

Surprising AFORE Results in Mexico

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Mexico's privatized compulsory pension system (*AFORE*) that came into existence on July 1, 1997 has produced quite a number of surprising results, which I would like to share with readers. The number of *AFORE* members grew rapidly during the first 18 months. By the end of 1998 almost 14 million members had already signed up for an *AFORE* (see the Table). This includes about 10 million active contributors (with the remaining four million, such as the unemployed and the recently retired, not contributing at the time). The total number employed in the formal sector in Mexico is slightly under 15 million. Thus, there has been a remarkably swift move on the workers' part to become members of the system. In this sense, over a very short period the system has achieved what was intended. Many observers were skeptical as to how quickly the new system would catch on: it is the speed that has been a surprise. In addition, the amount of money invested in the system has increased steadily. In its first year (July 1997 to July 1998), investments stood at about US\$3 billion (at an exchange rate of 10 pesos to the US dollar). Over the following seven months (July 1998 to January 1999), another US\$3 billion was invested. If this trend continues, in 25 years' time *AFOREs* will represent 40% of Mexico's gross domestic product.

CONSAR (the supervisory body for *AFOREs*) has stipulated that a minimum investment of 51% must be in inflation-linked bonds and at least 65% should be in assets with maturities of no more than 183 days. On January 31, 1999 over 75% of investments were in inflation-linked bonds (called *BONDE91*

and *UDIBONOS*). Another 15% were in *CETES* (Mexican Treasury bills). The average maturity of investment portfolios was 111 days, well below the 183 days stipulated. Because of the severe portfolio restrictions, there does not seem to be much variation in the funds' rates of return. The best performing fund in real terms over the initial 19-month period was Profuturo GNP, with 8.16%. Tepeyac was the worst with 5.79%, representing an overall average of 6.96%. Is that good? If there were no charges in any of these funds, it would be very good. Unfortunately, charges account for 20-25% of every peso contributed. Thus, after charges have been deducted, the rate of return is negative. One argument used by fund managers to justify these high charges is that funds are managed to maximize the returns for members, in which case, the funds should perform much better than a portfolio where the money is invested simply in *BONDE91* and *CETES* that meet the minimum statutory requirements. In such a fund, the rate of return would have been 6.2% and would have been passively managed and thus free from commissions. Why isn't anybody waking up to this fact?

Fund managers generally argue that much of the commission charged goes into advertising and other publicity in order to attract more customers. You would therefore expect to find a very strong relationship between publicity costs and the number of members in each fund. However, I have gathered some data on the publicity costs of *AFOREs* and the number of members they have and, unfortunately, this is not the case. To put it another way, funds are wasting a great deal of money on advertising that does not produce results.

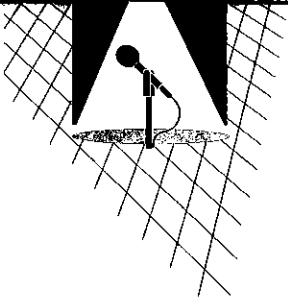
In Chile, one of the main features of the privatized pension system is the number of people switching funds: approximately one in three individuals changes fund every year. This imposes a huge cost on the system. In the case of Mexico, there is very little evidence of people switching funds. In the second half of 1998 (once fund-switching was allowed) fewer than 200,000 members switched funds. Of the 10 million active contributors this represents a very small proportion indeed. However, do we know who the people switching funds are? My research indicates that switching is much more common among high-income than low-income individuals.

Are *AFOREs* beneficial for new entrants to the system? To answer this question, we need to look at what proportion of the working wage the new system will replace when these workers retire. With a 5% real rate of return and the current costs of the new system, less than 50% of salary will be replaced at retirement for the average worker. Only for low-income workers (those on the minimum wage throughout their working lives) is the replacement rate around 90%. Thus, many Mexican workers will face a huge cut in their standard of living in retirement unless they save additional money on their own.

AFORE Membership at Year-end 1998

<i>AFORE</i>	Number of members
Atlántico Promex	188,205
Banamex Aegon	1,568,595
Bancomer	2,226,239
Bancrecer Dresdner	607,522
Bitel	1,304,719
Capitaliza	52,998
Confía Principal	114,340
Garante	1,533,250
Génesis	141,542
Inbursa	316,909
Profuturo GNP/Previnter	1,929,819
Santander Mexicano	1,968,585
Sólida Banorte Generali	1,190,605
Tepeyac	141,282
XXI	423,813
Zurich	119,251
Total	13,827,674

Source: *CONSAR*



EFRP/NAPF Conference: Monaco

The EFRP/NAPF International Conference 1999 was held at the Sea Club Conference Centre in Monte Carlo in early October. This two-and-a-half-day conference, which was attended primarily by Europeans, offered four themes (namely, 'The European Pensions Directive?', 'Topical issues', 'Today and tomorrow' and 'The euro'). Within these themes speakers were given specific subjects to address.

