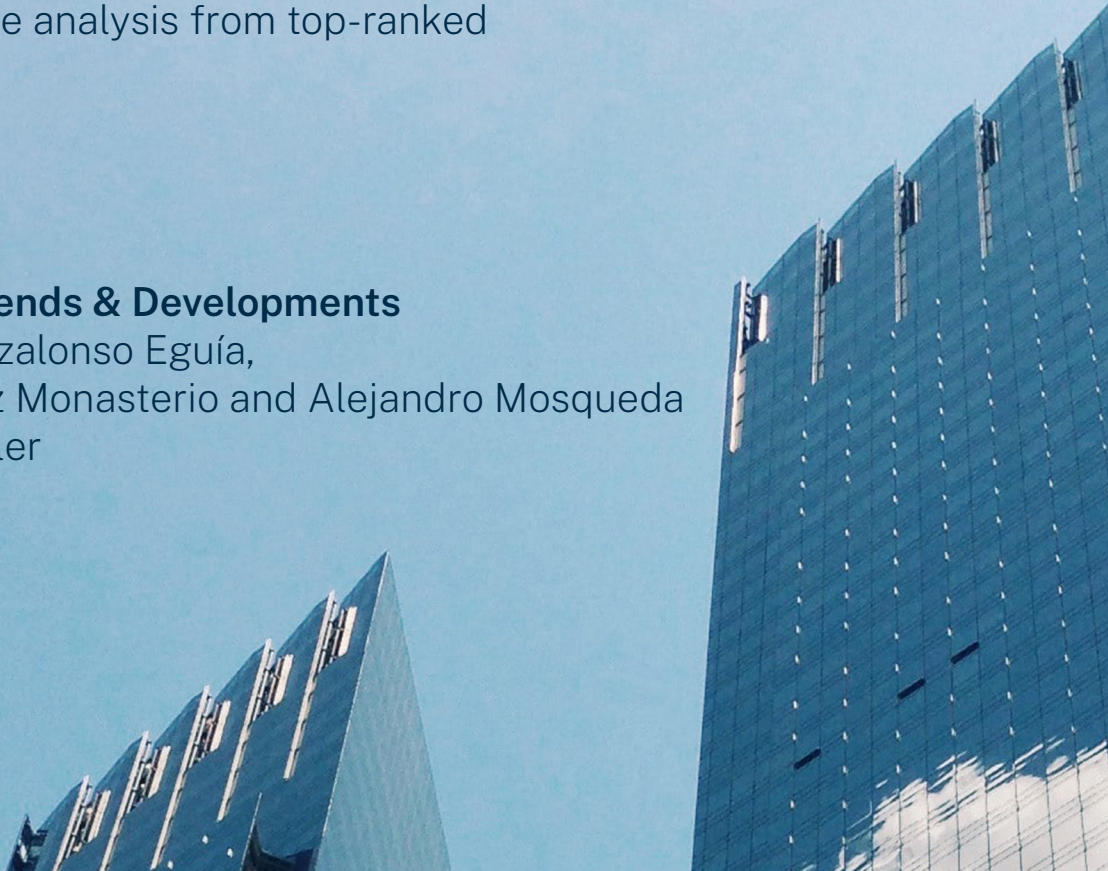

CHAMBERS GLOBAL PRACTICE GUIDES

Banking Regulation 2024

Definitive global law guides offering
comparative analysis from top-ranked
lawyers

Mexico: Trends & Developments

Pablo Perezalonso Eguía,
Isabel Ortiz Monasterio and Alejandro Mosqueda
Ritch Mueller



Trends and Developments

Contributed by:

Pablo Perezalonso Eguía, Isabel Ortiz Monasterio and Alejandro Mosqueda

Ritch Mueller

Ritch Mueller is a top-tier multidisciplinary transactional firm committed to offering high value-added legal advice to national and international clients engaged in structuring, developing and financing private businesses and public sector projects in Mexico. The firm represents Mexican, international and multilateral banks, as well as other financial intermediaries in secured and unsecured, bilateral and syndicated lending transactions of different levels of complexity involving Mexican obligors or assets. With a consistent presence in the market, Ritch

Mueller has actively participated in all phases of the credit cycle, including origination in bull markets as well as restructuring in the context of regional or global crises. The firm has played a pivotal role in advising the majority of foreign financial institutions that have established subsidiaries in Mexico, guiding them through the authorisation processes. Additionally, Ritch Mueller extends advisory services to industry organisations such as ISDA and the Mexican Banking Association, particularly in derivatives transactions within the Mexican market.

