BBVA | RESEARCH

Economic Watch

Mexico

April 9, 2014
Economic Analysis

Carmen Hoyo Martínez
consuelodelc.hoyo@bbva.com

Carlos Serrano Herrera
carlos.serranoh@bbva.com

Samuel Vázquez Herrera
samuel.vazquez@bbva.com

Fernando Balbuena Campuzano
Fernando.balbuena@bbva.com

Social Security Reform

- A universal pension scheme, an unemployment insurance plan have as well as several reforms on social security laws are proposed. These include the laws covering retirement saving schemes, social insurance and *Infonavit*, the national funding institute for workers' housing.

- The universal pension will offer a basic pension of MXN580 (USD45) a month to those over 65 who do not receive a social security pension, as well as those pensioners receiving less than MXN1,092 (USD84) a month. The universal pension will be funded by the Federal Government. In addition, the government will make payments into a trust for those who will turn 18 in 2014 and beyond.

- Unemployment insurance will be partly funded by employer contributions which are currently being used for housing. A Mixed Sub-account has been set up which can be used for unemployment, housing or retirement. The withdrawals for unemployment from the Retirement, Redundancy and Old-age sub-account from individuals' retirement accounts are eliminated.

- The Saving Systems for Retirement law provides for changes in the fee scheme, flexible investment funds and changes in transfer rules, while strengthening corporate governance of the *Afores*, the retirement fund administrators.

- The Social Security Law establishes unemployment insurance as one of the obligatory branches of the scheme, mandates that the Federal Government will pay workers' and employers' contributions for low-income workers and makes pension payment options more flexible, so as to allow for scheduled withdrawal and annuity combinations.

In March 2014 the Chamber of Deputies approved the rules for introducing the universal pension, the unemployment insurance plan and reforms of several social security laws, such as the Social Security Law, the Saving Systems for Retirement Law and the Workers' Housing Fund National Institute (*Infonavit*). The Chamber of Senators is currently analysing the above-listed reform initiatives. The most important changes are described below:

Universal pension

The universal pension consists of a basic benefit for people of 65 and over living in the country[1] who do not receive a social security pension, as well as those who, being eligible for a pension, receive a monthly stipend of less than MXN1,092 (USD84). Funding is provided by the Federal Government, and initially the Social Development Ministry (SEDESOL) will be responsible for rolling out the plan, later transferring the programme operations to the Mexican Social Security Institute (IMSS) by 2016 at the latest.

The monthly sum to be disbursed as the universal pension in 2014 will be MXN580 (USD45), which will be adjusted annually according to the National Consumer Price Index. This amount should be revised upwards every year until it reaches a monthly figure of MXN1,092 in real terms, depending on the availability of resources but in fifteen years at the outside. We estimate that the fiscal cost of the universal pension in 2014, taking into account only those over 65 who do not receive a pension, will be 0.27% of GDP.

In order to retain the right to receive the universal pension payment, beneficiaries must demonstrate that they are alive, comply with prevention procedures in health matters and, in the event of being pensioners, not be in receipt of a monthly pension of more than MXN1,092. If the universal pension beneficiary dies, their family will be given financial support for funeral costs, equivalent to two monthly universal pension payments. The lower age limit for receiving the universal pension will be gradually moved upwards, with a review of this parameter every five years, in line with the increased life expectancy of Mexicans.[2]

On the other hand, with the aim of ensuring the financial sustainability of the universal pension, the federal government will provide a trust, administered by the Central Bank, for people who from 2014 onwards reach 18 years of age. The resources paid into the trust will be apportioned individually as and when information is supplied to identify the person fully, and provided they are registered with a Retirement Fund Administrator ("*Afore*" in the Spanish acronym). The amount of this contribution will be determined on the basis of actuarial and demographic studies.

The universal pension will take the place of the "*Pension para Adultos Mayores*" programme (Pension for Elderly Adults); however, upwards of 15 non-contributory pension programmes for elderly adults granted at the state level will continue to exist.

[1] Mexicans resident in the country and foreigners who have had Mexican residency for at least 25 years.

[2] The minimum age will be calculated by applying the factor of 0.87 to the most recent life-expectancy projection at birth, published by the National Population Council (CONAPO).

Social Security Law (SSL)

Reforms to the SSL cover the following areas:

1. Unemployment insurance

This establishes one of the obligatory elements of the scheme, with the aim of protecting the worker who has been contributing to the Mexican Social Insurance Institute but who stops being in work and is not carrying out any income-generating activity on his or her own behalf. There is also the possibility that workers in federated bodies and city councils may contribute to unemployment insurance, as well as regional bodies and institutions[3].

