September 2005 www.latinrisk.com

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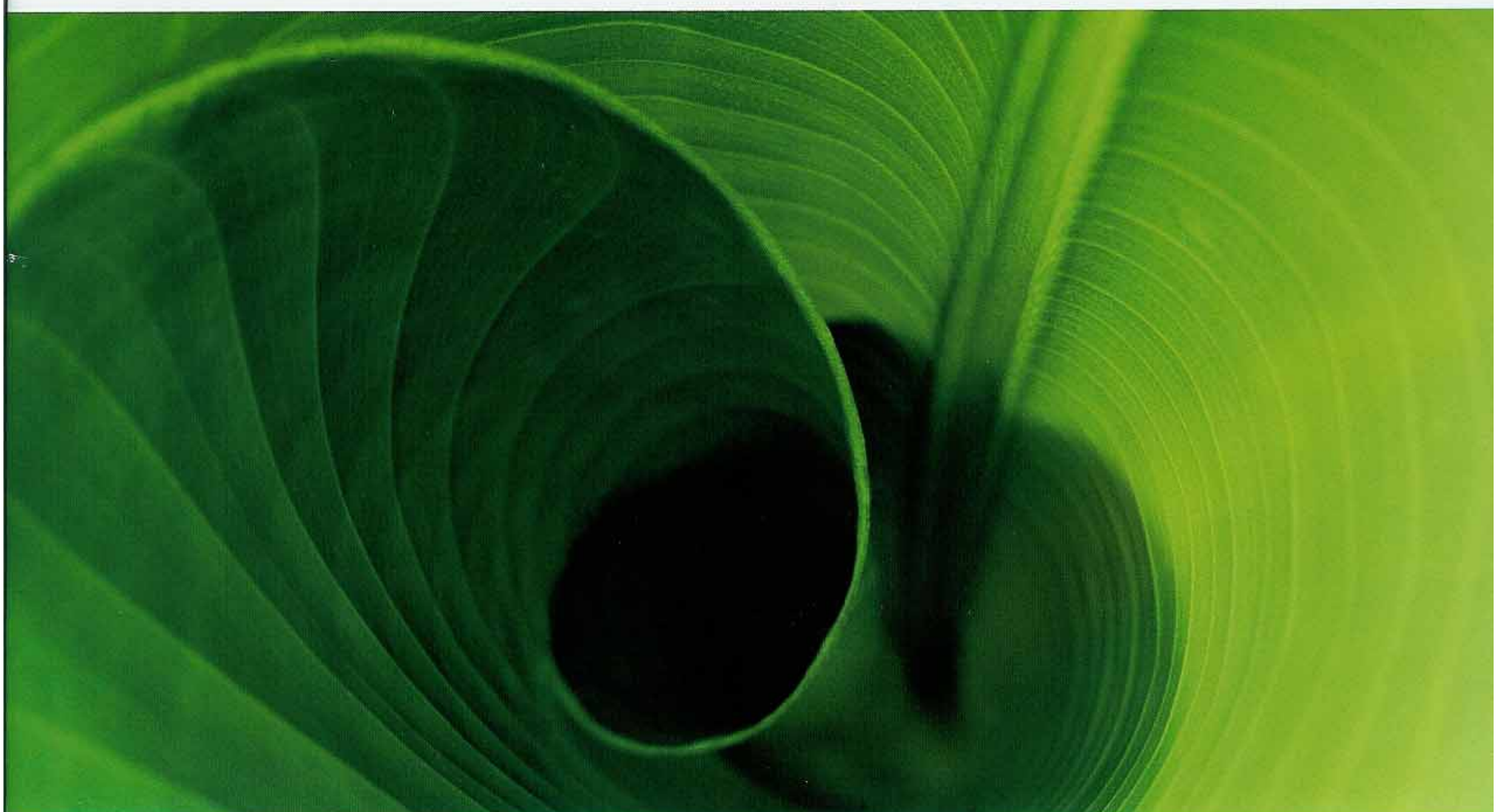

