

Derivatives Momentum Builds



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Derivatives are taking off in LatAm as domestic markets develop, helped by operational advances and nurtured by local exchanges. The credit crunch and legal gaps present resistance to further growth.

by Evan Koster and Oscar Stephens*

Local derivatives marketplaces – both listed and over the counter (OTC) – in certain larger LatAm economies are poised for growth despite the credit crunch. Underlying data supports this view, but there are lingering obstacles.

The number of listed futures and options on reported exchanges in LatAm increased to 1.05 billion in 2007 from 864.67 million in 2006, a rise of 21.28%, according to the Futures Industry Association (FIA), although the data from the first half of 2008 reflect a decline, which may represent the effect of the credit crunch. In terms of futures and listed derivatives, MexDer and the BM&FBovespa have seen significant growth.

BM&FBovespa, the largest derivatives exchange in LatAm, is now the seventh biggest in the world, in terms of number of contracts traded, from eleventh largest in 2005, the FIA says. BM&FBovespa says it closed 2007 with \$16.604 billion futures and options contracts traded, an increase of 56% in relation to the \$10.611 billion in 2006. The volume of futures and options on MexDer meanwhile jumped to \$228.97 million in 2007 from \$173.82 million in 2003.

Disaggregating this data further, 28-day TIIE short term futures was the leading derivatives contract on MexDer as of June, representing 78.52% of the total by volume. In fact, 28-day TIIE was the seventh largest globally traded contract in 2007, with 220.61 million exchanged during that year, FIA data shows. In 2007, most traded contracts on the BM&FBovespa were of interest rates – 56.8% of the total – followed by exchange rates at 27.2%.

New Products Take Off

While growth has clearly taken place in traditional vanilla products such as interest rate and foreign exchange futures, there is also evidence that more sophisticated products are being introduced. Several new contracts have been introduced by the BM&FBovespa, such as inflation hedging and ethanol. The exchange has also launched the Brazilian Carbon Market (MBRE) whose main objective is to develop an

efficient trading system for environmental certificates aligned with principles underlying the Kyoto Protocol.

MexDer has also sought to diversify its base by introducing new products, including sovereign bond futures, which increased in volume by 150% from 2006 to 2007, and IPC futures, which are linked to an equity index trading on the Mexican stock exchange.

Interest in these products reflect increasing investment activity by Mexican pension funds (*Afores*), as these products can provide an alternative to short-selling.

On the OTC side, we see similar trends. In Mexico, the average daily OTC derivatives turnover leapt to \$14 billion in 2007 from approximately \$5 billion in 2004. In Chile, the average daily turnover increased to \$2 billion in 2007 from approximately \$1 billion in 2001.

According to the Bank for International Settlements, average daily Brazil turnover in dollars reflects a decline from 2001 through 2007, although this may be due to strengthening of the *real* during that period. According to data from the Brazilian Center for Custody and Financial Settlement of Certificates and Bonds (CETIP), which acts as a clearinghouse for OTC derivatives, OTC derivatives in Brazil have also experienced recent growth. In January 2005, the total of OTC derivatives cleared by CETIP was 163 billion *reais* and in 2007 it was 240 billion *reais*, representing a 47% increase.

Growth can be explained by various factors. The first is overall expansion in these economies, and not just in the financial sector. Brazil's *real* GDP increased at an average of 4.25% from 2004 to 2007 and the Mexican economy swelled by 3.30% during 2007.

Local stock markets have also seen tremendous enlargement. In 2007, the number of IPOs on the Brazilian stock exchange reached 64 and total capital raised reached 55.5 billion *reais*, although IPO activity is significantly lower this year.

In the US and Europe, growth in derivatives and

Parting shot

secondary markets follows advancement of primary markets for offerings and commodities. If the pattern in the US and Europe is any indication, expansion of the primary market for securities and commodities should fuel growth in derivatives market as investors seek to hedge risk in the primary, as well as look for opportunities to seek more tailored exposure through individualized OTC solutions.

