Pensions in Mexico
A Long-Term Risk

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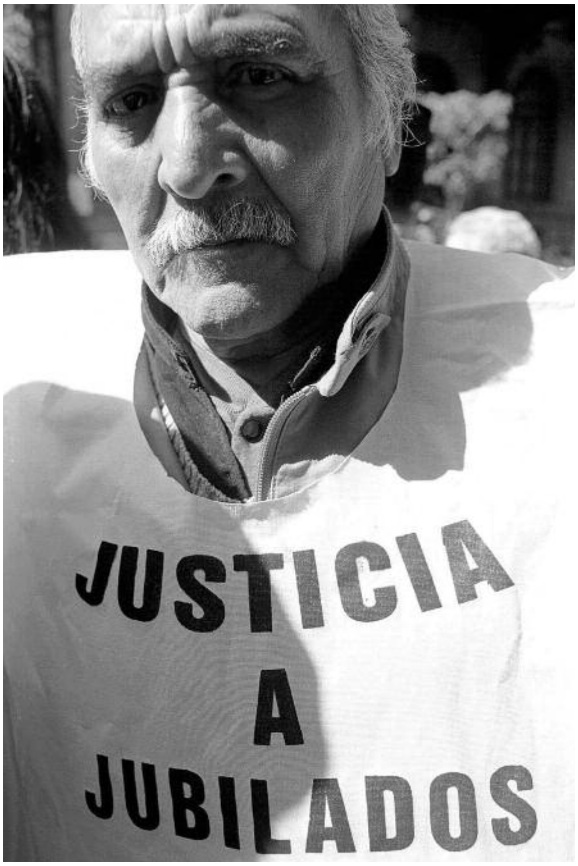

Victoria Valtierra/Cuartoscuro

"Justice for pensioners."

With the coming of economic globalization, over the last two decades, pre-existing problems in pension systems in practically all the countries of the world have sharpened. On the one hand, with increased life expectancy, the population pyramid now contains a larger number of retired persons and people of retirement age; the increase in unemployment has lowered the number of contributors to social security systems; and on the other hand, financial liberalization and the economic adjustments brought by globalization have sharpened pension systems' financial problems.

In Latin America, the crisis of the 1980s and the effects of structural adjustment aggravated unemployment and prompted an increase in informal labor: this led to a financial crisis in pension systems, which motivated increased pension reforms in the following de-

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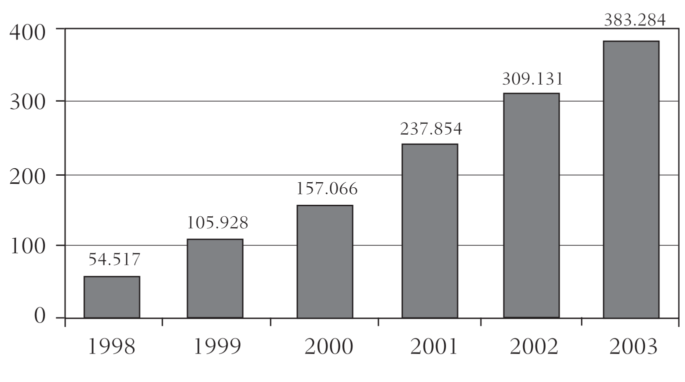
cade in 15 different countries, among them Mexico.

Even though pension reforms differ from country to country, their commonality is the private administration of workers' savings funds, replacing systems of distribution or of partial collective capitalization with regimes of full and individual capitalization. This transformation was fostered by the international financial institutions and the Latin American governments themselves in view of the crisis in public finances, and essentially they transfer most of the responsibility to workers and employers, leaving the state to fulfill a role of aid by guaranteeing minimum pensions for those enrolled in pension schemes and poor senior citizens.[1]

These reforms sparked a significant debate among important international institutions like the International Labor Organization (ILO) and the International Social Security Association (ISSA) on the one hand, and the World Bank on the other. The former argued that these reforms' risks would be greater than those that already existed given the presence of unpredictable economic factors like inflation, the volatile yield of pension funds, the fluctuating performance of the gross domestic product (GDP) and the decisions by the workers themselves. Both the ILO and the ISSA rejected the World Bank's opinion that the public pension systems had failed. Both recommended the existing systems be "perfected," or, in other words, a non-structural reform. In contrast, the World Bank proposed a radical (structural) change like the Chilean reform carried out in 1981 which would replace public systems with privately managed pensions, saying that they were better.[2] In addition, the bank mentioned other negative attributes of the public systems: the low pensions, the inequality of the different regimes, the system's non-existent contribution to domestic savings as well as low coverage. Finally, the vast majority of countries with pension problems, including Mexico, opted for the radical reform recommended by the World Bank, i.e. privatization, without realistically gauging its probable social costs.