Loosening the chains

Mexico's pension funds turn to derivatives

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A Mexican metamorphosis

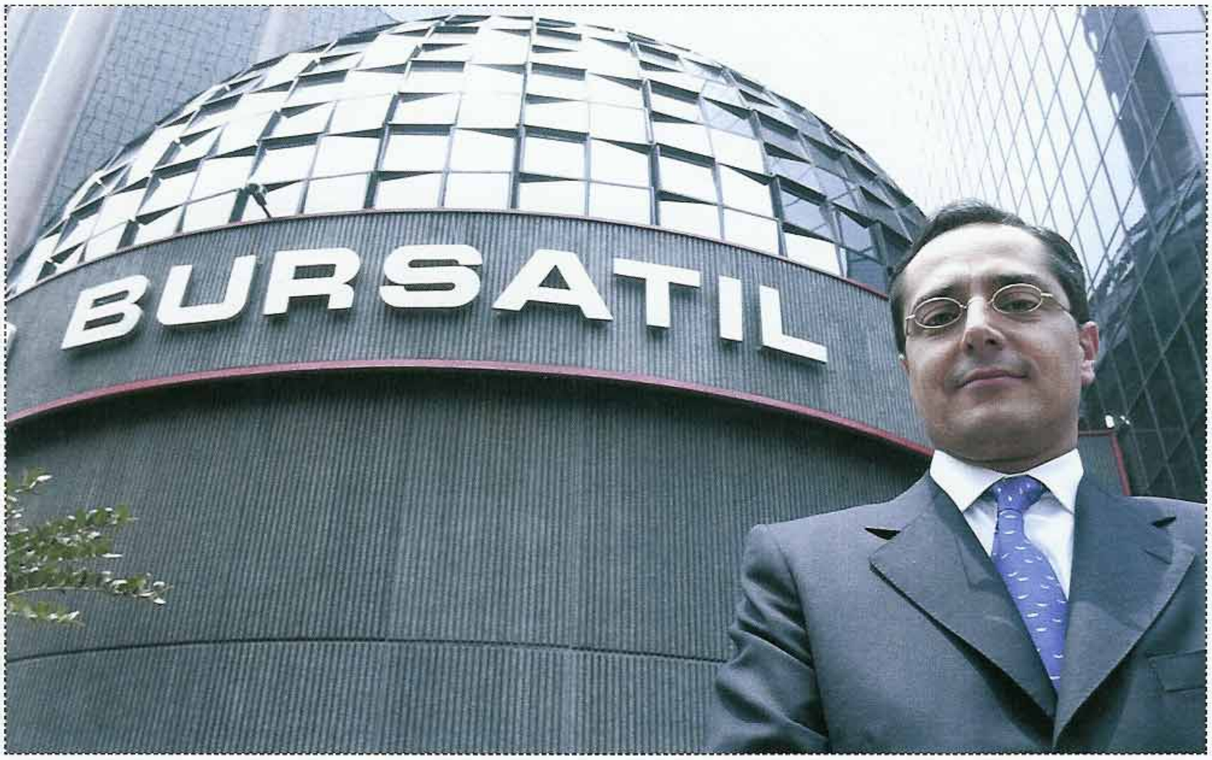
The Mexican derivatives market is undergoing a new round of liberalisation. Jorge Alegría, chief executive of the Mexican Derivatives Exchange, talks about the impact on trading volumes. By Arielle Weliky

Derivatives trading activity in Mexico is entering a new era. The country's financial regulator is close to finalising a new round of deregulation, which will enable the country's insurance companies to dip their toes into the derivatives market for the first time. It's the latest in a series of liberalisations that have opened up the domestic derivatives market to a wider array of participants, and comes hot on the heels of a rule change at the start of this year to allow Mexico's pensions firms to invest in equity derivatives.

