



# The Development of Local Markets in Mexico

May, 2007

# Agenda



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## **I. Economic Policy and Financial Development**

## **II. Strengthening Local Market Infrastructure**

## **III. Mexican Local Market Agenda**

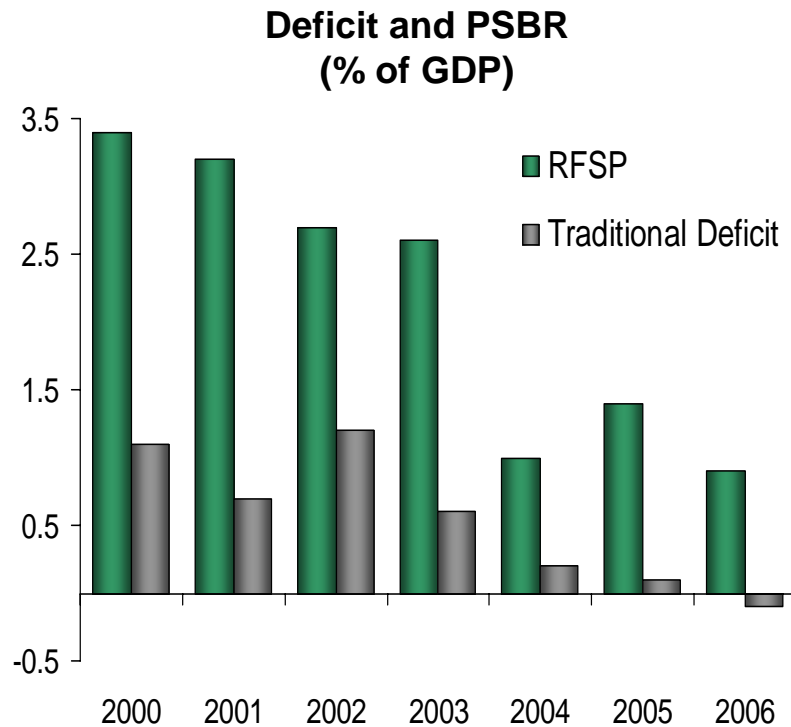
# I. Economic Policy and Financial Development



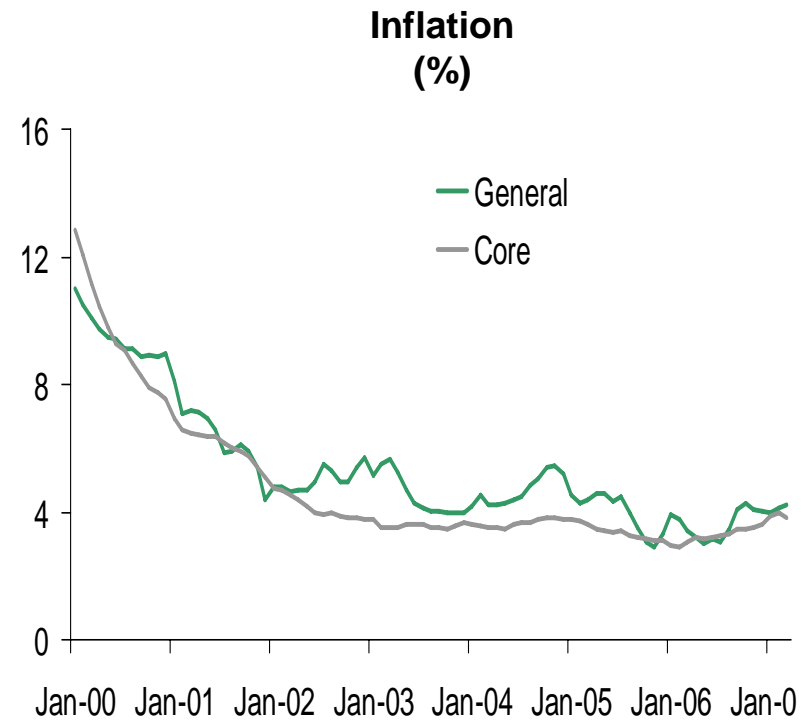
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## Macroeconomic and Financial Stability

The reduction of fiscal imbalances and a responsible monetary policy translated into macroeconomic and financial stability in Mexico.