Unemployment insurance will be financed by resources from the Mixed Sub-account[4] and the Solidarity Fund, as well as from governmental resources, should the previously mentioned funds run out. The Mixed Sub-account receives an employer's contribution of 3% of the worker's contribution base wage (CBW)[5] while the Solidarity Fund is built up with contributions from the Federal Government equivalent to 0.5% of the CBW, and will be managed through a public trust set up by the Federal Executive, in a development bank subject to the operating rules defined by the Inland Revenue and Public Credit Ministry (SHCP). We estimate that contributions to the solidarity fund will be in excess of USD692 million a year.

The unemployment insurance provides for a maximum of six monthly payments to be paid out of the Mixed Sub-Account: the first payment for 60% of the average contribution base wage from the last 24 months, the second payment for 50%, and four payments of 40% of this amount. The benefit may only be exercised once every five years, for workers who have been unemployed for more than 45 calendar days and who have contributed at least 24 months' contributions over a period not longer than 36 months[6]. They must also not be receiving additional income and demonstrate that they have carried out the promotion, placement and training programmes run by the Department for Work and Social Provision. Should the Mixed Sub-account not have enough resources to pay this benefit, the worker will receive payments equivalent to a monthly minimum wage (MMW), financed by the Solidarity Fund, for six months. Should the Solidarity Fund not have enough resources, the federal government will pay the benefit directly, equivalent to 1 MMW for each month left to cover the benefit.

Furthermore, from 2017 onwards the worker may choose whether the mixed sub-account will be administered by *Infonavit* or by the *Afore* (retirement fund administrator) where it is registered. For this purpose, the I*nfonavit* Law lays down that this Institute should set up and operate a limited company with variable capital which will manage and invest the resources of the mixed sub-account, functions which it will exercise exclusively for three years. From 1 July 2017, workers will be able to request the transfer of resources from their mixed sub-account to the *Afore* which is administering their individual account, provided that the *Afore* in which they will invest their resources has recorded a greater net yield in the previous tax year than *Infonavit*'s company. It has been decided that *Infonavit* will charge a fee for administering the mixed sub-account resources. The pension's regulator (CONSAR) , will approve this fee and will supervise the investments and regulate the accounting policies, corporate governance and auditing of *Infonavit*.

---

[3] In the case of contributors to the State Workers´ Safety & Social Security Institute (ISSSTE), the current law provides for the unemployed worker to be able to withdraw a sum from their retirement, redundancy and old -age sub-account. This sum is the lesser of: 75 days of their own Basic Wage over the previous five years, or 10% of the balance of their own sub-account, 46 calendar days after they become unemployed.

[4] The Mixed Sub-account will form part of the individual's retirement account, resources from which may be used to finance the unemployment insurance, top up the resources of a housing sub-account or else to contract an annuity or scheduled withdrawal.

[5] The employer's contribution of 5% of the CBW which is currently spent on housing will be divided into two parts: 3% will be allocated to the Mixed Sub-account, while 2% will remain in the housing sub-account.

[6] Seniority will be taken into account from 2013, so from 1 January 2015 onwards those who meet the requirements may request this insurance. For those who are unemployed in 2015 and 2016, should the balance in the mixed sub-account not be enough, up to 60% of the accumulated balance in the housing sub-account may be disbursed, provided that this is not committed to a housing mortgage.

Should the resources of the mixed sub-account be used to pay a mortgage, the employer's contributions pertaining to this sub-account will be applied exclusively to reducing the unpaid balance of the loan owed by the worker whilst the loan is in force. Should the working relationship end during the life of the mortgage, the unemployed worker may receive benefits of a fixed monthly amount equivalent to a minimum wage packet for six months, once every five years, paid for out of the Solidarity Fund. This also applies in the case of workers who took out a loan before the new law was passed.

Only temporary workers may not use the Solidarity Fund, given their repeated unemployed status, which could affect the financial balance of the institutions involved in managing it. For this reason, they may only receive resources that have accumulated in the mixed sub-account[7]. This is in order to avoid creating a distortion in the labour market which would create an incentive for the repeated loss of employment and for undeclared income.

