) has detracted 3.22 tn Eur from the flows generated by the Group in these two years. On the other hand, the effects of depreciation of currency on our debt has brought savings of nearly 3.86 tn Eur, to translate the debt in currency to euros. Thus, the accumulated loss of flows over the last two years has been comfortably covered (or to say the same, almost 2.4 times the average annual loss has been covered). When that effect is measured against 2003 (compared with the interest rates of 2002 in relation to the Euro), lost flows of 196 M Eur, are observed, more than compensated by savings of 859 M Eur in lesser value (when measured in euros) of the debt in currency.

The protection against future depreciations of Latin American currency in relation to the euro is based, firstly, on the debt in Latin American currency. Excluding Mexico (which is a net receiver of flows) on 31st December, the debt in Latin American currencies (other than the Mexican peso) was equivalent to 1.7 times the flows generated in Latin America. However, this debt is not uniformly distributed as a proportion of flows generated in each country, so their future effectiveness will depend on where the eventual depreciations may take place.

Moreover, protection against losses of value of the Latin American assets due to currency effects, is complemented by indebtedness in dollars in Spain, associated with investment, while the coverage is considered to be effective. On 31st December, that debt came to the equivalent of 1 billion euros. That net amount was less than that existing at the beginning of the year, after a change to euros (through derivative operations) the debt of nearly 4.8 billion dollars associated with the investment in Brazil. The reason for that operation was the decrease in effectiveness of the dollar as coverage for the Brazilian real, after the parity between both currencies in relation to the euro dropped over the second semester of 2002 (with a strong depreciation of the real) and the first semester of 2003 (with appreciation of the real and depreciation of the dollar). The operation materialised a positive results of 267.5 million euros, due to depreciation of the dollar from the beginning of the year until the moment of the operation to transfer the debt to euros. As a substitute for that debt, within a context of scarce correlation expected between the dollar and the Brazilian real, financial option structures traded with maturity distributed throughout 2004 for nearly 2.2 billion dollars, for protection against additional depreciation of

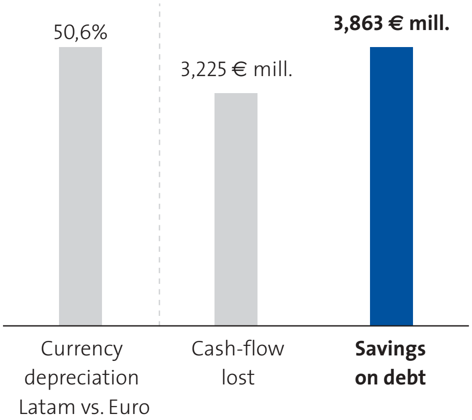
YEAR 2003

(Data in % and millions of euros)



YEARS 2002-2003

(Data in % and millions of euros)



the dollar against the euro, without incurring the negative effect of an appreciation of the dollar on the value of the debt.

Another essential element of exchange management was to minimise the negative financial results due to variations in the exchange rates, notwithstanding being able to maintain open currency positions (under strict supervision of the risk). The difficulties to minimise the risk have arisen due to the practical impossibility to cover the external debt in dollars of the subsidiaries in Argentina through derivatives; this amounted to the equivalent to 815 million euros on 31st December 2003. However, this had a beneficial effect in 2003, as the appreciation of the Argentinean peso against the dollar provided a positive result equivalent to 134.4 million euros. That figure, along with the 267.5 million euros materialised due to cancellation of debt in dollars aforementioned, led to a positive financial result due to the exchange rate effects totalling 401.9 million euros.

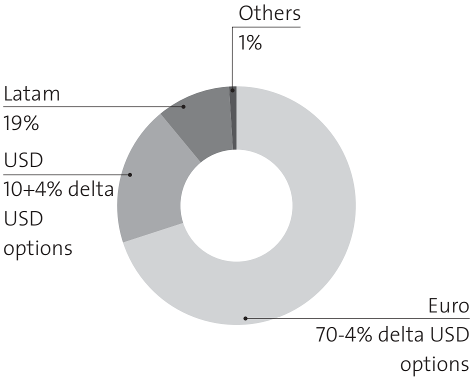
In the future, adoption of international accounting principles may increase the volatility of the financial results due to oscillations of currency, as internal loans to the Group will cease to be eliminated in the consolidation process, in order to calculate the exchange results.