Authors



Pablo Perezalonso Eguía of Ritch Mueller has more than 30 years of experience advising on international banking and securities transactions, banking regulation and derivative

financial transactions, capital markets, mergers and acquisitions, as well as data protection and fintech regulatory matters. He has advised Mexican and foreign financial institutions on both debt and equity issues through complex instruments including structured notes, warrants, tracs and capital notes. He has also participated in structuring and restructuring secured and unsecured credit facilities for Mexican private and public sector borrowers.



Isabel Ortiz Monasterio of Ritch Mueller has ten years of professional experience. In regulatory matters, she has advised national and international banks, as well as

brokerage firms and regulatory agencies in derivatives, securities purchase and repurchase transactions and securities lending, and has participated in the negotiation of agreements and drafting of internal policies for such institutions to operate in the Mexican market. She has also advised companies in fintech and data protection matters. Isabel also has experience in banking and finance, where she has participated in major financing and restructuring transactions advising foreign and domestic financial institutions.

Contributed by: Pablo Perezalonso Eguía, Isabel Ortiz Monasterio and Alejandro Mosqueda, **Ritch Mueller**



Alejandro Mosqueda of Ritch Mueller has relevant experience in the derivatives and financial regulation fields, advising financial institutions and sovereigns in the regulatory

analysis, negotiation and legal implementation of financial transactions, including derivatives, securities lending and repo in international markets. He has advised in the drafting and implementation of national regulation related to central banking operations, payment systems and market infrastructure. Alejandro has also advised on Mexico's relations with international financial organisations such as the IMF and the BIS, and assisted the negotiators of free trade agreements, such as the Mexico-European Union Free Trade Agreement and the Pacific Alliance.

Ritch Mueller

Av. Pedregal 24, 10th floor
Molino del Rey
11040
Mexico City
Mexico

Tel: +52 55 9178 7000
Email: contacto@ritch.com.mx
Web: www.ritch.com.mx

RITCH
M U E L L E R

Mexican Unclear(ed) Margin Rules: Benefits and Challenges

Introduction

On 14 March 2023 Banco de México, Mexico's Central Bank, issued Circular 2/2023, which modifies Circular 4/2012 governing derivatives transactions in Mexico (the "Mexican Margin Rules", "Mexican UMR" or "Circular 2/2023"). The primary objective of these rules is to introduce new initial and variation margin obligations to Mexican banks, broker dealers and investment funds engaging in uncleared over-the-counter (OTC) derivatives transactions (the "Derivatives Transactions").

In the explanatory note accompanying Circular 2/2023, Banco de México articulated that, in pursuit of fostering the robust development and stability of the financial system, the bank deemed it necessary to establish guidelines facilitating the determination of bilateral requirements for initial and variation margins in Derivative Transactions. The intention was to align with the best international practices in the field and mitigate counterparty risk, thereby enhancing risk management and contributing to a reduction in systemic risk within the derivatives market. The aim of this, in turn, is to promote the healthy development of the Mexican financial system.

Nevertheless, Mexican banks and broker dealers have conveyed that the introduction of the Mexican Margin Rules took market participants by surprise, given that the last consultation for feedback on the rules occurred four years ago in 2019. Notably, these financial entities highlighted that the Mexican Margin Rules imposed an implementation deadline of less than one year (as described below), deviating from the usual international trend where uncleared margin regulations (UMR) often feature implementation deadlines extending over six years. Moreover,

concerns have been raised by market participants regarding certain aspects of the Mexican Margin Rules, which they find either ambiguous or at odds with established international practice. Consequently, a significant number of market participants find themselves unprepared to achieve full compliance within the stipulated timeframe.

This article endeavours to conduct a comprehensive analysis of divergent perspectives surrounding the Mexican Margin Rules. It also aims to provide an in-depth exploration of the present status of the Mexican UMR, examining the enquiries and challenges raised by market participants and esteemed international organisations, including the International Swaps and Derivatives Association (ISDA). Furthermore, the article aspires to anticipate the trajectory of margin regulation in Mexico and its potential impact on the broader landscape of the Mexican derivatives market.