Graph 1

Investments of Workers' Savings in Securities (billions of pesos)



Source: Comisión Nacional del Sistema de Ahorro para el Retiro (Consar).

The Chilean experience, considered the most successful, does not confirm as expected the efficiency of private management. Among other things, the commissions of the Pension Fund Administrators (PFAs) are high and, even so, they still have problems of profitability: for example, in 1995, the funds' negative profitability (-4.7 percent) caused losses to the workers. According to Regina Clark, the ex-attorney general of the Institute of Insurance Normalization of Chile and an expert in pensions:

> In Chile, fewer than 50 percent of the 6.8 million people affiliated to PFAs contribute monthly; the replacement rate is 52 percent, while the promise was that workers would retire with 80 percent of their last wage; the fiscal cost is 5.9 percent of GDP, while the six operating PFAs handle U.S.$38 billion, the equivalent of more than 50 percent of GDP.[3]

The Privatization of Pensions In Mexico

Pensions of workers affiliated to the Mexican Social Security Institute (IMSS) were definitively privatized by the new

IMSS law passed December 8, 1995.[4] Scheduled to become effective January 1, 1997, the date was postponed until July 1, 1997 due to the state's financial inability to cover its contributions.[5]

The monies collected are managed by the Retirement Funds Administrators (Afores) with an account for every worker.[6] Each of the Afores is accompanied by a Retirement Funds Investment Society (Siefore), in charge of investing the savings deposited in securities and paying the pension when a worker who retires chooses the programed retirement option.[7] The worker may also choose a lifetime income, which he will transact with an insurance company to which the individual account funds will be handed over.

The workers' savings funds have increased significantly: between July 1997 and December 1998, they came to 54.517 billion pesos, a sum which increased seven-fold in the following five years. By 2002, the accumulated savings fund had reached 10 percent of GDP.

The privatization of pensions has been presented as a great achievement for workers and Mexico's economy. It is said that profitability from July 1997 to September 2002 was 28.6 percent a year,[8] and in 2003, it is estimated at 14.5 percent (from December 29, 2002 to August 29, 2003).[9] The reality is that yields for workers are much lower when the high commissions charged by the Afores are deducted and inflation is taken into account.

A great deal of pressure is being brought to bear for workers' savings funds to invest abroad with the argument that it would raise profitability.

Afores' and Siefores' Profitability

Let's look at the Siefores' income statements to get an idea of workers savings funds yields from 1999 to 2003. We can see in Table 1 that the main revenues come from interest accrued by the savings funds when invested in securities ("real and nominal rate instruments"), which came to 22.59 billion pesos in 2002, representing 82.4 percent of revenue. In second place is the profit from stocks that the Siefores sell to workers (presented as the sale of real and nominal rate instruments), for 4.378 billion pesos, which come to 16 percent of revenues.[10] Finally, there are the other earnings (premiums on government bond trading and other revenues), which represent only 1.6 percent. If general Siefores expenditures (1.032 billion pesos in 2002) are subtracted from total revenues, the result is a net profit of 26.384 billion pesos, which it is understood would go into the workers' savings funds. But commissions come to 10.961 billion pesos, which means that the workers had to pay out the equivalent of 41.5 percent of the net profits obtained by the Siefores in 2002. As Table 1 shows, the highest percentage of commissions was charged in 2002 and the lowest in 2003 (up until October).

We still have to analyze the impact of inflation on the profitability of workers' retirement savings, taking into account that the investments in securities and other assets shown on the Siefores' consolidated balance sheet as of December 31, 2002, came to 309.130 billion pesos. Of these, only the real rate instruments do not devaluate because they pay a real yield, while the nominal rate instruments do drop in value because of inflation. Since 2002 inflation was 5.7 percent, the nominal rate instruments lost 6.085 billion pesos, so that the real value of the investments was 303.046 billion pesos (see table 2). If the 5.7 percent inflation, or 1.504 billion pesos, is subtracted from 2002 net profits of 26.384 billion pesos, and the value of the nominal rate instruments (6.085 billion pesos) is also subtracted, the real net profit was 18.795 billion. Finally, if we subtract from this amount the commissions charged by the administrators, the result is a final real net profit of 7.834 billion pesos, or 2.6 percent of the real value of the 303.046 billion pesos in investments (see table 2).

We can see that the real net yields (see the bottom line of table 2) vary from year to year, with the highest in 1999 (6.8 percent) and the lowest in 2002 (2.6 percent). This shows that the yields for the workers were not as high as the National Savings for Retirement System Commission (Consar) would lead us to believe. In its monthly yields chart for October 2002, it shows a profit of 28.6 percent in the 63 months of operation.[11] This, however, does not take into account either the effects of inflation or the commissions charged the workers.