Interest Rate Risk
The financial costs to Telefónica are exposed to fluctuations in interest rates, mainly the Euribor, the Brazilian SELIC rate, the Chilean UF, and the dollar Libor. On 31st December 2003, 53% of the total debt (or 68.9 % of the long term debt), had its rate set for a period exceeding one year, an identical proportion to that on 31st December 2002 (that represented 65.3% of the long term debt).

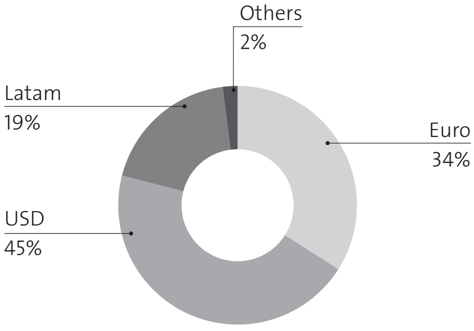
The financial costs in 2003 came to 1,462.6 million euros (excluding the positive exchange rates results of 401.9 million euros), 14% less than those in 2002. That figure of financial expenses in 2003 amounted to an average cost of 7.1% on the average net debt of the year. The strong increase in the Brazilian SELIC rate (with an average rate of 23.53% in 2003, against 19.25% in 2002) prevented a lesser global cost being obtained.

On 31st December 2003 maintenance of a high proportion of debt at variable rate in Euros (55%) and in Reais (100%) would allow the Group to

CURRENCY DEBT
(December 2003)



CURRENCY DEBT
(December 2002)



take advantage in 2004 of drops in interest rates that had already been taking place, especially since the month of June 2003, as the official rate of the ECB (2%) as well as that of the Central Bank of Brazil (16.5%) was at the minimum levels of recent years. In fact, the effective average cost of the debt in the second semester of 2003 was 6.6%, 0.5 percentage points lower than the average for the complete year. On the other hand, the debt in dollars taken by the group (and not transformed to other currencies by exchange rate derivatives) is maintained at fixed rates practically throughout. Due to this, the dollar Libor influenced only the formation of prices of coverages for purchase in dollars on term, against sale of Latin American currencies, which is especially relevant in the case of Chile.

Telefónica actively manages its exposure to interest rates through derivatives. Faced with expected drops in interest rates in 2003, it did not perform any swap operations to fix interest rates in debt in Euros at variable rates; on the contrary, options were sold on a nominal of 1.1 billion euros in swaps which, if exercised by the counterpart, would have caused the interest rates to be fixed in some cases, paying lower levels to those in force at the time of sale of the option, while in other cases, it would have involved receiving higher rates to those in force at the time of sale of the option (in exchange for paying a variable rate). On 31st December, all the options on swaps taken in 2003 had expired, generating a profit of approximately 6 million euros.

On the other hand, after the rise in the dollar rates in the last four months of the year, the terms of coverages of debt in dollars were extended, receiving a fixed rate for that currency.

Share price risk

One of the variable yield risks Telefónica is exposed to is that due to the price of its own shares, due to the share repurchase scheme announced in October, for an estimated amount of 4 billion euros up to 2006 (inclusive), linking the cash flow generation and the evolution of the share price.

On 31st December 2003, Telefónica S.A. held more than 40.5 million own shares which, if listed below their acquisition cost, would require provisions to be set aside against the Results Account.

If Telefónica is exposed to loss in the event of a drop in price of shares in portfolio, due to possible purchases of own shares, Telefónica has a contrary position: if the listed value rises, purchases become more expense and less shares may be acquired for the pre-set amount. To protect itself from that risk and in turn to avoid compromising cash flow not yet generated, in the last quarter of 2003, Telefónica acquired purchase options that granted the right (not the obligation) to purchase 33 million own shares at a preset exercise price, with maturities mainly in the central months of 2004. The maximum loss that may be experienced in this case is the premium paid on the option, if at maturity the price of the share is below the exercise price; however, in such case, Telefónica may purchase its shares on the market at a lower price.

On the other hand, Telefónica also entered into operations for a lesser amount consisting of (i) sales of put options (that would oblige the holder to purchase own shares if the price of the share were to decrease significantly) and (ii) call bought-call sold option structures sold at different exercise prices. On 31st December, the delta equivalent[1] of these structures was 4.7 million shares.