Basel Committee and IOSCO

In the aftermath of the Global Financial Crisis, the Basel Committee on Banking Supervision (BCBS) dedicated considerable efforts to instigate substantial reforms to OTC derivatives transactions. As the BCBS pointed out, the crisis underscored the imperative for enhanced transparency in OTC derivatives markets and the need for heightened regulation to curtail both the excessive and opaque risk-taking inherent in these transactions, thereby mitigating the systemic risk associated with OTC derivatives transactions markets (see [Margin requirements for non-centrally cleared derivatives](#)).

Responding to these challenges, the Group of Twenty ("G20") launched a reform programme in 2009 aimed at diminishing the systemic risk stemming from OTC derivatives. A pivotal ele-

ment of these reforms involved subjecting Derivatives Transactions agreements to higher capital requirements. This materialised in the G20's consensus to institute margin requirements on Derivatives Transactions. G20 member nations, including Mexico, urged the BCBS and the International Organization of Securities Commissions (IOSCO) to formulate a recommended regulatory framework. Notably, developed jurisdictions such as the United States, proactively implemented their UMR as early as 2013. It is noteworthy that the development of UMR persists even in these advanced jurisdictions, with compliance deadlines phased out on the scale of the in-scope firms.

Mexican obligations under the BIS/IOSCO

As per the findings of the Financial Stability Board, a research entity affiliated with the G20, Mexico's OTC derivatives market may be relatively modest on a global scale, yet it stands as the largest within Latin America (see [FSB publishes peer review on implementation of over-the-counter derivatives reforms in Mexico](#)). Furthermore, in conjunction with Brazil and India, Mexico is recognised by ISDA as a substantial economy characterised by noteworthy levels of derivatives activity (see [ISDA survey on OTC derivatives in emerging and developing markets](#)). From our perspective, Mexico, an emerging economy bolstering its financial markets at a rapid pace, is poised to assume a pivotal role in shaping the future of the derivatives industry in the region. Notably, Mexico is actively cultivating a robust foreign exchange derivatives market, responding to the escalating demand from international banks for derivatives and intricate structures. This demand is likely spurred by Mexico's expansive export industry and its geographical proximity to the United States.

Against this backdrop, Mexico, as a G20 member, assumed certain obligations to adhere to recommendations put forth by BIS/IOSCO. Consequently, Banco de México, the authoritative body responsible for issuing derivatives-related regulations, deemed it necessary to promulgate margin regulations in Mexico. In 2019, Banco de México released an initial draft of UMR for industry feedback. During this period, the ISDA and the Mexican Banking Association ("ABM") and the Mexican Brokers Association ("AMIB") collaborated to submit their comments to Banco de México. However, despite the industry's input, Banco de México remained silent for four years, until March 2023, when it unveiled the Mexican UMR – an entirely new set of regulations, diverging significantly from many of the comments provided in 2019.

Mexican law background

In Mexico, both standardised and OTC derivatives transactions fall predominantly under the supervision of Banco de México. Specifically, Circular 4/2012 issued by Banco de México is the main regulatory framework for Derivatives Transactions. This alignment with the central bank as the primary regulatory body for OTC derivatives reflects the historical context where complex transactions of this nature were initially executed primarily by banks. As per the Banco de México Law (*Ley del Banco de México*), the central bank is tasked with regulating all banking transactions entered by Mexican banks, encompassing OTC derivatives. Consequently, in 2012, Banco de México introduced Circular 4/2012 as the sole regulation governing OTC derivatives in Mexico for financial entities.

Notably, the scope of Circular 4/2012 has expanded over time, extending its applicability beyond banks to include various financial entities, including broker dealers and investment

funds. Given the scarcity of alternative regulatory frameworks concerning OTC derivatives in Mexico, Circular 4/2012, as amended, functions as the de facto law governing Mexican derivatives.

Within this context, it is crucial to underscore a historical prohibition in Mexico against banks providing collateral. Explicitly articulated in the Mexican Banking Law (*Ley de Instituciones de Crédito*), banks were traditionally barred from granting collateral. However, a notable exemption to this prohibition was introduced through secondary regulations issued by Banco de México. Up until 2023, Circular 4/2012 permitted banks and broker dealers to grant collateral for their OTC derivatives transactions with Mexican or foreign financial institutions.