It's good news for the country's derivatives exchange. By the end of April, pension funds had allocated 7% of the aggregate $44 billion worth of assets under management to equity index derivatives, says Jorge Alegría, chief executive of the Mexican Derivatives Exchange (MexDer). "And there is potential for pension funds' derivatives use to grow a lot more," he adds.

The entrance of pension firms will be an important boost to trading activity at the exchange, says Alegría. Total trading volumes fell to 70 million contracts in the first half of 2005, down from 102 million over the first six months of 2004. If all goes to plan, market deregulation could spread to the mutual fund industry by the end of 2005 – something Alegría claims is vital. "Unlike pension funds, mutual funds should be more active in short-dated derivatives and allowed to invest in equity derivatives referencing individual names."

Nonetheless, the exchange has managed to claw its way up the league tables. Last year, MexDer was the ninth largest exchange in terms of futures and options volume globally, up one place from 2003. However, if options volumes are not included, it is the fifth largest futures exchange.



Jorge Alegría, MexDer: "Market-makers have increased liquidity greatly, making trading on the exchange more attractive"

Nonetheless, for the first four years following the establishment of MexDer in 1998, the exchange failed to record a profit. "The main issue leading to losses was over-regulation. Market access was very difficult for investors and market-making development was stifled," says Alegría.

The seeds of the turnaround in MexDer's fortunes were sown in 2000, when Mexican regulatory authorities, including the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público), the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores) and the Central Bank (Banco de México) began a process of liberalisation that eventually led to the establishment of market makers in 2002.

Prior to 2002, banks and brokers were only permitted to trade on MexDer via a subsidiary authorised to deal in derivatives. The objective of creating the subsidiary was to isolate the risks that investors were taking in the new entity. This created an extra cost and logistical burden for market participants, and according to MexDer's Alegría, discouraged trading activity.

Aware of this disincentive, the Mexican authorities changed the rules in 2000. But it was only in 2002 after prospective market-makers modified trading systems and internal controls that the market-makers started trading directly on the exchange. The four largest banks in Mexico at that time – Banamex Citigroup, BBVA-Bancomer, Scotiabank Inverlat and Santander – were among the first to become market-makers. Fourteen firms currently make markets on MexDer, and these four banks continue to be the largest. "Market-makers have increased liquidity greatly, making trading on the exchange much more attractive," says Alegría.

As was the case at MexDer's inception, trading by Mexican banks still accounts for the bulk of activity on the exchange – around 75% of total volumes during the first half of 2005. But pension funds and other new entrants are making their presence felt, both in terms of trading activity and also the types of instrument traded across the exchange.

The introduction of several new contracts – namely, the five-year Mexican interest rate contract (the Mexican interbank equilibrium interest rate, TIIE), the five-year peso/dollar futures contract and the S&P 500 and Nasdaq 100 index exchange-traded funds (ETF) – was motivated by a desire to provide instruments better suited to the risk management and investment needs of pension funds.

For example, MexDer has introduced longer tenor contracts to help pension funds address duration mismatch between their assets and liabilities. One of the most actively traded contracts in recent years has been the three-year tenor interest rate futures contract referencing the TIIE. In March 2004, the exchange created a new five-year version of the futures contract, and plans to introduce a 10-year futures contract in the near term. Although it has received regulatory approval, the exchange is waiting for the interest rate market to become less volatile. The Mexican central bank has raised the benchmark overnight interest rate 12 times since February 2004, from 5.5% to the current 9.75%.

Alongside their use of interest rate derivatives for hedging, equity index products are proving popular with Mexican pension funds seeking an allocation to foreign stock markets, says Alegría. MexDer introduced S&P 100 index iShares and Nasdaq 100 index exchange-traded funds (ETF) in January 2005. The exchange also plans to introduce an ETF based on the US Russell 2000 in the third quarter of 2005.