Telefónica is also exposed to the fluctuations in the prices of shares in subsidiary companies, especially to the extent that these are not integrated in its core business, which can make it necessary to evaluate them at market prices. The most significant case

(1) The equivalent delta may be defined approximately as the number of shares whose value varies equal to the value of the options, where there are very small movements in the price of the shares.

during 2003 was the divestment from Antena 3, concluded with a profit of 392.3 million euros. In a contrary direction, the Pearson stake led to losses being recorded.

Liquidity Risk
Telefónica aims to adapt the maturity profile of its debt to its capacity to generate cash flows to pay it, maintaining a certain margin. In practice, that has led to monitoring of two criteria:

1. The average maturity of Group debt must be higher than the time required to pay the debt (assuming fulfilment of the internal projections, and all the flows generated being assigned to payment of the debt, and not to dividends or acquisitions).

2. The group must be able to pay off all its commitments in the coming 12 months, without having to resort to further loans or the capital markets (but maintaining the credit lines already firmly committed by financing institutions), assuming budgetary fulfilment.

On 31st December, the average maturity of the net financial debt – 19,235 million euros- was 6 years. At the Investor Conference in October, the Telefónica Group announced that it expects to generate more than 27 billion euros in a 4 year period, assuming exchange rates are maintained at 2002 levels. In spite of the weakness of the Latin American currencies in relation to the euro (mostly due to the weakness of the dollar), the existing margin allows confidence that the first criteria was being fulfilled on 31st December.

Fulfilment of the second criteria was proven on checking the gross maturity of debt in 2004 (5,587.1 million euros), with the sum of (i) the liquid assets on 31st December (temporary financial investments in the amount of 3,199.6 million euros and cash and bank balances in the amount of 336.4 million euros) (ii) the annual cash generation (that amounted to 5,735.3 million euros in 2003), and (iii) the lines of credit committed by banking firms with maturity exceeding one year, or extendable on option by Telefónica (6,368 million euros on 31st December). The existing margin allows accommodation of dividend payment of 40 cents per share (about 2 billion euros) and acquisition of the Latin American cell phone companies of Bell South, recently announced (for 5,850 million dollars). Fulfilment of these criteria as a consolidated Group is not reflected in the fulfilment reached by each individual company, although progress is being made in that direction.

In spite of the measures put into place to guarantee its liquidity, Telefónica considers the possibility of easy access to the capital markets to be of high importance for development of its business plans and strategy, and for management of its liabilities, and therefore, the legal or tax restrictions on such access can have a negative effect on it. Likewise, to maintain access to swift credit, on good conditions in price and terms, Telefónica keeps watch on the balance between the risk of its business and its financial structure, as well as the main credit ratios. The following table shows these ratios and the variables involved in their calculation.

Operating figures in 2003 — Millions of euros

I	EBITDA	12,602.1
II	Free cash flow	6,312.4
III	Capex	3,727.1
IV	Dividends of Telefónica S,A,	1,233.3
V=II+III-IV	Cash flow withheld (before the capex)	8,806.2

Liabilities at December 2003

A	Financial debt	19,235.3
B	Guarantees	683.5
C	Net commitments for staff reduction	3,189.6
D=A+B+C	Total debt + Commitments	23,108.4

Financial ratios

Financial debt / EBITDA	1.53
Total debt + Commitments/EBITDA	1.83
Cash flow withheld (before capex)	
Total debt + Commitments	38%

Country risk

In 2003, there has been a progressive return to stability in Latin America. Throughout the year, the perception of the sovereign risk in the majority of Latin American countries where Telefónica operates has descended. Thus, the margin of public debt of Brazil in U.S. Treasury bonds was reduced from nearly 13.7 per cent to 4.6, the margin of Peru from 5.5 to 3.1, and that of Mexico from 3.0 to 2.0 per cent (in all cases, according to the EMBI index by JP Morgan). Argentina, on the contrary, has maintained the situation of unpaid public debt, in spite of which it achieved a positive growth in GDP with moderate inflation.

The improved setting and positive expectations are no obstacle for Telefónica to continue with a strict monitoring of the risk of unforeseen loss of value of Latin American assets due to possible social, economic or political instability. Due to this, Telefónica has continued to act along two major lines (apart from ordinary management of the business):

1. To partially compensate the assets with liabilities in Latin American companies not guaranteed by the parent company, so an eventual loss in assets is accompanied by a reduction in liabilities, and

2. To repatriate the funds generated in Latin America that are not expected to be put to profitable use in the future, through business opportunities in the region.