NAPF CHAIRMAN'S INTRODUCTION

Mr Alan Pickering, Chairman of the UK's National Association of Pension Funds, in his apposite introductory remarks, made the point that we could not allow people to be under the illusion that a working career from age 25 to 55 would bring them a two-thirds pension. Retirement could no longer be calculated as a mere five years and it would continue to increase. He thought it was silly to perpetuate the myth that people could work for just 30 years and expect to be comfortably off in retirement. If State pension age were deferred to 70, this would give a clear signal to the electorate. Employers would then have the choice of replicating what the State was currently providing or telling employees to provide for themselves. Governments should play their part by providing fiscal advantages, but they should *not* interfere by saying how benefits should be provided (for example, via defined benefit versus defined contribution arrangements) or how much they should be. Among the many reasons for the move from defined benefit to defined contribution arrangements, Mr Pickering thought two were sad:

- fashion, and
- regulatory/fiscal considerations.

He viewed the pay as you go versus funding debate as something of a sideshow, although funding could certainly help, because there was a big advantage when making a promise to back it up with something real: it imposed a discipline. However, he warned that, as funds were accumulated, there would be those who looked at all these assets and "got ideas". He thought it was important to fire a shot across the bows of those who might not want to put the assets to the most efficient use. He was not advocating that those voices should be ignored; rather, that those who had ideas for these assets should be part of an adult debate about directing resources into non-market activities. What mattered was that the debate should be taken at the level of the head and not of the heart.

THE EUROPEAN PENSIONS DIRECTIVE?

Mr John Mogg, Director-General of the Internal Market and Financial Services (DG XV) of the European Commission in Brussels, saw the current pace of change in European Union (EU) financial markets as little short of breathtaking. It reminded him of the Chinese curse, "May you live in interesting times." Regulatory principles and supervisory arrangements that had served Europe well in recent decades were now under

examination. Change was inevitable if we were to uphold financial stability, seize the unique opportunity offered by the euro for the creation of a modern financial infrastructure and pave the way for the smooth enlargement of the EU financial market to the candidate countries. The introduction of the euro was proving to be a powerful force for reshaping EU financial markets. He noted that the incoming Commission was placing the creation of a modern regulatory framework for EU financial markets at the centre of its work programme. There had been unqualified support for the Commission's Financial Services Action Plan, issued in May this year. This plan, which had received the unequivocal backing of ECOFIN* Ministers and Heads of State and Government at the recent European Council meeting in Cologne, was a wide-ranging document comprising 43 measures intended to serve four objectives, as follows:

- completing the single wholesale market;
- facilitating and securing access to retail markets;
- modernizing prudential control; and
- creating a fiscal environment that did not hamper cross-border activities.

He said that five forum groups had been set up (with market practitioners, consumers, etc.), in order to get a market feel from the players. The Commission was placing financial services in a broader framework. Mr Mogg stressed that – like the European Federation for Retirement Provision – the Commission wanted to see a liberalization of the market. However, he described the ambitions of the EFRP as "lofty" and asked who was wrong, answering, "We're both right!". He felt that the opportunities were there but where the Commission was more cautious was in understanding that account had to be taken of the structure and organization of pension provision as well as of pension funds in the 15 different member states. The Commission had also to ensure that liberalization of investment and management went hand in hand with the best possible protection of beneficiaries. While the European Community (EC) already had a comprehensive set of prudential rules for banks, insurance companies, investment firms and investment funds, supplementary pension funds, along with reinsurance, were still the only financial institutions to be regulated exclusively at national level. In some countries restricted investment opportunities impeded pension funds from using the most efficient and sound investment policy, which acted to the disadvantage of employers and beneficiaries. Furthermore, heterogeneous investment rules tended to hamper EU capital market integration. Excessive restrictions on private-sector securities limited the benefits in terms of the growth, job creation and competitiveness expected from a single, deep and wide EU capital market. For example, pension funds were often prevented from participating in the financing of small and medium-sized companies. Lastly, the differences that EU citizens experienced when wanting to work 'cross border' inhibited labour mobility.

