



Mexder: A Futures Market With Global Appeal

By John Mathias

The Mexican Derivatives Exchange is increasingly seen by global players as an opportunity to diversify their listed derivatives product offering. Customers at home and abroad are taking more interest in this exchange's products, due to a large degree to the decline in inflation and the perceived growth and stability of the Mexican economy and the Mexican peso. The exchange itself is taking steps to encourage greater foreign participation by adopting new business practices and removing critical tax and legal disincentives. Global players are continually looking to markets outside the "Big Four" exchanges for new profit opportunities, and Mexder fits the bill in more ways than one.

What distinguishes Mexder from many other markets in the developing world is its willingness to adapt to international business practices. Like most other exchanges established in the last 10 years or so, the exchange is totally electronic. Unlike many other exchanges in the developing world, however, Mexder no longer demands that trading members of the exchange have a physical presence in the country. In October the exchange authorized remote trading, a step welcomed by global futures firms. Another crucial difference is in clearing and settlement. Mexder's clearinghouse, Asigna, uses algorithms based on risk-based margining that are relatively easy to replicate. This again is welcomed by global futures firms. The exchange also permits omnibus accounts and has worked closely with the government to eliminate tax issues that caused many institutional hedgers to take their business offshore.

Last but not least, Mexder's product development strategy has targeted the demand for products to manage new and existing risks in the Mexican economy. In particular, it has succeeded in developing a very active market for short-term interest rate futures. Its TIEE 28 futures contract plays a central role in the hedging of interest rate risk in Mexico, and it has become one of the most actively traded futures contracts in the world. Recent changes in pension fund

investment rules could make another big success out of its equity index futures and its new line of single stock options.

European Model

To understand the success of this futures exchange in recent years, it is worthwhile examining the underlying factors in some detail. First, the exchange benefits from strong support from the government. Mexder was created in December 1998 under the auspices of the central bank, Banco de México, and the ministry of finance, Hacienda, as part of a long-term plan to develop the Mexican financial markets. The authorities continue to provide support to the exchange. For example, candidates for Mexican primary dealer status gain significant credit for active participation on the exchange. Most recently, the exchange has lobbied successfully for the abolition of the withholding tax laws for debt market instruments and single stock options, a major hindrance for international participants in its markets. This was in marked contrast with other developing countries, where exchanges have had some difficulty in persuading the authorities to remove withholding taxes.

Mexder, in this context, resembles European derivatives exchanges, which grew significantly in the 1980s and 1990s with the firm and often direct backing of their gov-

ernments. This European aspect to Mexder's development is highlighted by its close relationship with Meff. The Spanish exchange has a 7.5% shareholding in Mexder, has a representative on the Mexder board, and supplies its S/MART electronic trading platform to Mexder. Since March 2004 various products have been successfully listed on this system, starting with individual stock futures and stock index futures, and more recently with single stock options and government bond contracts.

Trading Activity

Mexder has a broad spectrum of products, covering futures on the main national stock index as well as a number of individual stocks, international currencies and short-term interest rates. The exchange also plans to list a series of single stock options this year, and is considering the possibility of listing a natural gas futures contract. However, trading activity is relatively concentrated. The star contracts are the short-dated interest rate contracts, and, in particular, the TIEE which in November 2005 accounted for 94.5% of total exchange volume and 98% of open interest. Volume in the IPC stock index future in the same month was under 1% of the total and trading in single stock futures has not been material.

Trading activity in 2005 was well off the 2004 peak of approximately 204 million

contracts, but the exchange still ranks among the top 20 in the world in terms of the number of contracts traded. The very rapid volume growth seen in 2003 and 2004, largely based on a surge of interest in the TIEE contract, is giving way to steady and more diversified interest in Mexican listed derivatives by both national and international players. This interest is based on customer and proprietary hedging needs, rather than the kind of speculation seen in other developing markets, such as the Kospi stock index options in Korea.

The main challenge for Mexder is to develop longer term interest rate products, in particular futures based on the M3 and M10 Bonos issued by the government, and the series of individual stock options which will come on stream this year following the introduction of options on América Móvil in 2004. Active trading across the broad spectrum of products is the key to the sustained success of this exchange.

Financial Strength

The structure of the clearinghouse is an important additional strength of the exchange. Asigna performs the standard duties expected of a clearinghouse: acting as counterparty to all trades on the exchange, margining, clearing and settlement of contracts, risk management, and custody of the clearing and members' contribution funds.



MexDer
Mercado Mexicano de Derivados

Clearing Members

- BBVA Bancomer
- Citibank Banamex
- Santander Serfin
- Scotiabank Inverlat

Market Makers

- Banco del Centro, S.A. GF Banorte
- Banco JP Morgan, S.A.
- Banco Nacional de México, S.A.
- Banco Santander Serfin, S.A.
- Banorte Casa de Bolsa, S.A. de C.V.
- BBVA Bancomer, S.A.
- Deutsche Bank México, S.A.
- Finamex Casa de Bolsa, S.A. de C.V.
- GBM Casa de Bolsa, S.A. de C.V.
- HSBC México, S.A.
- ING Bank (México), S.A.,
Institución de Banca Múltiple
- Invex Casa de Bolsa, S.A. de C.V.
- Ixe Banco, S.A.
- Monex Casa de Bolsa, S.A. de C.V.
- Multivalores Casa de Bolsa, S.A. de C.V.
- Nacional Financiera, S.N.C.
- Scotiabank Inverlat Casa de Bolsa, S.A. de C.V.
- Valores Mexicanos Casa de Bolsa, S.A. de C.V.