Source: SHCP



Source: Banxico

# I. Economic Policy and Financial Development



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## *Legal Framework*

The pension reform dates from 1997. Additionally, other important legal reforms in the financial area were undertaken during the last few years.

- Securities Market Law
- Organic Law of the National Savings and Financial Services Bank
- Credit Institutions Law
- Financial Groups Law
- General Law of Auxiliary Credit Organizations and Activities
- Mutual and Investment Funds Law**
- Insurance Corporations Law
- Organic Law of the Federal Mortgage Association
- Reform to the Retirement Savings
- Reform for Real Estate Investment Trusts (FIBRAS)**
- Combating Money Laundering and the Financing of Terrorism
- Guaranteed Credit Competition and Transparency Law
- Popular Savings and Credit Law

- Organic Law of the Rural Financing Institution
- National Banking and Securities Exchange Commission Law
- Reform to the Development Financial System
- Reform to the Law of Credit Guarantees**
- Reform to the Credit Institutions Law related with “Prompt Corrective Actions”
- Reform to Bank Secrecy
- Insurance Sector Reform
- Mortgages Development Bank Reform (SHF)**
- Banking Distress Law
- SOFOMES Creation**
- Credit Cards “Cloning” Prevention
- Risky Capital Investments
- Pawn Shops

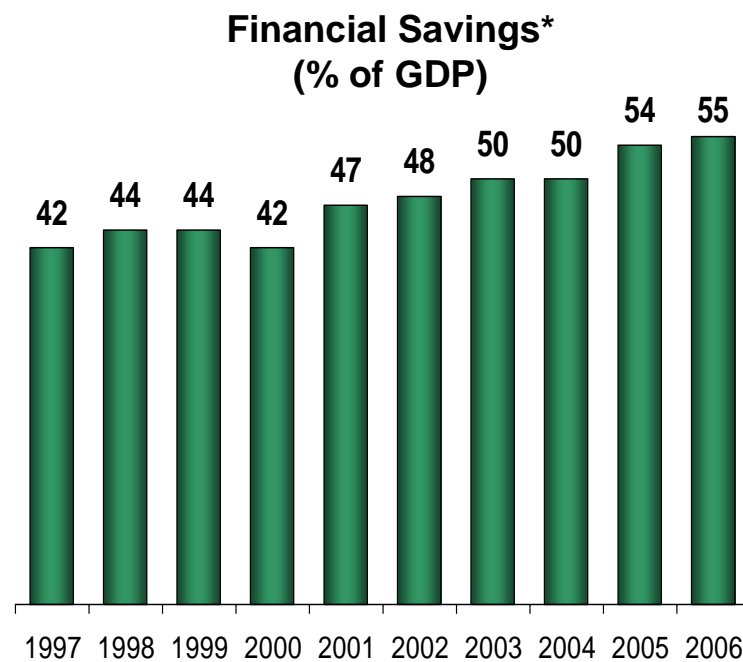
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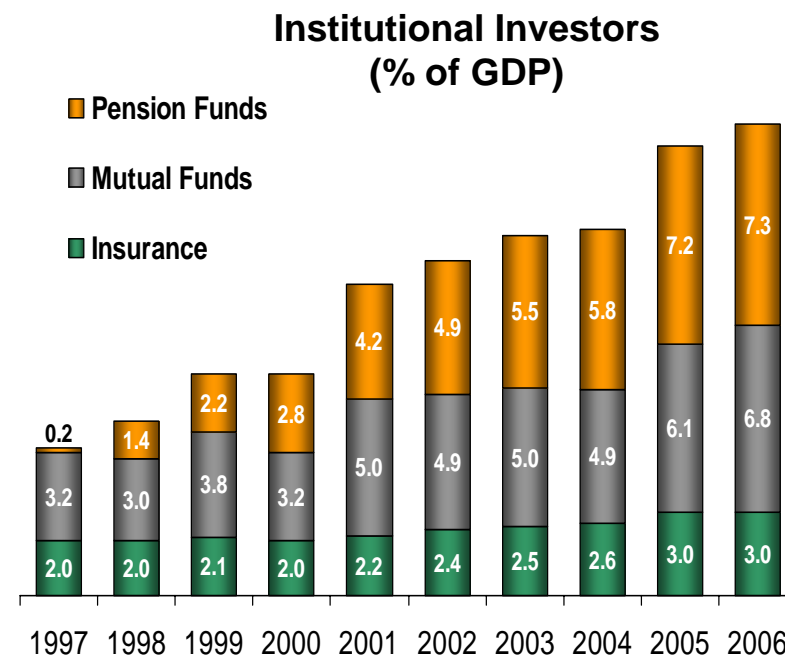
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## *Development of a local investor base*

