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# A sleeping giant awakes

Mexico is being touted as a potential rival to the Bric (Brazil, Russia, India and China) economies. It has a strong derivatives exchange and a budding over-the-counter market. Natalie Coomber takes a closer look

Two phrases dominate investor thinking at present. The first, as evidenced by the endless talk about the subject, is the credit crunch. The second is the search for a safe haven from the credit storm that surrounds most western economies.

And here Mexico finds itself in an unusual position compared to its northern neighbour.

José Maria de la Torre, director of Latin America products at BBVA, says: "We don't think that Mexico will be particularly affected by the credit crunch. Although credit availability has dropped, we do not believe that such decline will affect Mexico. In fact, the country is benefiting from a number of macroeconomic changes such as the relocation of US factories to reduce transportation and labour costs."

And this drift south is only the start of something bigger, say many. "Mexico is an exciting doorway into the rest of Latin America," says John Dempsey, vice president for business development at RTS Realtime Systems. And although each of the countries should be viewed separately, he believes the region is a sleeping giant.

Certainly, Mexico's economic growth is a pointer to its vitality. The latest figures tend to bear this

completion of our IPO, which allowed us to place 242.4 million shares and raise Ps4,000 million. Said funds allowed us to complete the corporate restructure, increasing our market share to 97.4% at MexDer, 97.5 at Contraparte Central de Valores and 89% at Asigna Compensación."

During the second quarter 2008 contract volume at MexDer decreased 66.3% from the second quarter of 2007 and 59% compared with the same six-month period in 2007. However, much of this can be explained by the new 10-year swap contract, which is the modernized version of the original flagship TIEE but represents the equivalent of 1,200 old contracts.

"We have added a change of size of the Mexican Libor as it was only a very small contract of \$10,000. We are keeping the original but half the traders have moved to the new contract," says Jorge Algeria Formoso, chief executive at the Mexican Derivatives Exchange.

"We wanted to do it because of the international standard, and even though it looks like volumes are down, revenue is still up 15% because of the successful implementation of this product and the growth of trading in the 10-year bond futures." These latter products have become popular with investors trading the long-end of the curve.

## International interest

So far in 2008 Interactive Brokers UK and Morgan Stanley have both become new members. Gerald Perez, managing director, Interactive Brokers UK, says: "Lots of changes in the regulation have happened for the better. Also, the exchange's association with the Spanish exchange has been very beneficial."

Perez praises the management team at MexDer, saying that they are very progressive and accepting to outside entities that wish to enter the marketplace. "It is an important marketplace for us because we are a very large broker-dealer in the US and a lot of Mexicans trade the US markets, and *vice versa*."

Perez praises the education of the population, as well as the corporate governance structure. Interactive Brokers is involved in the exchange's equity and equity derivatives products, drawing on



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out. Gross domestic product grew at about 3% (annualized) because of domestic demand in Q2, exports to countries other than the US and public spending. This is up from the first quarter when Mexico grew 2.6% and the US economy gained only 1%.

Causing a recent stir has been the initial public offering (IPO) of Mexican Derivatives Exchange (MexDer) in conjunction with its stock equivalent, which when it was first touted in May was hoping to raise Ps4.6 billion (\$443.8 million).

In its first earning's report, Bolsa Mexicana de Valores's chairman and president Guillermo Prieto Treviño said: "During this first quarterly earnings report, I wish to highlight the success on the



the fact that the exchange makes them appealing both to European and US-domiciled customers – both groups of which the brokerage has had interest from.

Jorge Alegria Fomoso says that is hard to track where volume is stemming from because many international banking institutions use omnibus accounts but they know that they have traders from as far away as Australia. However, one of the exchange's priorities in the short term is to fit in with international standards, and it has just signed RTS Realtime Systems to implement front-end trading screens for all Mexican members.

John Dempsey at RTS, says: "You have got a prototype of a hard working, committed, driven working place. It is an example to a lot of other exchanges, even some which have been around for some time."

He says as they begin to work closer with members and the MexDer team, demoing the systems that are to be put in place – which Dempsey describes as "different, but not scary different" – he realizes how sophisticated the workforce is and how far the derivatives market has come in such a short space in time. Increasing the speed, implementing ways to quote for options and differing order types were some of the key features in RTS's winning proposal. Algeria says that he was very impressed by the "commitment of the RTS staff".

The exchange plans to offer proximity and co-location service, which members have been requesting, by the first quarter of 2009, and may consider moving to an integrated equity and derivative platform as part of the Mexican Stock Exchange Group.

Alongside futures and options, currency swaps and swaptions are becoming more liquid. As well as individual products gaining traction, more and more

firms are beginning to deal in derivatives. In 2006 a number of structural changes such as the abolition of withholding tax and a new tax code went a long way to opening up the markets. Then last year Mexican mutual funds also got the go ahead to become involved in the sector, the effects of which are really only beginning to be felt this year. Algeria says these mutual funds will behave like or convert into hedge funds.

"Some *Afores* [Mexican pension funds] have already met the regulation to use derivatives and we believe many more will do so in the coming months," says BBVA's de la Torre. "We think that with time *Afores* and mutual funds will become major customers. Major corporations demand complex derivatives structures quite often to hedge foreign currency-denominated revenue streams and liabilities."

He adds that small corporations are also gaining expertise, and they will become important clients in the future.

Most of BBVA's customers are located in Mexico City, Monterrey and Guadalajara, and operate in a variety of industries from construction to retail and lodging. Many need to hedge foreign currency revenue streams while others are beginning to ask for products to hedge their exposure to commodities. De la Torre says that he expects this sector to develop rapidly, because several Mexican corporations are transforming themselves from being producers of commodities to users of them.

Alongside this, it is the equity derivatives sector that is holding BBVA's attention. "Even though that segment of the market is on a nascent stage, we think it will develop rapidly in the coming years. Institutional investors are becoming more familiar and comfortable with derivatives. Their equity positions have been growing rapidly since Mexican regulators lifted and changed regulation that limited their exposure to this asset class," says de la Torre.

### Key to development

The key to the further development of the Mexican derivatives market is investor education. "I think the first step that we have to achieve to attract Mexican customers is to do education – to teach what is a derivative and how it can be used," says Guillermo Camou who has been leading Scotia Capital's Mexican Derivatives Exchange Project since 1995 and who works in the MexDer building.

"The market needs more participants. The current director and team of the exchange are doing a very good job. We need to be in front of the customers who want to invest in emerging markets." In Camou's opinion, many potential customers are focusing their efforts on China, Russia or Brazil before Mexico, but they seem to be witnessing a sea-change.

Industry players say the team at MexDer and the professionals in the domestic Mexican markets are sophisticated and, refreshingly, are a pleasure to do business with. ■



RTS' John Dempsey: the new systems were "different but not scary different".