In this sense, to reduce the liquidity risk as an individual company without requiring support from Telefónica S.A., in 2003, Telefónica de Argentina restructured its debt maturity profile through a bond lengthening operation with a face value of nearly one billion dollars, without reducing principal or interest, which was accepted overall by two thirds of the bond holders.

As to repatriation of funds, in 2003, 1,317.7 million euros were taken from Latin America, most in dividends or capital reductions (887.6 million) and the rest in interest and principal on loans to the Latin American subsidiaries, and for management fees. The flow of funds continued in the opposite direction toward Mexico, where Telefónica Móviles made material investments amounting to 483 million euros to launch the GSM network and had operational needs arising from a negative EBITDA of 108.7 million euros.

Derivative policy

On 31st December 2003, the nominal amount of derivatives exposure came to 30,915.3 million euros. That volume is so high because derivatives may be applied several times to the same debt for an amount equal to its face value; for example, a debt in currency may be transferred to euros at a variable rate, and then on each one of the interest rate periods, rate fixing may be performed using a FRA. Even so, it is necessary to be extremely cautious in using derivatives to avoid problems due to errors or lack of knowledge of the real position and its risks.

The policy followed in use of derivatives has placed emphasis on the following points:

i. Existence of a clearly identified underlying value, on which the derivative is applied, as a valid possibility for coverage accounting. Among the acceptable underlying values there are the results and revenue expected in currency other than the euro, that is reasonably secure or foreseeable, even if these do not adapt to the criteria required by the accounting regulations for treatment as coverages. The coverages with economic sense in the Group's opinion do not always fulfil the effectiveness test established by the different accounting regulations to be treated as such coverages; the decision to maintain them once the effective test is not passed and to record the results in the Profit and Loss Accounts. In this sense, due to their importance, it should be emphasized that, during part of 2003, financing was maintained for 4,769 million dollars associated with investments in Brazil up to the month of May, in spite of breakdown of the parity between the Brazilian real and the dollar against the euro; when the cancellation of the debt in dollars finally took place (mostly by disposing of currency swaps) a profit of 267.5 million euros was obtained.

ii. Adjustment between the underlying value and one of the sides of the derivative, with the greatest possible precision.
That adjustment is aimed especially at the debt in foreign currency and derivatives of coverage of payments in foreign currency; however, even when a perfect coverage of the flows is sought, the scarce depth of the Latin American derivative markets has led to there being historical imbalances between the characteristics of the coverages and the debts covered. It is the intention of the Telefónica Group to reduce those imbalances, as long as that does not involve disproportionate transaction costs. On other occasions, the coverages have been made in holding firms (Telefónica S.A., Telefónica Móviles S.A. and TISA) while the debt was maintained at other subsidiaries, which has led to the operations not fulfilling the coverage criteria required by the accounting regulations and the results being recorded in the Profit and Loss Accounts. The main reasons for that separation between the coverage and the underlying value have been the possibility of differences in the legal validity of the local coverages against the international ones (due to unforeseen legal changes) and the different credit quality of the counterparts (of the companies in the Group involved as well as the banking institutions). On the other hand, interest rate derivatives may also suffer imbalances with the underlying values covered, especially when these are of shorter terms, as when Telefónica goes into long term swaps, caps, or collars to protect itself against rises in interest rates that may raise the financial costs generated by the promissory notes and commercial paper, with maturity in a few months, although the successive renewal of which is very probable.

iii. Capacity to evaluate the derivatives at market prices, using the value calculation systems available in the Group.
The fundamental tool to evaluate and manage the risks of derivatives and of the debt is the Kondor+ system, licensed by Reuters, widely used among diverse financial entities.

iv. Sale of options only when there is an underlying exposure that counters the potential loss of exercising the option.

In 2003, Telefónica sold short term options on swaps at euro interest rates, that gave a counterpart the right to enter a swap receiving a specific fixed interest rate, lower than the prevailing level at the time of selling the option; thus, if the rates dropped, Telefónica would transfer part of its debt at variable rate to fixed rate, at lower levels to the initial ones, having collected a premium.

The directives for risk management are issued by the General Management of Corporate Finance of the Telefónica Group and implemented by the financial managers of the companies (ensuring they are in keeping between the individual interests of the companies and those of the Group). The General Management of Corporate Finance may authorise deviations on this policy due to justified reasons, normally due to the narrowness of the markets or clearly limited, reduced risks. Likewise, the entry of companies in the group due to acquisitions or mergers, requires time to adapt.