The combination of macroeconomic stability and financial reforms had a positive impact on savings. Pension funds played an important role in the expansion of financial savings.



Source: SHCP \*M3a minus coins and bills



Source: Banxico

# I. Economic Policy and Financial Development

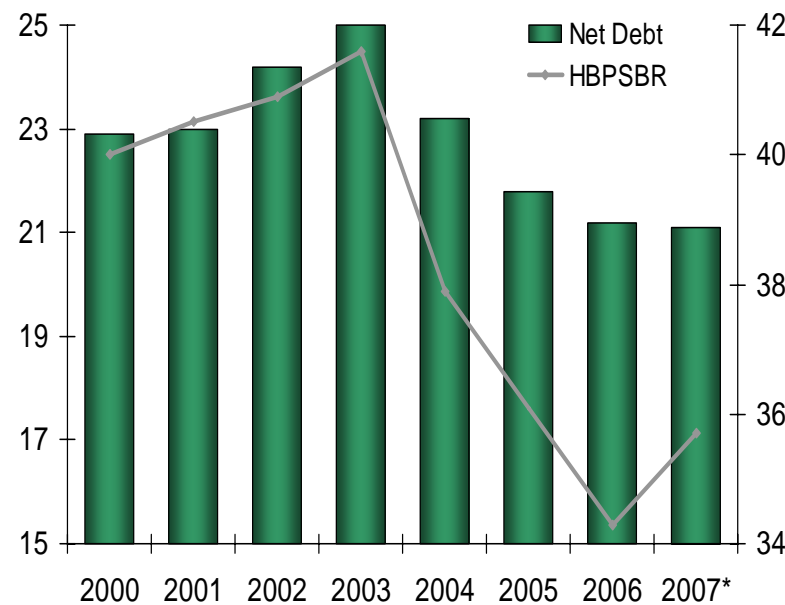


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## Debt Management

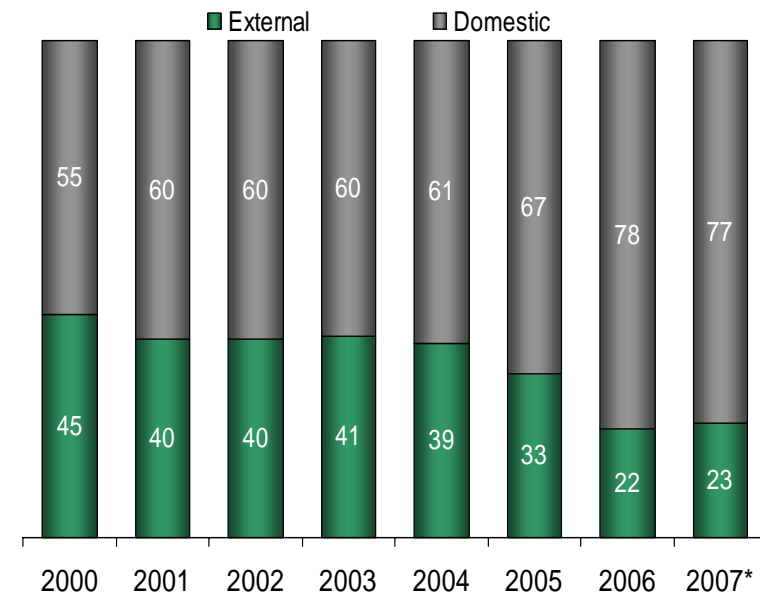
Fiscal discipline has reduced public liabilities as a percentage of GDP and the public credit policy was aimed at shifting the composition of debt in favor of domestic sources.