2. Withdrawals for unemployment charged to the individual retirement account are eliminated

The introduction of unemployment insurance eliminates withdrawals for unemployment being charged to the Retirement, Redundancy & Old Age (RRO) sub-account of the individual account administered by the *Afores*[8]. The provision of these resources implied a proportional reduction in the weeks a worker has contributed, but established the option of paying back the resources to recover those weeks of "lost" contributions.

3. Contributions for low-waged workers

The subsidy for employment will be used to cover workers' quotas. Thus, the Federal Government will cover workers' contributions for those workers whose CBW is between one and two times the monthly minimum wage. In compensation, the subsidy for employment will be adjusted in the amount of workers' quotas. With this modification, which does not have a net effect on the employee's net income, two tax instruments come into play to reduce the barriers to the formal economy for lower-income workers.

4. Regime for registering on Social Security

In order to incentivise workers who are currently not registered on Social Security, the Federal Executive has been empowered to grant temporary administrative capacities to employers included in the registration scheme laid down in the Income Tax Law, so that they comply with the obligations set out by the SSL for registering their workers and paying the corresponding employer/employee quotas.

The administrative faculties granted will at no point compromise the resources of the IMSS in financing the respective benefits, given that the Federal Government will offset the differences generated as a result of these faculties, in the total of the worker-employer quotas. Likewise, the administrative faculties will be subject to gradual implementation over five years, which will enable employers from the outset to meet their constitutional obligation of registering their workers in the mandatory IMSS regime, without a financial impact compromising their company's financial viability in the short term.

5. Payment for those who are not entitled to receive a pension

In the case of those workers who between 60 and 65 years old, no longer in work and who have not contributed enough to receive a redundancy or old-age pension , the worker may keep the balance of their individual account in an *Afore* and make programmed withdrawals (PW) from it, or else carry on contributing

[7] In this case, the payment in a single disbursement, equivalent to twice the average CBW over the last 26 weeks of contributions registered on the unemployment insurance, will be taken into consideration.

[8] The final CBW may be withdrawn up to 30 days, with a limit of 10 MW, or, should the worker have more than 5 years of contributions, the lower sum of the following: 90 days of CBW or 11.5% of the balance of the RRO sub-account.

until they have paid in enough weeks to have a right to the pension. If the funds are insufficient to obtain a scheduled withdrawal that is greater than or the same as the minimum wage, the worker will have the option of making monthly withdrawals of a MMW until the balance of their individual account is exhausted.

6. Flexibilising options for paying retirement benefits

Up to now, the options for paying an Old-age or Redundancy pension were either an annuity or PW. In order to make these options more flexible, from now on both schemes can be combined, that is, some of the resources can be received as a PW, keeping the balance of the individual account in the *Afore*, and using another part by taking out an annuity with a pension insurer.

Retirement Saving Systems Law (RSSL)

In order to strengthen retirement saving systems (RSS), the following modifications are proposed:

1. Changes to the *Afores*' fee-charging system

The current fee scheme on balances managed, as charged by the *Afores* and the average for which is 1.24% in 2014, sets out no relationship between the yields achieved by the *Afores* (performance) and the fees charged. So, the new fee scheme will consist of two components: one calculated as a percentage of the value of the assets under management, and the other calculated according to fund management performance[9]. In addition, in those cases where an *Afore* omits to present their annual fee proposal for authorisation by the National Commission on the Retirement Savings System (CONSAR), that administrator will be obliged to charge the lowest fees in the market: if the fee proposal is rejected it will have to charge 75% of the SAR's lowest fee.

2. Greater diversification in the *Afores*' investment regime

Up to now, *Afores* could only invest in financial assets subject to public offer; however, from now on they may finance productive projects which are privately listed (direct negotiations with issuers or companies). The Central Bank will decide with which types of securities the investment firms specialising in retirement funds (Siefores) may carry out repurchase agreement operations and lending operations with government and banking securities. In both cases, the criteria, guidance and limits laid down by the Central Bank and the National Banking & Securities Commission (CNBV) must be followed, in order for the *Afores* to be permitted to make these investments.

3. Adopting a new model for transferring individual accounts

The worker is currently allowed to change *Afore* once a year; however, according to CONSAR, a very high percentage of transfers (50.9%) are made to *Afores* with lower net yields. Thus, with the aim of improving the quality of the transfer and reducing the commercial expenses of *Afores*, the transfer right may be exercised once every three years, with an option to do so after a year, provided this change is to an *Afore* which offers better yields and shows higher performance[10] in the services provided to workers. Likewise, the workers will have the right to keep their individual account with the same administrator for an additional period of a year, renewable for equal periods.