However, Mexican pension funds' appetite for exposure to foreign indexes is not limited to the US. MexDer is currently negotiating licensing contracts with index providers for Asian and European indexes. According to Alegría, there is no fixed schedule for the introduction of such products. "Part of the delay with global indexes is due to members not really knowing about the indexes. Many are only now learning about such exposures and navigating the different indexes," he says.

The activity in equity and fixed-income products by pensions firms is having a knock-on effect on the market, says Alegría. There has been an increase in interest from overseas, with the flow from domestic hedging and investment activity drawing foreign players into the market. Some of the newer international players include JP Morgan and Merrill Lynch, both particularly active in the TIIE futures contract, according to a MexDer official.

"There is potential for pension funds' derivatives use to grow a lot more"

Jorge Alegria, MexDer

Until January this year, foreign banks had to navigate a maze of regulations to be allowed to trade directly on MexDer. In particular, they were required to disclose client lists and draft individual agreements for each investor to trade on the exchange. They were also not allowed to trade directly, and instead were required to trade through a Mexican brokerage firm. But at the start of 2005, regulators allowed foreign firms to trade directly via a single account, therefore streamlining the access to direct trading.

Attracting more foreign investment is one of MexDer's main goals, says Alegría. Regulatory reform is helping the exchange realise its ambition, but how will it counter prejudices about Latin American financial markets' lack of robustness?

Alegría claims the exchange's risk management and clearing technology is as sound as that of any other exchange, and so this shouldn't be a concern to foreign institutions. MexDer's clearing house is called Asigna, and it uses the US Options Clearing Corporation's Theoretical Intermarket Margin System, a risk-based methodology for measuring the monetary risk of options and futures positions.

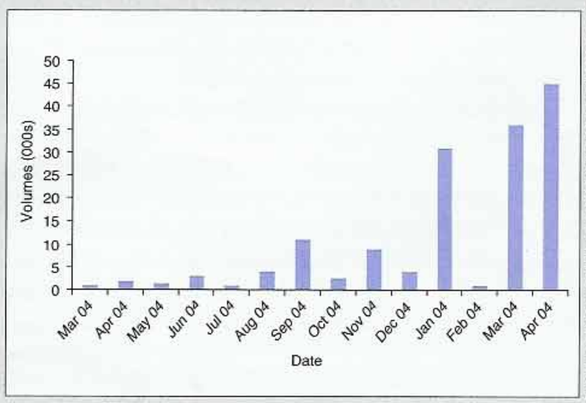
Asigna has put in place measures beyond traditional margining to safeguard against liquidity and credit risk. The clearing house requires additional margin from clients depending on their credit quality. It also has circuit breakers or limits on intra-day price moves that, if breached, cause trading to be halted. Alegría is confident that systems and processes can handle the extreme risks that so often erupt in emerging markets. "Back-testing demonstrates that the clearing house mechanisms and the safety network [of additional funds] work very well, even when stressed to very high volatility environments," he says.

New options

One of MexDer's biggest projects has been the development of its options market, which began in April 2004. A year later, the monthly ticket volume reached 50,000,000 (see chart right). Among the contracts now trading on the exchange are options referencing América Móvil – the largest Mexican-based provider of wireless telephone services – and the S&P 100 Index iShares.

But the majority of options trading this year have been on contracts referencing the Naftrac 02, an exchange-traded fund sponsored by Nacional Financiera, Mexico's largest development bank. Naftrac 02 options accounted for just over 80% of total options trading volumes. Meanwhile, options on the IPC equity index accounted for 19% of total options trading activity. The S&P 100 Index iShares contract was introduced in January 2005.

MexDer is currently working to expand the contracts traded on the exchange to include more individual equity options and index options, although the exchange declined to give further details. The technology underpinning MexDer's options market was purchased from a Spanish derivatives exchange – Mercado Español de Futuros Financieros (MEFF) – which has a stake in MexDer's options market.



Source: MexDer