**Net Debt and HBPSBR  
(% GDP)**



Source: SHCP \*Up to March 2007

**Federal Government Net Debt  
(% GDP)**



Source: SHCP \*Up to March 2007

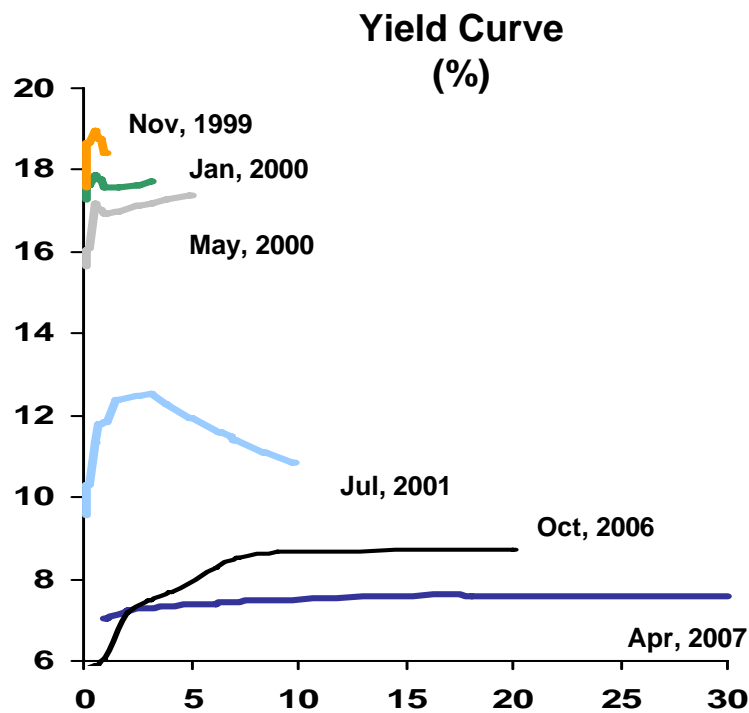
# I. Economic Policy and Financial Development



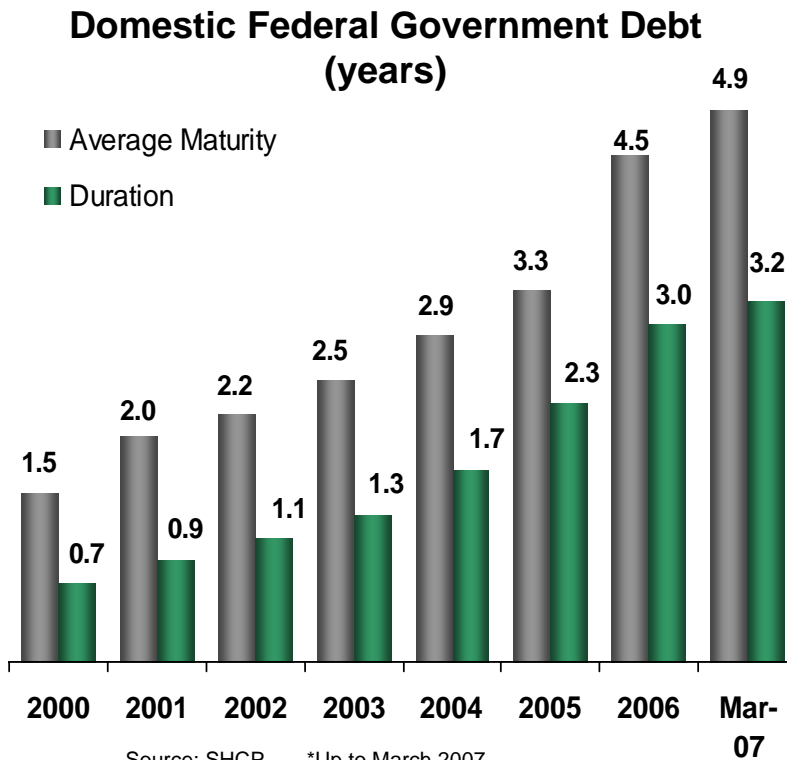
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## Debt Management