[9] The component on performance will be calculated based on the yields that workers have obtained from the investment of their resources, and may represent up to 0.3% of assets under management

[10] Up to 20% of the parameter used for the transfer right may be based on the performance indicator in services. The CONSAR will carry out the calculation for this indicator according to the provisions issued to this effect

4. Sending of pension forecast reports to workers

The *Afores* will have to send workers a pension forecast report once a year, giving information about their retirement savings situation and their pension outlook (different pension scenarios that the worker may receive on retirement), with the aim of encouraging more awareness and the savings culture in the long term on the part of the system's savers. Likewise, the advertising activity that the *Afores* can carry out will be extended.

5. New allocation rules for new workers

In 2014 there are 10.6 million allocated individual accounts, that is, of those workers who did not choose an *Afore*, who pay the same fee as a registered account without receiving any service in exchange. From now on, in order to decide to which *Afore* the CONSAR should assign these accounts, the criterion of lowest fees will be introduced as a differentiating feature (as well as greater net yield, better services and higher registry of allocated accounts). In this way, the allocated accounts will pay lower fees and the *Afores* will have greater incentives to register workers who stay on as allocated clients.

In the second place, the Service Provider function will be transformed, so that it provides better yields to workers.

6. Strengthening of the *Afores'* corporate governance

Corporate governance of the *Afores* is to be strengthened, by clearly establishing the responsibilities and functions of the government bodies, whether the administrators themselves with their investment funds or their key executives. There is a provision for the creation of an Audit Committee and a Corporate Practice Committee, with the participation of independent members to improve the administrators' internal supervision and control mechanisms. Similarly, the requirements which independent board members and the regulatory controller must meet are strengthened, in compliance with the best corporate governance practices. All of the above will provide greater certainty and clarity to the activities of the administrators and their investment funds.

7. New operating obligations for the *Afores* and new supervisory faculties for CONSAR

Guidelines have been set down for better operating, technological and legal risk management in the RSS. Special emphasis has been taken to ensure the confidentiality of information and documents about operations and services, as well as granting new faculties to the CONSAR:
a) To regulate financial groups, by virtue of the fact that *Afores* already exist which are the dominant financial institutions within the financial groups to which they belong, in the light of which the CONSAR is given faculties to regulate, authorise and supervise this area.
b) To exercise immediate preventive and corrective functions, in order to limit as effectively as possible any kind of problem that might arise during RSS operations which might put workers' interests at financial or operating risk.
c) To suspend or limit the operations carried out by any of the participants of the RSS, should they stop observing the applicable regulations.
d) To approve, through the Board of Governors, the guidelines followed by the CONSAR itself when it informs the general public about any sanctions imposed on an *Afore*.

8. Handling workers' requests and/or complaints

The *Afores* will be required to deal with workers or their beneficiaries, help them, guide them, follow up issues on their behalf and resolve their questions and requests to do with the management and operation of their individual accounts, as well as the administrative procedures arising from them. For this purpose, in the event of the solution requiring the intervention of third parties, the workers or their beneficiaries should be given guidance as to which actions and measures they ought to take. Likewise, services and products in the area of pensions, once vetted by the CONSAR, should be provided.

9. Voluntary saving incentives

An incentive scheme for increasing voluntary contributions for workers affiliated to the IMSS has been set up. For each peso contributed voluntarily by the worker, the Federal Government will contribute 20 cents, to an upper limit of MXN60 (USD4.60) a year. In addition, the *Afores* will be able to offer incentives to workers making voluntary contributions, such as accepting voluntary contribution deposits using payment networks (similar to banking agencies).

10. Greater legal guarantees and easier procedures for beneficiaries

In the event of an individual-account holder dying, the *Afore* will have to pay the balance on the individual account in a single disbursement to the beneficiaries designated by the worker, thus avoiding having to start a legal action, as is the case at the moment. To this end, the names of the beneficiaries, as well as the proportion attributable to each, will be introduced into the text of the fund management contracts, names and proportions which may be changed at any time by the account holder.

