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Amendments to Circular 4/2012 from Banco De México¹ (Initial and Variation Margins)

On March 14, 2023, Banco de México published Circular 2/2023 in the Official Gazette of the Federation, whereby Circular 4/2012, containing the Regulations of Derivative Transactions (hereinafter the "Rules"), was amended. The amendments mainly incorporate the obligation of Mexican banks and broker dealers, as well as other financial institutions, to post and receive initial and variation margins.

The following are the most relevant provisions:

- The incorporation of several definitions such as Netting Master Agreement, Event of Default, Initial Margin, Variation Margin, Initial Margin Amount and Initial Margin Threshold.
- Rule 6.2 *Margins* is incorporated, which establishes the obligations of the parties to guarantee Initial Margins and Variation Margins of the Entities² and Investment Funds that enter into Non-Centrally Cleared Over-the-Counter Derivatives Transactions.³
- Transactions entered into with the Federal Government, Banco de México, the *Instituto para la Protección al Ahorro Bancario* (IPAB), eligible foreign governments and various international financial institutions are not required to post margins.
- The Rules define Netting Master Agreement as the agreement executed between two parties of Derivative Transactions, in writing or in electronic format in accordance with due formality, individually or included in the derivatives master agreement.
- The Netting Master Agreement must, at least, provide for **(i)** the creation of a single net payment obligation in respect of all obligations arising from all individual Derivative Transactions covered by such agreement, in the case of an Event of Default, after the relevant two-day suspension period established in article 176 of the Banking Law (*Ley de Instituciones de Crédito*); **(ii)** the right of the non-defaulting party to terminate or early terminate by close out, on net basis amounts, all the Derivative Transactions entered pursuant to such agreement, in the event of an Event of Default, after the relevant suspension period, **(iii)** the right of the non-defaulting party to terminate or early terminate or by close out, on net basis amount, all the Derivative Transactions entered pursuant to

¹ Banco de México is Mexico's Central Bank.

² For the purposes of the Rules, Entities are Mexican Banks, Brokerage Dealers and *Financiera Rural*.

³ For the purposes of the Rules, Non-Centrally Cleared Over-the-Counter Derivatives Transactions are the Derivatives Transactions which netting and liquidation of obligations are not executed through clearing houses or foreign financial institutions that act as central counterparties.

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such agreement, as well as to liquidate or net the collateral, without delay, in the case of an Event of Default. The exercise of such right will be subject to the provisions of article 176 of the Banking Law. Under such article, Derivatives Transactions will become due and payable two business days after the date when the revocation of the authorization to organize and operate as a bank is published in the Official Gazette of the Federation and will be netted; notwithstanding the terms of the corresponding agreement or any other statutory provision. Once the statutory two business day term has elapsed, the obligations under the Derivative Transactions will become due and payable and may be netted; (iii) the agreement may not include any provision whereby the non-defaulting party is allowed to make a payment for an amount less than that which would correspond to it in the event that the Event of Default does not occur or would have no obligation to pay amounts that otherwise it would have to.