Great emphasis has been placed on the management of public debt. The Federal Government has been able to establish a proactive debt policy geared towards increasing the duration of its internal debt and reducing the dependence on external debt.



Source: SHCP



Source: SHCP \*Up to March 2007

# I. Economic Policy and Financial Development



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## *Mexican Local Instrument Liquidity*

The Mexican local government bond market has attained good levels of liquidity by international standards. The Mexican local instruments accounted for 30% of local markets turnover of all local emerging market trading, while Brazilian and Turkish local debt activity accounted for 12% and 11%, respectively.



Source: EMTA "Fourth Quarter 2006 Debt Trading Volume Survey"

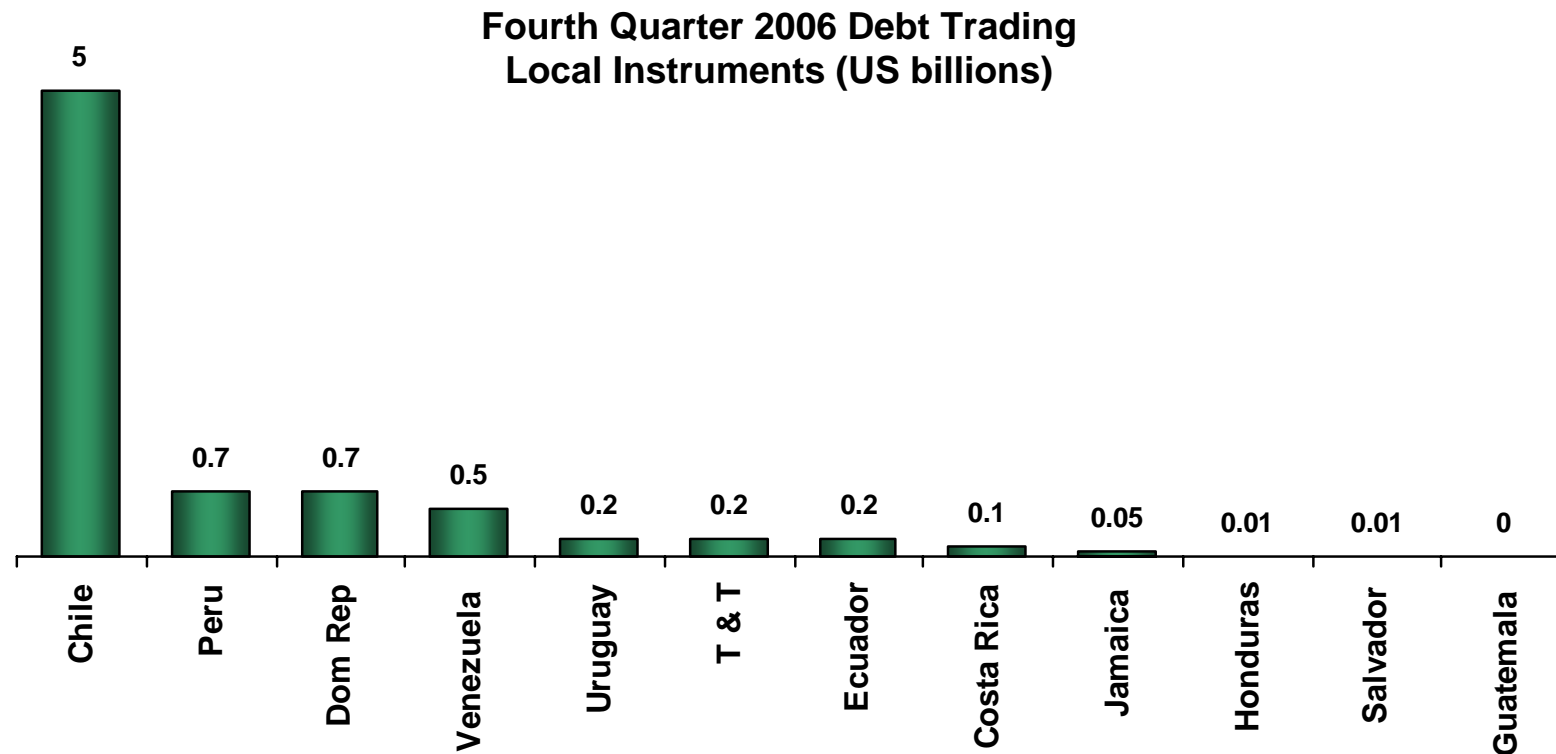
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## *Latin American Local Instrument Liquidity*