Members

- Acciones y Valores Banamex, S.A. de C.V.
- Banorte Casa de Bolsa, S.A. de C.V.
- Banco Inbursa, S.A.
- Banco Nacional de Comercio Exterior, S.N.C.
- BBVA Bancomer Derivados
- Darka, S.A. de C.V.
- DerFin, S.A. de C.V.
- GAMAA Derivados, S.A. de C.V.
- GBM Casa de Bolsa, S.A. de C.V.
- GFD, S.A. de C.V.
- Merrill Lynch México S.A. de C.V.
- Monex Derivados, S.A. de C.V.
- Multivalores Casa de Bolsa, S.A. de C.V.
- Operadora de Derivados Serfin, S.A. de C.V.
- Scotia Inverlat Derivados, S.A. de C.V.
- SERAFI Derivados, S.A. de C.V.
- Stock & Price, S.A. de C.V.
- Valores Mexicanos Casa de Bolsa,
S.A. de C.V.
- Vector Casa de Bolsa S.A. de C.V.

Where Asigna stands out is in its exceptionally strong financial backing, which ensures the financial stability of the clearing and settlement process.

The clearinghouse was incorporated in 1998 as an administration and payment trust within BBVA Bancomer, one of the country's leading banks, and it is backed by a group of trust banks consisting of Citibank Banamex, Scotiabank Inverlat, Santander Serfin, and S.D. Indeval, the Securities Deposit Institute, as well as BBVA Bancomer. With the exception of S.D. Indeval, all of these banks are members of non-Mexican banking groups (one U.S., one Canadian, and two Spanish) with capital measures that meet the highest international standards. This construct, unique in listed derivatives markets in Latin America or in the rest of the developing world, is made possible by the relative clarity of Mexican property laws relating to clearing and settlement. The participation of global foreign banking groups as trust banks in the clearing and settlement structure highlights the international nature of the exchange and its adherence to global standards.

Recent Reforms

In 2005, Mexder confronted a number of issues that over time will significantly support growth on the exchange and make it more attractive to both national and international players. On the domestic front, the most significant event was the liberalization of the investment rules for Mexican pension funds, known locally as Administradoras de Fondos de Retiro. These are now permitted to invest up to 15% of their assets in equities, and in listed derivatives as part of their hedging strategies. Prior to this reform, their investments were primarily in Mexican government and corporate debt. The expected result of this reform is that these funds, as they become more familiar with equity investments and hedging strategies, will drive a very substantial increase in the trading of IPC index futures and the series of single stock options coming on stream this year.

On the international front, investment in fixed income futures and single stock options was hampered by withholding tax rules which, depending on the country of the legal entity trading, could be as high as 35%. This became a serious impediment to Mexder's growth in 2004, when a number of international players took an interest in Mexico's swap market and entered the busi-

ness as counterparties to local institutions. As a result, significant amounts of trading in Mexder's TIEE contracts, which are often packaged together and traded as strips known as "engrapados", moved to the over-the-counter market to avoid withholding tax. This contributed to material declines in volume on the Mexder exchange from Summer 2004 onwards.

The withholding tax rules were eventually abolished with respect to fixed income futures in October 2005 under a temporary enabling measure, then incorporated permanently into the tax law in December. Mexder officials expect a similar measure in the near future to abolish withholding taxes on single stock options. This successful negotiation with the Mexican tax office, the finance ministry and the central bank demonstrates the recognition by the exchange of concrete legislative obstacles to its growth, and its willingness to take issue with them. This is in marked contrast to other markets in Latin America, in particular Brazil, where tax rules and legal procedures (e.g. the consularization of documents) continue to hamper the development of international business.

The second significant development for international participants has been the authorization in October 2005 of remote trading. As mentioned above, it is now possible to be a trading member of the exchange without necessarily being resident in Mexico. Remote trading membership will allow global firms to concentrate their trading in legal entities already established for listed derivatives quoted on other exchanges. This avoids the one legal entity per national market syndrome that has bedevilled futures and options elsewhere in the developing world. Remote clearing membership is still not yet possible, but discussions on this further stage are already underway and will depend ultimately on regulatory and central bank approval. Remote clearing membership would be a significant further aid to Mexder, as participation by global firms in a national market depends, in general, on perception of the minimal necessary critical mass, this being substantially reduced if the legal entity and its employees are already in place.

Moving to FIX

Two other processes are underway which will facilitate trading by international institutions on the Mexder exchange: the application of the FIX API and the development of Peso funding for the margin of foreign players. Mexder is totally electronic, but

access depends on trading systems provided by clearing members, and these systems in general have not kept pace with the technological advances developed by international software vendors. The local trading systems are, moreover, stand-alone, hampering the ability of global firms to integrate Mexder into the spectrum of services they provide. The application of FIX, currently in its final stage of testing, should change this. International ISVs will be able to use FIX to build the appropriate gateways and interfaces and add Mexder to the list of exchanges on offer. In this way, the use of FIX facilitates the development of remote trading memberships, essential for the broadening of the exchange membership.

The second process that started in 2005 was the introduction of short-term Peso margin funding facilities for international clients. Mexder sets tight margin deadlines, and international clients relying on ad hoc FX transactions often fail to meet the required funding times. The major clearing banks, in particular the trust banks, are now starting to offer short-term funding packages at reasonable interest rates which greatly facilitate day-to-day processing of Mexder trades transacted by international players.

In summary, Mexder is in the process of building a listed derivatives market which sets an example for developing markets with its infrastructure, trading and clearing systems, regulatory environment, and willingness to do battle with the issues which normally hinder business in the developing world: tax, technology, and bureaucracy. Its task ahead is to create substantial interest in products other than the TIEE and to create an expanded international trading and clearing membership. The signs for this expansion are highly promising: If the Mexican economy continues to grow, Mexder has every chance of gaining the lion's share of the hedging transactions of financial investors, both established and new. ■

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