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Credit Derivatives in Mexico: Regulatory Evolution and the Rise of Total Return Swaps

Introduction

In recent years, Mexico's derivatives market has come a long way. Mexican financial entities have become more sophisticated (the implementation of margin rules and triparty repo settlement being notable examples). Global banks have increased their activities in Mexico, and the range of products available to market participants, which includes large corporates and government entities, has expanded considerably. Yet there has been one notable exception to this growth story: credit derivatives. Long treated as something close to taboo, credit derivatives remain a product class that regulators approach with extreme caution and that most financial entities simply avoid.

For years, very few Mexican banks held an authorisation from Banco de México (Mexico's central bank, or "Banxico") to enter into credit derivative transactions, and there was even a period when no bank had one at all. The regulator's caution was understandable: credit derivatives played a prominent and controversial role in the 2008 global financial crisis, and the prevailing view in Mexico was that these instruments carried risks the domestic market was not yet equipped to manage.

That began to change in June 2023, when Banxico published Circular 6/2023, amending Circular 4/2012 (the main regulation governing derivatives transactions in Mexico, or the "Derivatives Regulation"). Banxico sought to reactivate this dormant corner of the market by opening the door for a broader range of entities to participate, modernising outdated definitions, and signalling that credit derivatives are now ready to play a more meaningful role in the Mexican financial system.

This article explains the regulatory framework for credit derivatives in Mexico, the changes introduced by Circular 6/2023, and takes a closer look at Total Return Swaps, which are a type of derivative that has been gaining significant traction in the Mexican market.

The regulatory landscape: how derivatives are governed in Mexico

Banxico is the primary regulator for Mexican financial entities regarding their derivative transactions.

The Derivatives Regulation was published in the *Diario Oficial de la Federación* (Mexico's official gazette) on 2 March 2012. It covers the full spectrum of regulated entities: banks, broker-dealers (*casas de bolsa*), investment funds (*sociedades de inversión*), regulated multi-purpose financial companies (*Sociedades Financieras de Objeto Múltiple – Sofomes*) with patrimonial ties to banks, general deposit warehouses (*almacenes generales de depósito*), and insurance companies (*instituciones de seguros*). The Derivatives Regulation defines permissible derivative types, eligible underlyings, authorisation processes, counterparty requirements, documentation standards, margin and collateral rules, and reporting obligations.

Credit derivatives under Mexican law and regulation, and why has Mexico been so cautious?

To understand why Circular 6/2023 is significant, it helps to step back and examine what credit derivatives actually are under Mexican law and why they have historically been treated with such caution.

The Derivatives Regulation defines credit derivatives (*Operaciones de Derivados de Crédito*) and includes within this definition:

- Credit Default Swaps (CDS);
- Total Return Swaps (TRS);
- Credit-Linked Notes (CLN); and
- any other derivative or structured operation where a right or obligation is triggered by the occurrence of a "Credit Event" (*Evento de Crédito*).

In plain terms, these are agreements that allow one party to pay another to assume the credit risk of a third party, which is generally a borrower, a bond issuer, or any entity with outstanding financial obligations.

A CDS works as follows: the buyer pays a periodic fee (similar to an insurance premium) to the seller. If a Credit Event occurs, such as a default on debt, a declaration of bankruptcy, or similar actions, the seller compensates the buyer, either through a cash payment or by accepting delivery of the affected instrument in exchange for its face value. Importantly, under Mexican regulation, the parties' obligations are triggered regardless of whether the buyer has any actual exposure to the referenced entity or suffered any real loss. This feature distinguishes a credit derivative from an insurance contract, and insurance policies in the credit or financial guarantee lines are expressly carved out of the definition.

A TRS is different. Here, one party (the "total return payer") agrees to pass along the entire economic performance of a reference asset that includes interest, principal payments, and any appreciation to the buyer. In exchange, the buyer pays a periodic amount, typically based on a fixed or floating rate, and absorbs any depreciation in the asset's value. The parties can also build in a Credit Event trigger that terminates the contract early and leads to a settlement reflecting the impact.

CLNs are debt instruments where the issuer pays the principal and interest through maturity unless a Credit Event occurs first. If one does, the notes are redeemed below par, or the holder receives instruments issued by the entity that triggered the event. They blend a bond-like structure with embedded credit protection.