Even though macroeconomic conditions among Latin America and Caribbean countries have improved, sound economic policies are not sufficient to enhance liquidity and facilitate the development of local markets.



Source: EMTA "Fourth Quarter 2006 Debt Trading Volume Survey"

# Agenda



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# I. Economic Policy and Financial Development



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## *Local Market Microstructure*

- ❑ **Issuance Calendar:** Announced quarterly by the Federal Government, specifies the instruments to be issued and placed in each weekly auction. Announced jointly with public entities issuance (such as PEMEX)
- ❑ **Auction Rules:** The Government Securities Auction Rules were modified in 2002, in order to improve the efficiency of the allocation process
- ❑ **Issuance Reopening Policy:** Policy focused in create faster size benchmark and minimize the number of securities
- ❑ **Strips Market:** Allows market participants to strip any of the existing fixed rate government securities, enhancing the depth of secondary markets
- ❑ **Exchange Program:** Was implemented to reduce the high levels of government cash balances needed to redeem bonds close to maturity by exchanging fixed rate bonds

## II. Strengthening Local Market Infrastructure



### *Local Market Microstructure*

#### ❑ **Price Vendors**

- Guarantees fair pricing
- Transparency of portfolio valuations of banks/institutional investors
- Supports the regulatory framework on risk management (Afores)
- Fosters the development of local market indexes

#### ❑ **Market Makers**

- Increases liquidity in the secondary market of domestic debt
- Introduces best international practices
- Promotes investment in government instruments
- Promotes derivatives market
- Incentives to be a market maker: “green shoe” option and standing repo facility

## II. Strengthening Local Market Infrastructure



### ***Clear Communication Strategy***

#### **❑ Investors Relations Office**

The IRO is in charge of developing a personal and ongoing dialogue with investors and analysts.

#### **❑ Economic Policy Guidelines**

The Economic Policy Guidelines are set and released annually. The general issuance strategy is outlined in this document.

#### **❑ Public Debt Policy Guidelines**

Along with EPG, the debt office releases a more detailed document to present the strategy for the following year.

#### **❑ Internet Portal**

A web page was placed online to provide timely and detailed information of the public debt legal framework, debt statistics and transaction reports.

#### **❑ Surveys**

Started in 2006 to know the market participants' opinion about prospective issues and operations.