Valuation

The universal pension sets out a basic pension for elderly people who are currently not covered or who receive a monthly pension of less than USD84, financed with fiscal resources. This pension substitutes the "*Pension para Adultos Mayores*" programme, but leaves the other non-contributory pension programmes at state and municipal level in place. Although the payment of this benefit represents the introduction of a zero-pillar in the Mexican pension system, the initial pension of USD45 a month is equivalent to 53% of the minimum welfare line as calculated by the National Council for Assessing Social Development Policy (CONEVAL), so it may not be enough to avoid elderly people finding themselves in poverty. However, given that the amount of the pension is smaller than the IMSS minimum guaranteed pension (USD200 a month), there are no incentives for workers to stay in the informal labour market in order to secure the universal pension. Furthermore, the federal government will make contributions to pre-finance the universal pension for people who turn 18 from 2014 onwards. These resources will initially be paid into a trust, and will be put in a person's name when that person has an account in an *Afore*. Although the amount of this contribution will have to be enough on an actuarial basis to guarantee the payment of the universal pension at retirement age, we consider it sensible that the trust should be administered by the Central Bank. Nevertheless, we recommend that the said contribution remains in the trust and is not put in a individual account, since there will be people who at the end of their working life will not meet the requirements for receiving the universal pension.

Unemployment insurance, on the other hand, can serve to stabilise the economy during recessions; it does not cause problems in public finances, it helps labour re-integration, it does not represent an increase in labour costs for the employer and it generates an incentive for formal employment. We believe that in the short term housing demand will be unaffected, given that it does not prevent access to workers who currently qualify forit, nor does it give access to those whose working situation, whether as a result of unemployment or because they do not have enough points, does not currently qualify them to receive a mortgage under Infonavit's operating conditions. On a longer time horizon, as the sum of the mixed sub-account is used on the unemployment insurance, the resources available for *Infonavit*'s loan supply can be run down, which is why we believe that the system should establish the option for the worker to be able to withdraw the resources used in the mixed sub-account, once he or she has re-joined the labour market, in order to recover both the balance and the equivalent in qualification points to be given a mortgage loan or to increase the payment on their pension if they so desire. Furthermore, we consider that the company which *Infonavit* will set up to invest the resources from the mixed sub-account should not charge a fee. When it comes to the investment regime, given that the resources may be used in the short- or medium-term, whether for unemployment or housing, we recommend considering an investment horizon that is matched to the fund's possible liquidity requirements.

We believe that the RSS Law reforms will stimulate greater competition between *Afores*, based on offering better conditions to savers, using new transfer rules and a new fee scheme which introduces a percentage on performance in the yields obtained. In addition, the new provisions to strengthen corporate governance of *Afores* and to flexibilise their investment regime will mean that RSS performance can be improved to benefit workers. Specifically, the fact of allowing *Afores* to invest in private offering securities is seen as a hugely positive change, since it will allow investment to become more diversified. Thus, the *Afores* can now invest in private equity assets, as pension funds do in advanced financial systems, since it is more complex and less desirable that they should be funded by public share issues. Now CKDs (development capital certificates) can be issued in private placements, which are the best arrangement, since by their very nature they are instruments whose characteristics are better suited to private issue.

In terms of incentives for voluntary saving, which on the one hand establish new channels for being able to make voluntary contributions through payment networks, these are a positive measure aligned with public policies promoting the population's financial inclusion. However, we believe that although it is a first step, the limit of USD4.60 a year for the governmental contribution for incentivising voluntary saving by workers does not go far enough. One idea for incentivising voluntary saving is to introduce a scheme similar to the "*Save More Tomorrow*" scheme in the USA which enables workers who choose to do so to save automatically a percentage of their future wage rises for pension purposes (in 401(k) pension plans).

The changes to the SS Law incentivising the incorporation in the social security system of workers who are currently not registered, as well as the governmental subsidy of worker-employer quotas for low-waged workers, are considered positive because they promote the formal employment economy. Furthermore, new payment rules for those refused a pension, which establish that the resources in the individual account should be paid through either programmed withdrawals, or monthly payments equivalent to 1 MMW (should the balance be insufficient), limit the likelihood of a worker who does not meet the requirements for receiving a pension obtaining the resources in a single disbursement. This policy is in line with international regulation trends in social security, which recommend a constant flow of income to minimise the possibility of the elderly person having no resources when they retire. In terms of the measures to make the options of paying benefits for retirement more flexible by being able to combine scheduled withdrawals with annuities, the latter make it easy to diversify the sources of income on withdrawal, and encourage better management of the risks to which workers are exposed when they retire, such as longevity and financial risk. The balance managed by the *Afores* in the form of scheduled withdrawals means that the financial yields of the individual account can be used, as well as the remaining balance being inheritable should the pensioner die; whereas taking out an annuity transfers the risk of longevity to the pension insurers, since the payment of this benefit will continue as long as the pensioner lives.