Mexican Unclear(ed) Margin Rules: overview and problems

New provisions on Circular 2/2023

(a) Collateral

Under the new provisions of the Mexican Margin Rules, Mexican banks, broker dealers, investment funds and insurance companies are allowed to provide collateral among themselves and with a broad spectrum of counterparties, including corporate entities, as opposed to the prior rules which permitted only that collateral could be granted by those entities to Mexican or foreign financial entities. Importantly, this can be accomplished without specific approvals from Banco de México, provided the initial margin surpasses a specific threshold, set at approximately USD8 billion.

However, even if the initial margin threshold is not met, financial entities retain the option to apply to Banco de México for authorisation to provide collateral to parties other than financial entities. Although not formally articulated, Banco

de México has unofficially acknowledged that prior authorisations to grant collateral to counterparties can continue to be utilised for margin exchanges. Clarity on this matter remains somewhat elusive within the stipulations of Circular 2/2023.

(b) Entry into force

Circular 2/2023 outlines three crucial dates that require careful consideration by market participants. The first is 15 March 2023, marking the commencement of the requirement for all trades executed on or after this date to adhere to the Mexican UMR. The second is 31 December 2023, when a mandatory exchange of margins is set to be enforced for all entities falling within the scope of the regulation. And the third date is 15 March 2024, which serves as the deadline for the modification of all Derivatives Transactions agreements to align with the Mexican UMR.

However, these stipulated dates have given rise to several unresolved queries. Firstly, there is ambiguity in the drafting, suggesting that transactions conducted between March 2023 and December 2023 had to comply with Mexican Margin Rules even before the obligation to exchange margins became effective. This implies a unique backward-looking valuation approach, potentially positioning Mexico as the first global jurisdiction to adopt such a methodology. Secondly, the regulation mandates that agreements be modified by 15 March 2024, while margin exchange obligations commence in December 2023. The procedural aspect of how Banco de México envisages margin exchange occurring without prior modifications to the agreements remains unclear.

Thirdly, the December 2023 deadline was a mere nine months from the publication date of Circular 2/2023. This compressed timeframe posi-

tions Mexico as the jurisdiction with the shortest preparation period to comply with the UMR, compared to its global counterparts.

In response to these challenges, market participants have actively sought an extension of the Mexican UMR's entry into force and sought clarification from Banco de México on the distinctions between the three specified dates.

On 6 December 2023, Banco de México published in its annual financial stability report that the dates of entry into force of the Mexican UMR would be extended – for banks, broker dealers and investment funds, until 31 December 2024, and for development banks and corporates, until 30 September 2025. These new dates apply both to complying with the Mexican UMR and to modifying the relevant agreements accordingly.

However, this is speculative, as the applicable regulation is still pending publication and the financial stability report is not legally binding.

(c) New local derivatives agreements

In alignment with the updated regulatory framework outlined in Circular 2/2023, a crucial step towards compliance involves the negotiation of new local derivatives and collateral master agreements. Presently, the Mexican derivatives industry utilises local equivalents of ISDA documentation to enter into Derivatives Transactions. Specifically, this involves the use of the *Contrato Marco para Operaciones Financieras Derivadas* (CMOF) as the Mexican equivalent of the ISDA master agreement. Additionally, the *Contrato Global para Otorgar Garantías* (CGG) functions as the Mexican equivalent of the Credit Support Annex (CSA). It is worth noting that, in addition to the local master agreement and CSA, counterparties also execute pledge (*prenda*) agreements.

At present, Mexican agreements lack provisions for facilitating initial and variation margin exchanges, despite the existence of a definition for an independent amount. Consequently, these agreements will require renegotiation to align with the new requirements introduced by Circular 2/2023. Currently, industry stakeholders such as the ABM and AMIB are actively engaged in this process, with the latter boasting more than two decades of experience in this domain.

(d) Eligible and exempted counterparties

Circular 2/2023 incorporated a list of exempted entities, effectively delineating those outside the scope of the margin obligations. However, a notable lacuna in the regulation lies in the inclusion of the term “Mexican Federal Government” without providing a specific definition or clear parameters for its coverage. This lack of precision introduces ambiguity, given the diverse array of public entities – some of considerable significance in the derivatives landscape – that may or may not fall under the umbrella of the Mexican Federal Government. Notable participants such as the Mexican state-owned oil company, *Petróleos Mexicanos* (“Pemex”), and the Mexican state-owned electricity company, *Comisión Federal de Electricidad* (CFE), are examples of entities whose status remains uncertain within this context.