For the owners of the Afores, however, profitability is very high: in 2002, their profit before taxes came to 2.693 billion pesos. They paid 926 million pesos in taxes, which left them with

Table 1
Siefores Income Statements and Afores Commissions (1999-2003)
(billions of pesos and percentages)

	1999[1]		2000[1]		2001[1]		2002[1]		2003[2]	
	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%
Interest on investment in securities	14.852	80.8	17.260	78.3	23.783	80.6	22.590	82.4	22.332	74.7
Profit on sale of real and nominal rate instruments	3.335	18.2	4.478	20.3	5.254	17.8	4.378	16.0	7.150	23.9
Borrowing of securities and other revenues	0.185	1.0	0.301	1.4	0.455	1.6	0.448	1.6	0.431	1.4
Total net revenues	18.372	100.0	22.039	100.0	29.492	100.0	27.416	100.0	29.913	100.0
Less general expenditures	0.523	2.8	0.712	3.2	1.143	3.9	1.032	3.8	1.124	3.8
Net profit	17.849	97.2	21.327	96.8	28.349	96.1	26.384	96.2	28.789	96.2
Afores' commissions	6.958		9.780		10.399		10.961		10.021	
Commissions/ net profit		39.0		41.2		36.6		41.5		34.8

[1] From January 1 to December 31.
[2] From January 1 to October 31.

Source: Afores and Siefores financial statements, Comisión Nacional del Sistema de Ahorro para el Retiro (Consar).

1.767 billion pesos in net profits. If we take into account that the paid-in equity or capital came to 6.936 billion pesos, their real yield was 25.5 percent. In 1999, Afores' profits were 20.9 percent; in 2000, 25.7 percent; in 2001, they went up to 45.6 percent; and until October 2003, they were already at 55.7 percent (these calculations were made based on data published in the Afores' and Siefores' financial statements).

Afores/Siefores Unresolved Problems

The Afores have committed irregular business practices, among which are misleading publicity; multiple accounts (in two or more Afores); the inappropriate cancellation of accounts; a lack of accounting entries or erroneous entries of contributions, etc. Based on workers' complaints, the National Savings for Retirement System Commission (Consar) has levied fines on practically all the Afores. For example, in the first two months of 2000, it fined 10 Afores 1.818 million pesos.

In addition to the aforementioned practices, they were also fined for the lack of financial statements about transfers among Afores, late information to Consar about field representatives leaving the Afores' employ and a lack of information about voluntary contributions.[12]

The Risks of the Privatized Pension System

The most important longer-term risks for our pension system are inflation, generally linked to the crises of the Mexican economy, the continual deficit in formal job creation and workers' low wages. A bout of hyperinflation could wipe out the real value of the savings funds. For example, during the 1994-1995 crisis, inflation averaged around 60 percent. In addition, the jobs deficit and low wages could prevent the consolidation of the system and result in insufficient savings for a decent life for pensioners.[13] Thus, of the 30.3 million workers affiliated to Afores in June 2003, only 12.3 million were active because the rest were either out of a job or were not registered with the IMSS; that is, 59.4 percent were inactive workers.[14]

In addition, the workers' savings funds are only minimally used in productive investment: Siefores investments in public government debt have reached up to 94 percent of the total, except in recent months, when they dropped to 89 percent. This investment strategy contradicts the justification given for the privatization of the IMSS pension system. Actually, workers' funds are financing the federal government's public debt. In other words, the state is maintaining the operations of the private administrators.

The de-nationalization of the Afores/Siefores is also becoming a problem. Of the 17 original companies involved

Table 2
Estimated Real Yield for Workers
(billions of pesos)

	1999[1]	2000[1]	2001[1]	2002[1]	2003[2]
Investment in real and nominal rate instruments	105.928	157.066	237.854	309.131	383.284
Investment in nominal rate instruments	12.895	24.802	69.930	106.762	126.932
Annual inflation rate	12.32%	8.96%	4.40%	5.70%	2.68%
Drop in value of nominal rate instruments (2 x 3)	1.589	2.222	3.077	6.085	3.402
Real value of investments (1-4)	104.339	154.844	234.777	303.046	379.882
Net Siefores profit (table 1)	17.849	21.327	28.349	26.384	28.789
Minus annual inflation applied to net profit	2.199	1.913	1.247	1.504	0.772
Minus drop in value of nominal rate instruments (4)	1.589	2.222	3.077	6.085	3.402
Real net profit	14.061	17.192	24.025	18.795	24.615
Minus Afores commissions (table 1)	6.958	8.780	10.399	10.961	10.021
Real yield of workers' savings fund	7.103	8.412	13.626	7.834	14.594
Real yield/ real value of investments	6.8%	5.4 %	5.8%	2.6%	3.8%

[1] Form January 1 to December 31.
[2] From January 1 to October 31.