Although CLNs are securities rather than agreements (unlike TRS or CDS), the Derivatives Regulation treats them as credit derivatives.

The definition of Credit Event is broad (perhaps too broad) as its application to specific cases can prove problematic. It covers insolvency or bankruptcy filings, payment defaults, debt restructurings, repudiation of obligations, moratorium, regulatory intervention under resolution frameworks, and even credit rating downgrades, where the downgrade triggers a contractual obligation.

Credit derivatives are important for any sophisticated market because they allow participants to unbundle credit risk from everything else and distribute risk among different parties. A bank sitting on a large loan portfolio can buy credit protection through a CDS without selling a single loan. An institutional investor seeking exposure to a particular Mexican corporate credit can obtain it synthetically through a TRS, without purchasing bonds in the secondary market. As Mexico's capital markets continue to deepen, these tools are becoming increasingly relevant for both domestic and cross-border transactions.

But this is where the Mexican story diverges from the global one. While credit derivatives became mainstream products in the United States and Europe long ago, Mexico's regulatory approach was always more conservative. Banks needed a specific, separate authorisation from Banxico to enter into credit derivative transactions, on top of their general derivatives' authorisation. This was not a rubber-stamp process. Very few banks went through it, and there were stretches where essentially none had an active authorisation. The regulator kept the market on a very short leash, and the practical effect was that credit derivative activity in Mexico remained minimal for years.

There was one exception: banks could enter into credit derivatives outside of Mexico through their foreign branches. Banxico took notice and concluded that if banks were going to engage in these transactions regardless, it was preferable to supervise them within Mexico rather than have them executed overseas.

What changed with Circular 6/2023

Circular 6/2023, published on 15 June 2023, represents the most significant effort in years to breathe life into Mexico's credit derivatives market. Banxico's stated goal was to promote the sound development of the financial system by broadening who could participate in credit derivative transactions. In practice, the amendments signal something more fundamental: the era of treating credit derivatives as taboo is over.

More counterparties at the table

This is the headline change. Before Circular 6/2023, banks could only enter into credit derivative transactions with two types of counterparties: other banks authorised by Banxico to trade credit derivatives on their own behalf, and foreign financial entities.

The amendments opened the door much wider. Banks can now sell CDS and TRS to broker-dealers, investment funds, specialised retirement fund investment companies (*Sociedades de Inversión Especializadas en Fondos para el Retiro*, or "*SIEFOREs*"), insurance companies, and other institutional investors. Interestingly, there is a regulatory contradiction regarding pension funds: Circular 6/2013, which governs derivatives transactions by pension funds, explicitly prohibits credit derivatives, while the Derivatives Regulation now permits them. This contradiction remains unresolved.

For other entities, there are guardrails. These new counterparties can only participate as buyers of protection, they can only reference underlyings that they are authorised to hold and actually maintain in their portfolios during the life of the trade, and, in the case of TRS, the transaction must be fully funded. That last requirement is significant: the buyer must put up the agreed payment amount at the outset in exchange for receiving the cash flows and any upside on the underlying.

That said, the opening is still carefully calibrated. Insurance companies and pension funds face significant limitations, as they can only participate as buyers, only to hedge risks related to assets they actually hold, and with operational requirements (including risk management units, board reporting, and valuation controls) that add meaningful compliance costs. The regulator is letting these entities into the market, but on a tight leash. The approach is consistent with Banxico's long-standing philosophy: open the door gradually, rather than all at once.

Broker-dealers step up

Another notable development is the express authorisation for broker-dealers to conduct credit derivative transactions, both on their own behalf and on behalf of third parties. Before these amendments, their role in the credit derivatives space was limited. Now they have a clear legal basis to act as intermediaries and principals, which positions them as important players in market development, going forward.

Cleaner definitions

Circular 6/2023 also cleaned up several outdated definitions. The descriptions of CDS, TRS, CLN, and Credit Events were all revised to reflect more precisely how these products actually work. At the same time, a handful of legacy terms "Risk Asset" (*Activo de Riesgo*), "Credit Risk" (*Riesgo de Crédito*), "Buyer of Protection" (*Comprador de Protección*), and "Seller of Protection" (*Vendedor de Protección*), were formally repealed.