Mr Mogg remarked that in the decades ahead member states would have to safeguard pensioners' standards of living,

* Economic and Finance

maintain solidarity between the generations and contain public expenditure. To support member states' action in response to these demographic trends (increased reliance on pension funds etc.), the Action Plan and the recent Communication on Supplementary Pensions underlined the need to draw up an EC framework in this area on two main planks:

- a directive covering the investment and prudential rules applicable to pension funds, in order to protect beneficiaries and facilitate cross-border investment and management, preparing the ground for cross-border pension fund membership; and
- the progressive co-ordination of national tax arrangements governing supplementary pension products with the object of eliminating the current discrimination that affects institutions wishing to market their services on a cross-border basis.

As regards the directive, he said it was hard to be definite about timing but we were probably talking about the first half of next year. On tax, he was aware that some member states would find ever greater co-ordination very difficult to come to terms with.

Mr Mogg then discussed the three main features of the forthcoming proposal for a directive on pension funds. The first was that the directive would be specifically targeted at pension funds. Some member states or industry representatives had expressed the concern that the Commission might be preparing a directive on all occupational pension services regardless of the nature of the provider, but this was not so. There were already specific EC frameworks for banks, insurance companies and investment companies and, as it was necessary to be consistent with existing legislation on financial services, pension funds needed their own legal framework that took account of their special characteristics. The Commission did not want to use the same rules as for life assurance, although there might be similarities where a pension fund itself offered a financial guarantee.

The second feature was that the directive would pursue the same internal market objectives as previous Commission initiatives. This meant that freedom of investment and the freedom to appoint any duly licensed manager/custodian established in the EU would be two key objectives of the directive. A *qualitative* approach to supervision would therefore be proposed. It would, however, be consistent with the overriding need to ensure security. He said that the Commission saw the need for pension funds to have enough flexibility to define an investment policy that really suited the nature and duration of the liabilities. This was seen as a source of both efficiency and security. However, the Commission was aware that the pure prudent person principle was not acceptable to all member states. Some argued that a currency-matching requirement (between commitments in euros and assets in other currencies) was necessary - they had relied on quantitative investment limits for certain asset categories and their supervisory systems functioned on the basis of clear quantitative rules. For them, switching from quantitative limits to a purely qualitative system was seen as technically difficult and legally uncertain. Such member states would, of course, have to justify their demands strictly on prudential grounds and any compromise would not jeopardize the freedom that pension funds in some member states already enjoyed. Regarding investment rules, the Commission's objective would be first to preserve the freedom where it existed and, secondly, to increase it as much as

possible in other member states. By the same token, member states should not impose constraints that prevented pension funds from implementing proper asset/liability management strategies and, at the same time, investment in equities and unlisted securities should not be excessively penalized.

The third feature was that this proposal would be more ambitious than previous Commission initiatives. Here he highlighted two angles:

- there would be an appropriate prudential framework so as to ensure security (in particular, the proper calculation of liabilities, licensing, fit and proper criteria, etc.); and
- the Commission was willing to establish the necessary mutual recognition of prudential supervision so that cross-border membership of pension funds became possible.

The two objectives were linked. Before allowing funds to manage pension plans on a cross-border basis, all member states needed to reach a consensus on how beneficiaries' protection could be ensured. The idea was to liberalize pension fund investment and management rules as much as possible. The Commission believed this would only be achievable and acceptable to all member states and the European Parliament if these liberalizing measures were incorporated into a proper prudential framework. The intention was not to impose detailed regulation but to define good practices and develop broad principles that could cater for the diversity of pension funds/regulations in the member states. Achieving the mutual recognition of the member states' prudential regimes was essential, so as to pave the way for some form of cross-border affiliation.

Tax co-ordination was a prerequisite for achieving cross-border affiliation. For the time being, it was in most cases impossible to obtain tax relief on contributions paid to institutions that were established in another member state and this was a major reason why a pension fund could not manage plans on a cross-border basis. The Commission wanted to try to find a solution at the political level that could be applied uniformly for the benefit of all citizens. This would provide greater legal certainty for employees and "economic operators" and would remove fiscal disincentives to the exercise of their basic right to freedom of movement and freedom to provide services respectively. He said that this issue had been discussed with member states within the framework of the Tax Policy Group. Discussions were based on three commonly agreed principles:

- no harmonization,
- no discrimination, and
- no revenue shortfall.

He explained that 'no harmonization' meant that member states' systems of pension taxation should be co-ordinated in order to eliminate or neutralize the present inconsistencies between them, thus avoiding double taxation and double exemption.

In the longer run and in line with its step-by-step approach, the Commission could see its work being focused on:

- finding basic criteria of what formed a genuine old-age scheme for general tax recognition;
- establishing tax rules applicable to transfers of acquired pension rights;