Source: Afores and Siefores financial statements, Comisión Nacional del Sistema de Ahorro para el Retiro (Consar); inflation rates in accordance with the Bank of Mexico's consumer price index.

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when the system began to operate, four had to sell their assets because they did not achieve the market share predicted and because of their low profitability. Of the 13 remaining, 11 became partners with foreign institutions and only Inbursa and Siglo XXI are owned by national institutions. Currently a great deal of pressure is being brought to bear for workers' savings funds to invest abroad with the argument that it would raise profitability, but this disregards the need to contribute to investment in Mexico. These funds would not only be financing the government's public debt, but also financing investment in developed countries, the ones who least need Mexican workers' savings.

Just as the ILO and the ISSA warned, the long term risks of individual full capitalization saving funds systems have become a reality, in this case for Mexican workers. Even though inflation has been dropping since the IMSS pension system was privatized, from 1999 to 2003 inflation has cost the savings funds 24.01 billion pesos (see table 2). In addition, the high commissions charged the workers make for a cut in the real net yield of almost one-half. It is also clear that the Mexican pension system is not healthy, given that almost 60 percent of the people signed up in the Afores make no contributions because they have no job, or if they do, they are not registered with the IMSS because they work in the informal sector. In the long run, when workers retire, they very probably are going to find that, like in the case of Chile's system, pensions will have a real value that is seriously below the original calculation and insufficient for a decent life.

In summary, the private administrators have all the advantages: by law, they receive workers' savings without having to deal with the collection problems the IMSS has; they charge the workers high commissions; despite Consar regulation, their capital is mostly foreign, and therefore their high profits are sent abroad; they say they are benefitting workers with high yields when the reality is that the yields are low and do not cover the risk of a potential hyperinflation in the long run. And, as if that were not enough, they hold the workers hostage for 25 years with the government's blessing and approval of legislators. VM

Notes

[1] Luis Gutiérrez Urdaneta, "La reforma pensionaria en América Latina," *Economía: Teoría y Práctica*, new era, no. 10 (Mexico City) 1999, pp. 79-80.

[2] Carmelo Mesa-Lago, "Las reformas de las pensiones en América Latina y la posición de los organismos internacionales," *Revista de la CEPAL,* no. 60 (Santiago de Chile), December 1996, pp. 74-75.

[3] Yalin Cacho, "Cuestionan expertos de América Latina el sistema de capitalización individual," *El Financiero* (Mexico City), 1 December 2003, p. 8.

[4] Until today, the State Workers Institute for Social Security and Services (ISSSTE) pension system has not been reformed, even though there has been strong pressure from the private Retirement Funds Administrators (Afore) for its privatization. In July 2003, 12.4 million workers were affiliated to the IMSS and 2.4 million to the ISSSTE.

[5] For a summary of the privatization process of IMSS pensions, see Odilia Ulloa Padilla, "SAR a Afore: o su privatización," *Revista Lux* (Mexico City), March-April 2002, pp. 49-52.

[6] To make up the pension, the retirement, old-age unemployment and old age insurance (RECEAV) takes into account a quota of 6.5 percent of the base wage used for payment calculation (SBC) (5.15 percent from employers; 1.125 percent from workers and 0.225 percent from the state), plus a state contribution calculated at 5.5 percent of the general minimum wage. In addition, there is a 5 percent quota of the SBC for a housing fund managed not by the Afores but by the INFONAVIT, a housing institute for private sector workers.

[7] Until now, 13 Afores manage the obligatory savings funds and 13 Siefores invest them. Banamex, Bancomer and Profuturo also manage retirement funds with voluntary contributions through other Afores and Siefores in addition to the obligatory savings funds.

[8] *El Financiero, Análisis* (Mexico City), 7 October 2002, p. 20.

[9] *El Financiero, Análisis* (Mexico City), 5 September 2003, p. 20.

[10] This profit inflates the Siefores results. While this is reflected in the increase in the value of the stocks adjudicated to the workers, it is actually fictitious. It is like saying, "I'll sell you stocks at a high price, but that will not hurt you because your stocks include this extra price." The problem is that this inflates the results fictitiously.

[11] *El Financiero, Análisis* (Mexico City), 7 October 2002, p. 20.

[12] *La Jornada* (Mexico City), 19 April 2000, p. 18.

[13] Because of growing unemployment and underemployment rates, by December 1997 (six months after privatization began), the Afores already had three million persons affiliated who were inactive, that is, they did not contribute new savings. By the end of 1999, inactive accounts had increased to 6,044,894. *El Financiero* (Mexico City), 21 February 2000, p. 18.

[14] *El Financiero* (Mexico City), 25 July 2003, p. 4.