## II. Strengthening Local Market Infrastructure



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### ***Operational Issues: International Clearing & Settlement Systems***

- ❑ Euroclear and Clearstream have arrangements with local banks in order to allow Mexican local market securities to be settled through their systems
- ❑ Allow trading with Mexican local instruments (including Cetes, Bondes D, Bondes 182, Udibonos, Brems, Mbonos & Equities)
- ❑ Facilitate trading of local instruments among foreign investors
- ❑ Facilitate trading of local instruments between foreign investors and local participants
- ❑ Access to the secondary markets and increased liquidity
- ❑ Promotes the participation of new foreign investors in the local markets
- ❑ Within the Latin American region, very few countries have a clearing house for government securities; and only Mexico and Argentina's local debt can be traded through international clearing and settlement systems

## II. Strengthening Local Market Infrastructure



### *Fiscal and Operational Issues*

#### ❑ **Tax Treatment**

Foreign investors are exempt from any withholding tax on their investments in government securities

#### ❑ **Inclusion of the Mexican Market in global indexes**

As a result of several requests made by the Federal Government, the Mexican local market has been incorporated in the most important global fixed income indexes:

- JP Morgan Broad Index (January 2003)
- Merrill Lynch Global Broad Market Plus Index (June 2003)
- Lehman Global Aggregate Index (January 2005)

#### ❑ **Design and execution of innovative transactions**

Debt exchange warrants are an efficient tool for investors to get exposure to the Mexican local market

## II. Strengthening Local Market Infrastructure



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### *Foreign Investor Participation on Local Markets*

- ❑ While improving the Mexican microstructure, the role of foreign investors has been very relevant
- ❑ Foreign investors participation bring several benefits:
  - Diversification of the investor base
  - Increased demand for long duration instruments
  - Technology transfer to local participants
  - Greater interest from analysts and more quantity/quality research focused on local market strategy
  - Foreign investors operate actively in the market, and by doing so, they help to improve liquidity, reducing market volatility

# Agenda



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# III. Mexican Local Market Agenda



## ***Local Market Agenda***

Having developed liquid local markets during the past several years, now the Mexican Government is focusing its debt management strategy on improving the microstructure of local markets in order to enhance the price discovery process and make markets more efficient.

At the moment, the Mexican Government continues working on several fronts:

### **□ Buyback and Exchange Program of Securities**

A Exchange Program was implemented with the objective of smoothing out the amortization profile of domestic debt.

Currently analyzing the possibility of introducing a regular Buyback Program as a complementary strategy, and in the future expects to use the Exchange Program as a tool for developing and managing the yield curve.

### **□ Udibonos Issuance Policy**

An important issuance of inflation indexed instruments is expected from the private sector, related to housing, infrastructure and other structured debt. Because of that, the issuance policy of inflation indexed bonds (Udibonos) will be used not only as a diversification tool but also as a way to promote liquidity and efficiency in the real yield curve.

## II. Mexican Local Market Agenda



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### *Local Market Agenda*

#### □ **Frequency of Issuances and Number of Benchmarks**

Additional efforts will be directed towards strengthening the fixed rate benchmarks, maintaining an important outstanding amount of each reference and a reduced number of bonds across the yield curve in order to foster liquidity for the efficient performance of the yield curve.

Nowadays, the Federal Government auctions 3, 5, 10, 20 and 30 year references.

Average size of outstanding peso denominated fixed rate bonds is 40 billion pesos, with a couple of bonds reaching 82 billion pesos. By virtue of the reopening policy, by 2012, the average target size of the bonds will be 75 billion pesos, and in a few cases will reach 120 billion pesos.

# III. Mexican Local Market Agenda



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## *Local Market Agenda*

### □ Repo and Securities Lending Market

An active repo and securities lending market is fundamental for the development of financial markets, improving the market microstructure in order to foster local market efficiency.

In recent years, the Federal Government has been working on the development of the Repo and Securities Lending Market.

- Fiscal Issues
- Legal Issues
- Regulatory Issues
- Incentives

The Mexican Government found that the standing repo facility might inhibit the development of the Repo and Securities Lending Market since this facility represents an exclusive alternative for the market makers. Nowadays, the Government is working on the alignment of those benefits.