- An Event of Default is defined as the failure of any payment obligation in a Set of Transactions Subject to Netting, including any event of *concurso mercantil*, insolvency, suspension of payments, liquidation or similar procedure to which the party of the relevant Derivative Transaction is subject, as well as any other objective cause attributable to such party, according to the provisions of the relevant Netting Master Agreement.
- Additionally, the Entities, Investment Funds, General Deposit Warehouses and Sofomes that enter into Non-Centrally Cleared Over-the-counter Derivatives Transactions must provide: **(i)** processes for the verification with their counterparties (*conciliación*), regarding the form and terms according to which the valuation of this type of Derivative Transactions and of the assets that are pledged as collateral will be carried out periodically; **(ii)** dispute resolution mechanisms; **(iii)** the party that be the calculation agent to carry out the valuation of Derivative Transactions, and if applicable, the valuation agent of the assets granted as collateral, and **(iv)** procedures to periodically evaluate the possibility of regularly carrying out the compression of the Derivative Transactions entered into with its counterparties.
- Similar to other jurisdictions, for the case that Netting Master Agreements or agreements for the exchange of Margins are entered into, an independent legal analysis from an independent third party (opinion) must be carried out to verify that such Master Netting Agreement complies with the requirements of the Rules, and that in the event of a legal dispute, including any arising from an Event of Default, it is considered reasonable to assume that the competent jurisdictional authority has sufficient elements to determine that the relevant agreement is legally valid, binding and enforceable under the laws of the relevant jurisdiction.
- The Rules provide that the assets received as collateral, in connection with the exchange of Margins, must be managed or held by one of the following financial entities **(i)** a Mexican Entities **(ii)** a Mexican clearing house, **(iii)** a foreign clearing house, **(iv)** a foreign market infrastructure, or **(v)** a foreign financial entity
- In order for an Entity to contract with a foreign market infrastructure or foreign financial entity to be the custodian or administrator of the securities, an independent legal review by an independent expert with knowledge of the applicable regulations in the relevant jurisdiction (opinion) must be performed to certify that the administration and custody of the collateral complies with the Rules.

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- The Rules define the specific characteristics and assumptions under which Initial and Variation Margin must be exchanged, as well as the exceptions, thresholds, minimum amounts and models for their calculation. The Rules establish that the Threshold for the exchange of Margins is 20,000 million UDIs (inflation indexed units), the Threshold of the Initial Margin is 125 million UDIs, and the Minimum Transfer Amount is one million 250 thousand UDIs. Variation Margin does not have a particular threshold. However, the Rules establish that the counterparties must receive Variation Margin in the case that the amount of such Margin is positive and to give in the case the amount is negative. For Non-Centrally Cleared Over-the-Counter Derivatives Transactions, entered into with the same counterparty of a Netting Master Agreement, Entities and Investment Funds will have the right to recognize such agreement for the calculation of the Variation Margin amount. It is important to highlight that the Rules allow the parties to use the above-mentioned amounts or if authorized by Banco de Mexico, the parties may use their own internal models and thresholds.
- The Rules establish that in case that a Non-Centrally Cleared Over-the-Counter Derivatives Transaction is entered into under a same Netting Master Agreement between and Entity or Investment Fund and any other counterparty, the Entity or Investment will have the right to calculate the Margins amount over the net amounts in respect to all of the Non-Centrally Cleared Over-the-Counter Derivatives Transactions under such master agreement.
- The Rules establish Eligible Collateral⁴ and Minimum Excess (Haircut) amounts. Regarding the collateral that will be considered as eligible it is stated that only the following will be authorized: cash deposits and securities of their portfolio authorized by the Rules. In addition, the Minimum Excess (Haircuts) of each asset pledged as collateral will be determined by the credit rating and risk of each asset, being the asset with the Minimum Excess the cash (zero (0)) and the maximum Shares and convertible securities included in main indexes (fifteen (15)).
- Derivative Transactions which are not cleared through clearing houses or foreign institutions acting as central counterparties, which have been entered into prior to the entry into force of the Rules, will not be subject to the Margin exchange obligations contained in the Rules.
- The Entities and the Investment Funds that are within the scope of the Rules, will have **until March 15, 2024** to amend their master agreements in order to establish the procedures by which they will carry out the exchange of Margins.
- The obligation of the Entities and Investment Funds to determine the value of the Margins and notify them to their counterparties on the same Business Day of the calculation will apply as from **December 31, 2023**.

⁴ Amongst others, governmental bonds, shares, convertible securities included in major indexes and cash.

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We advise that Entities, Investment Funds and, as the case may be, General Deposit Warehouses and Sofomes, establish mechanisms to be in compliance with the amendments and avoid possible contingencies. We would assist you in such process, if required.

Should you require additional information in this regard, please contact Pablo Perezalonso Eguía (pperezalonso@ritch.com.mx), a partner in Ritch Mueller's banking and regulatory law practice.

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