Recently, Banco de México affirmed the exclusion of pension funds and multi-propose investment firms from the scope of the Mexican UMR. However, the regulatory framework itself lacks clarity on this matter, leaving room for continued ambiguity. As a result, the industry awaits further elucidation on the precise inclusion or exclusion criteria for entities falling under the term “Mexican Federal Government” and seeks additional clarity on the exempt status of pension funds

and multi-purpose investment firms within the regulatory scope of Circular 2/2023.

(e) New industry legal opinions

The Mexican UMR introduce a series of new legal opinion requirements that come into play when engaging in Derivatives Transactions. Specifically, these legal opinions are imperative for various scenarios, encompassing the execution of both local and international master derivatives agreements, the engagement with international custodians, and the utilisation of an internal model for calculation of the initial margin.

Notably, Banco de México has recently expressed the possibility that legal opinions may be issued with respect to each counterparty rather than on a per-transaction basis. However, the specific delineation of this aspect remains unclear within the framework of the Mexican UMR, leaving room for continued uncertainty within the industry regarding the precise requirements for delivering legal opinions under these regulations.

(f) Custody

A pivotal concern within Circular 2/2023 revolves around the prescribed characteristics for collateral custody in the context of initial and variation margin. While the Mexican UMR permit financial entities to self-custody collateral, this approach introduces a set of complex challenges. Firstly, the regulations lack clarity on how financial entities can effectively segregate collateral within their own accounts, adhering to bankruptcy remoteness criteria, without the involvement of third-party custodians. This raises uncertainties about the practical implementation of such self-custody arrangements.

Secondly, a notable point of contention arises from the requirement, as stipulated in the Mexi-

can UMR, that upon a declaration of insolvency, collateral must be expeditiously transferred to the non-defaulting party following the early termination of the relevant master agreements. However, a nuanced challenge emerges when the collateral takes the form of securities, especially if the collateral taker is subject to insolvency or bank resolution. Mexican law does not currently permit an immediate transfer of securities after the early termination of agreements when the secured party is in such circumstances. This regulatory constraint could pose impediments, as the defaulted party may face limitations imposed by a third-party liquidator, hindering the prompt transfer of securities. The absence of clarity on this point has implications for the issuance of legal opinions until Banco de México provides clarity on the permissibility of immediate asset transfers upon the declaration of insolvency or bank resolution in accordance with applicable law. This issue does not arise when the pledgor is the party subject to insolvency or resolution and the secured party holds the collateral.

Adding to the complexity is the current lack of a robust infrastructure to support the establishment of third-party custodians. One potential solution under consideration is the establishment of a trust (*fideicomiso*) serving as a central clearing house, akin to the model employed by Mexican Asigna, the standardised derivatives Central Counterparty (CCP). However, the implementation of such a structure is anticipated to be a time-intensive process, further adding to the intricacies of the evolving regulatory landscape.

(g) Compatibility of standardised model with the ISDA SIMM

The framework established by the Mexican UMR permits financial entities to use internal models, subject to prior approval from Banco de Méx-

ico. Circular 2/2023 introduces a proposal for an internal standardised initial margin model, designed for use by counterparties not authorised by Banco de México to employ their internal models. Banco de México asserts that this standardised model aligns with the international standards for initial margin models.

Predominantly, banks and broker dealers in Mexico express a keen interest in adopting the ISDA Standard Initial Margin Model (SIMM), widely acknowledged as the de facto internal model with global applicability. However, concerns have been raised by various market participants, including ISDA, regarding perceived inconsistencies within Circular 2/2023. These potential inconsistencies, if substantiated, could render Banco de México's internal model requirements incompatible with the ISDA SIMM.

The resolution of these identified issues is crucial, as without clarification and a formal confirmation from Banco de México affirming the compatibility of the ISDA SIMM with Mexican UMR requirements, entities would be precluded from utilising this widely adopted model. This scenario would require reliance on alternative models or the standardised model proposed by Banco de México.

(h) IM thresholds

Despite the absence of explicit variation margin thresholds under the Mexican Margin Rules, an informal indication from Banco de México suggests that the established initial margin thresholds may also extend to the variation margin. However, regulatory clarity on this specific aspect remains pending, introducing a level of uncertainty within the regulatory framework.