Broader equity underlyings

The amendments also expanded the range of equity securities that can serve as underlying assets for derivative transactions. Previously, the rules referred only to "shares" (*acciones*). The revised language covers shares or any other securities representing a portion of an entity's capital, along with groups or baskets of such securities and securities referenced to them that are listed on a stock exchange. It is a subtle but meaningful change for structured products and equity-linked derivatives.

Insurance companies enter the framework

Insurance companies were formally added as recognised participants in the derivatives framework. They can now carry out derivative transactions on their own behalf for hedging purposes and are authorised to provide guarantees in connection with their derivative operations. This brings insurers into the regulated derivatives ecosystem under clear rules, rather than leaving their participation in a grey area.

What stayed the same

Not everything has changed. General deposit warehouses and *Sofomes* remain prohibited from entering into credit derivative transactions. Investment funds can only use credit derivatives for hedging with respect to underlying assets they hold in their portfolios throughout the life of the trade. Assignment of rights or obligations under credit derivatives is permitted only where the documentation expressly provides for it. These restrictions reflect the deliberate, incremental approach that has characterised Banxico's handling of credit derivatives from the start.

Total return swaps: why they matter now

Among the various credit derivative products, TRS have been getting the most attention in Mexico lately. While CDS tend to dominate the global conversation about credit derivatives, TRS offer something different and, for many purposes, more flexible.

The appeal is straightforward. A counterparty seeking economic exposure to a particular credit, whether a corporate bond, a loan, or a portfolio of receivables, can obtain it through a TRS without actually buying the asset: no need to go through the settlement mechanics of a bond purchase, no need to hold the asset on the balance sheet, no need to deal with transfer or registration requirements. Conversely, a bank holding the asset can use a TRS to offload the economic risk to a willing counterparty while retaining legal ownership and preserving the client relationship.

Under the new framework, banks can enter into TRS as sellers with all newly eligible counterparties – broker dealers, investment funds, *SIEFOREs*, insurance companies, and institutional investors – as long as the buyer fully funds the transaction at inception. That full-funding requirement is worth emphasising; it makes the TRS function more like a funded credit position than a traditional unfunded derivative, significantly reducing counterparty risk.

There are also important considerations under Mexican securities law. When the reference asset consists of shares issued by a Mexican listed company and the counterparty is the issuer (or a subsidiary) of those shares, the transaction can trigger share repurchase rules, disclosure obligations, short-swing trading restrictions, internal approvals and market-manipulation prohibitions under the Securities Market Law (*Ley del Mercado de Valores*). Anyone structuring a TRS with listed equity as the reference asset needs to think carefully about these overlays.

The growing use of TRS in Mexico tracks a global trend. These instruments are increasingly popular for portfolio management, synthetic financing, and structured credit transactions worldwide. The regulatory clarity provided by Circular 6/2023, particularly the expanded counterparty framework and the full-funding requirement, gives market participants a more predictable environment in which to use them.

What comes next

The changes introduced by Circular 6/2023 mark a real turning point. For over a decade, credit derivatives in Mexico existed in the rules but barely existed in practice. The combination of regulatory caution, limited authorisations, and a small universe of eligible counterparties kept the market from developing. Circular 6/2023 is an explicit attempt to change that, not by throwing the doors wide open, but by expanding access in a measured, controlled way that reflects lessons learned from international experience.

Going forward, the regulatory agenda will likely focus on complementary reforms. Margin requirements for non-centrally cleared derivatives (already partly addressed by Circular 2/2023), trade reporting through central data repositories, and alignment with international standards on unique transaction and product identifiers (UTI and UPI) will continue to shape market infrastructure. The interplay between regulatory capital treatment and hedging effectiveness under Mexico's banking rules will also remain a key driver of how actively financial entities use these products.

For international market participants, the message is straightforward: Mexico's credit derivatives framework is now more developed, more accessible, and better aligned with global standards than it has ever been. After years of being treated as instruments to avoid, credit derivatives are finally being recognised for what they are: essential tools for managing credit risk in a maturing financial system.