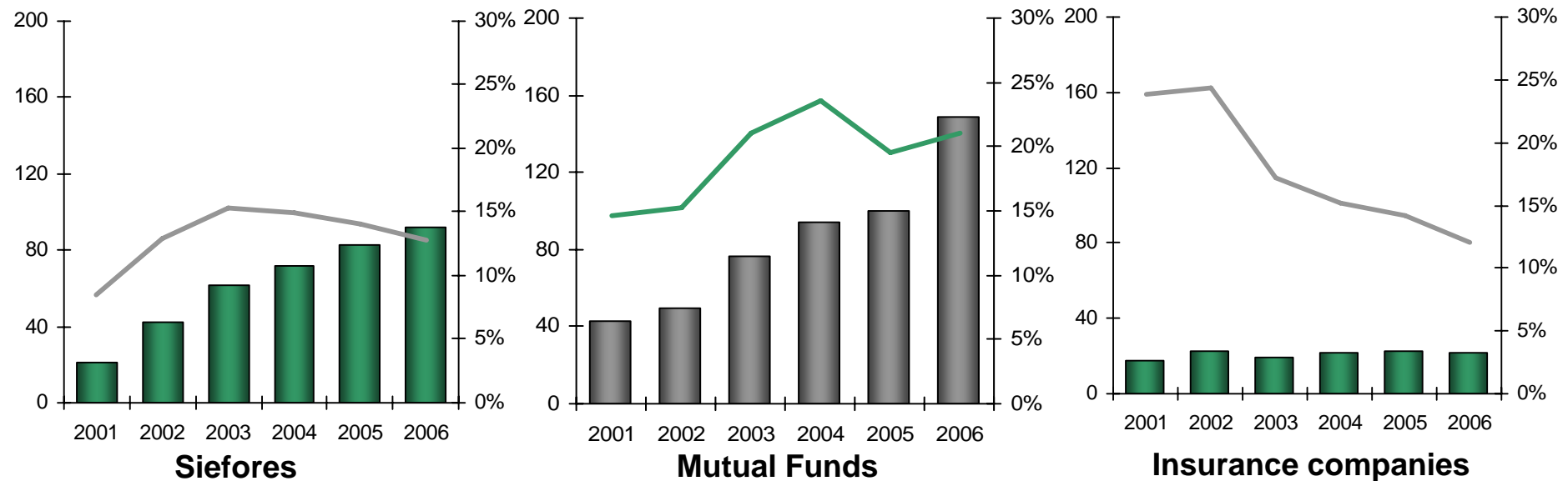
## II. Strengthening Local Market Microstructure

### *Corporate Debt: Challenges and Opportunities*



On the other hand, the corporate debt market is less developed. The portfolio of all institutional investors is highly concentrated on government securities. Corporate bonds plus infrastructure and housing financing represent in average only 18% of their total portfolio.

Corporate Bonds in Institutional Investors' Portfolio  
(Billions of pesos, % of portfolio)



Source: Banxico

## II. Strengthening Local Market Microstructure



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### *Corporate Debt: New Financial Instruments*

- The structured securities market is a relatively new and small market in Mexico that started in 2001 and includes mainly:
    - **Mortgage Backed Securities (MBS).**- Recent issues of MBS represent 80% of total issues
    - **Receivables or Future Flow-Backed Securities.**- Securitization of toll road and state and municipalities revenues coming from federal transfers constitute more than 60% of the outstanding market
    - **Real Estate Investment Trusts (REITs or FIBRAS).**- Public corporation or trust that pools capital to manage, acquire, develop or finance real estate
    - **Venture Capital / Private Equity Funds.**- With the introduction of SAPI (Sociedad Anónima Promotora de Inversión) in 2005, legal certainty was increased for instruments commonly used in the venture capital and private equity industry, such as preferred stock, warrants, tag-along and drag-along rights
- In 2006, further reforms to the legislation were made, to facilitate the creation of private equity trusts or FICAPs



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<http://www.hacienda.gob.mx/ucp>