(i) Substitute compliance and intragroup exemptions

The Mexican Margin Rules introduce a provision for substitute compliance with other jurisdictions deemed equivalent. However, the definition and criteria for determining these “equivalent jurisdictions” remain ambiguous, as the authorisation for substitute compliance is expected to be evaluated on a case-by-case basis. This lack of clarity introduces a notable dimension of uncertainty into the regulatory landscape.

(j) Use of collateral

The regulations governing the re-use or rehypothecation of posted collateral in both initial margin and variation margin show a high degree of rigidity under the Mexican Margin Rules. Specifically, a strict prohibition is in place against the rehypothecation or any form of re-use of posted collateral in the context of the initial margin. On the other hand, in the context of the variation margin, counterparties are permitted to rehypothecate cash, although they are precluded from reusing securities in any capacity. Notably, various banks, broker dealers and ISDA have raised concerns, emphasising that this prohibition diverges from international standards where, in specific scenarios, securities may be rehypothecated.

Industry actions

Facilitating clarification on Mexican UMR

Amid the prevailing uncertainty confronting market participants with regard to the Mexican UMR, numerous roundtable discussions have been held over the past several months, involving nearly all the Mexican banks and broker dealers. The ABM and AMIB have also been encouraged to foster a connection with the regulatory authority. The tangible outcome of these sessions materialised in a comprehensive letter jointly drafted by the ABM and AMIB, encom-

passing more than 100 enquiries directed to Banco de México, seeking elucidation on various aspects of the Mexican UMR.

Collaboration with ISDA

A collaborative effort with ISDA has also resulted in two detailed letters communicating the concerns of ISDA's members to Banco de México. These letters urge Banco de México to consider specific issues within Circular 2/2023, particularly those related to the internal model, as ISDA has identified potential incompatibilities with the SIMM. Moreover, ISDA presented approximately ten enquiries seeking clarification from Banco de México, some of which are discussed in this article.

Advocacy for extension and formal petition

In addition, the ABM and AMIB are pursuing an extension for the implementation date of the Mexican UMR. A petition endorsed by all the banks and broker dealers in Mexico was simultaneously formally submitted to Banco de México, requesting the issuance of 29 written confirmations addressing the intricacies delineated in this article.

The Mexican banking and brokerage community, assisted by legal advisers, is currently navigating the complex submission processes for substitute compliance and intragroup exemptions, alongside embarking on the remediation of master agreements.

Conclusions

Upon careful examination, it becomes evident that the Mexican derivatives market currently faces challenges in fully complying with the Mexican Margin Rules within the specified timeframe. However, the introduction of the Mexican UMR by Banco de México is seen as a crucial step to fulfil its obligations as a member of the BCBS and IOSCO. Enforcing the Mexican UMR is anticipated to bring about substantial

benefits, including the potential advancement of the Mexican financial system and enhanced global standing for the jurisdiction. Nevertheless, uncertainties persist, particularly surrounding certain ambiguous aspects of the UMR.

Regarded by many as the most significant financial regulatory reform of the decade, the Mexican Margin Rules herald a transformative shift in the Mexican derivatives market. While some market participants express concerns that swift enforcement might require the migration of local derivatives agreements to foreign jurisdictions governed by New York or English law, we presume that regulatory clarity could yield positive outcomes for the market. The new regulations provide an opportune moment to reassess local derivatives agreements, injecting an international dimension that could lead to a broader use of Mexican law in governing transactions, but at the same time aligned with the best international practices. Notably, the collaborative efforts of the ABM and the AMIB in advocating for their members underscore the constructive nature of the regulatory process. Furthermore, Banco de México's transparent engagement with market participants enhances its reputation as a world-class institution dedicated to issuing effective regulations for the benefit of the country.

While certain aspects of the regulation await further clarification, there is optimism in the industry that the Mexican derivatives market will undergo expansion, attracting international custodians, hedge funds, margin settlement institutions, and other key players. This evolution positions the country not only as a local financial centre but as a significant global participant in the derivatives market. The coming months are expected to see the resolution of pending issues and further define the trajectory of the Mexican derivatives landscape.

CHAMBERS GLOBAL PRACTICE GUIDES

Chambers Global Practice Guides bring you up-to-date, expert legal commentary on the main practice areas from around the globe. Focusing on the practical legal issues affecting businesses, the guides enable readers to compare legislation and procedure and read trend forecasts from legal experts from across key jurisdictions.

To find out more information about how we select contributors, email Katie.Burrington@chambers.com