This may, of course, occur in a more truncated timeframe than what occurred in the US and Europe, where derivatives markets did not see substantial growth until the 1980s. Financial engineering, products and operational systems are now available and readily transferable.

Legal Advances

Other reasons to be optimistic include development of a local infrastructure, both legal and operational, which facilitates legal certainty and market efficiencies. On the legal front, there have been a number of positive developments. The first has been the adoption in Brazil, Mexico and Chile, of more favorable bankruptcy legislation, particularly regarding close-out netting.

Provisions that permit a derivatives party to net transactions in a bankruptcy situation help create certainty in

derivatives contracts. They eliminate the possibility of a bankruptcy trustee cherry picking among derivative transactions and only enforcing those that are favorable to the bankrupt party at the expense of the non-bankrupt.

Other countries are evaluating proposals to modify bankruptcy legislation to prohibit cherry picking. In addition to favorable changes in bankruptcy legislation, in Mexico and Brazil there have been enactments which have clarified the authority of entities – such as banks and other financial institutions and hedge funds – to enter into certain types of derivative transactions.

Finally, in both Brazil and Mexico there have been model local master agreements developed by local banking trade organizations that follow in large part the International Swaps and Derivatives Association master agreement, with certain differences tailored to local legal and market requirements.

On the operational side, both MexDer and the BM&FBovespa have improved capabilities to process and

settle derivative trades. MexDer recently began using an operational system which is the protocol upon which many of global exchanges are based. This should facilitate improved communication between MexDer and other exchanges around the world.

In addition, MexDer accepts collateral in US Dollars without the need to convert into pesos or to transfer the collateral account to a Mexican based account. The BM&FBovespa also believes that consolidation of the futures exchange with the stock market will result in improved efficiencies.

While legal and operational developments are certainly positive, there are, however, certain lingering obstacles to an explosion in local derivatives. There is still legal

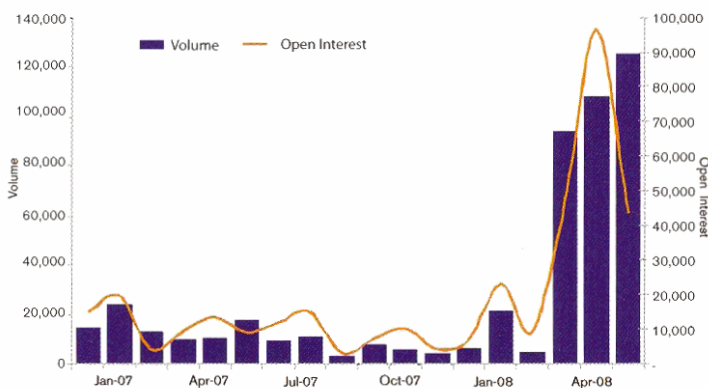
uncertainty in Colombia and Peru, for example, as to the enforceability of close-out netting in bankruptcy, and as to the authority of certain counterparties to trade derivatives.

In addition, it is still unclear as to the ultimate effect of the credit crisis in the US. If gains in the development of the local stock markets dissipate and derivatives dealers take a conservative approach to extending trading credit lines – which would help fuel expansion – growth may not be as promising.

Some may view this outcome as positive. After all, derivatives have been described by Warren Buffet as financial “weapons of mass destruction” and many commentators have warned, especially in the current credit crisis, of systemic shocks that derivatives – especially credit derivatives – may have in worsening a recession or economic crisis due to the interlocking nature of derivatives and counterparty defaults.

Others may view growth in this market as a sign of the maturation of local capital markets that can enhance local liquidity by providing hedging opportunities and enhanced ability to mitigate risk. Whichever side of this debate you are on, it is clear that local derivatives markets are building momentum and should ultimately end up running at full speed. **LF**

Mexican Derivatives Activity
Taking off



Source: MexDer

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