Chapter 5

Improving the design of the accumulation phase in the Mexican pension system

This chapter focuses on the accumulation phase of the funded defined contribution part of the Mexican pension system. It looks at the different investment strategies adopted by pension plans (SIEFORE) within the framework of the multi-funds age-related scheme. It also discusses the impact of existing investment restrictions, issues related to fees charged to members and the different approaches implemented to increase competition and reduce fees, risk-based supervision, governance and regulation. The chapter concludes with some recommendations that allow more choice on investment strategies, address high charges and increase competition among pension funds (AFORE).

* The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

This chapter focuses on the accumulation phase of the Mexican fully funded defined contribution (DC) system and argues that there is room to improve its design. The accumulation phase is organised around specialised private asset managers (*Administradoras de Fondos para el Retiro*) known as AFORE that manage workers' individual retirement accounts where IMSS and ISSSTE workers deposit their contributions.[1] AFORE place contributions in investment funds called SIEFORE (*Sociedades de Inversión Especializadas en Fondos para el Retiro*). AFORE manage individual retirement accounts and SIEFORE invest the assets accumulated in those accounts.

This chapter looks at the different investment strategies adopted by SIEFORE within the framework of the multi-funds age-related scheme. It also discusses the different investment restrictions and their impact on investment strategies. The chapter then addresses issues related to fees charged to members and the different approaches implemented to increase competition among AFORE and thus reduce fees. Other issues related to the accumulation phase include risk-based supervision (RBS), governance and regulation in general. The chapter ends with some recommendations based on the OECD Roadmap for the Good Design of Defined Contribution Pension Plans, the OECD Core Principles for Pension Fund Regulation, and the IOPS Principles for Supervision.

5.1. The current investment regime of SIEFORE may not be optimal

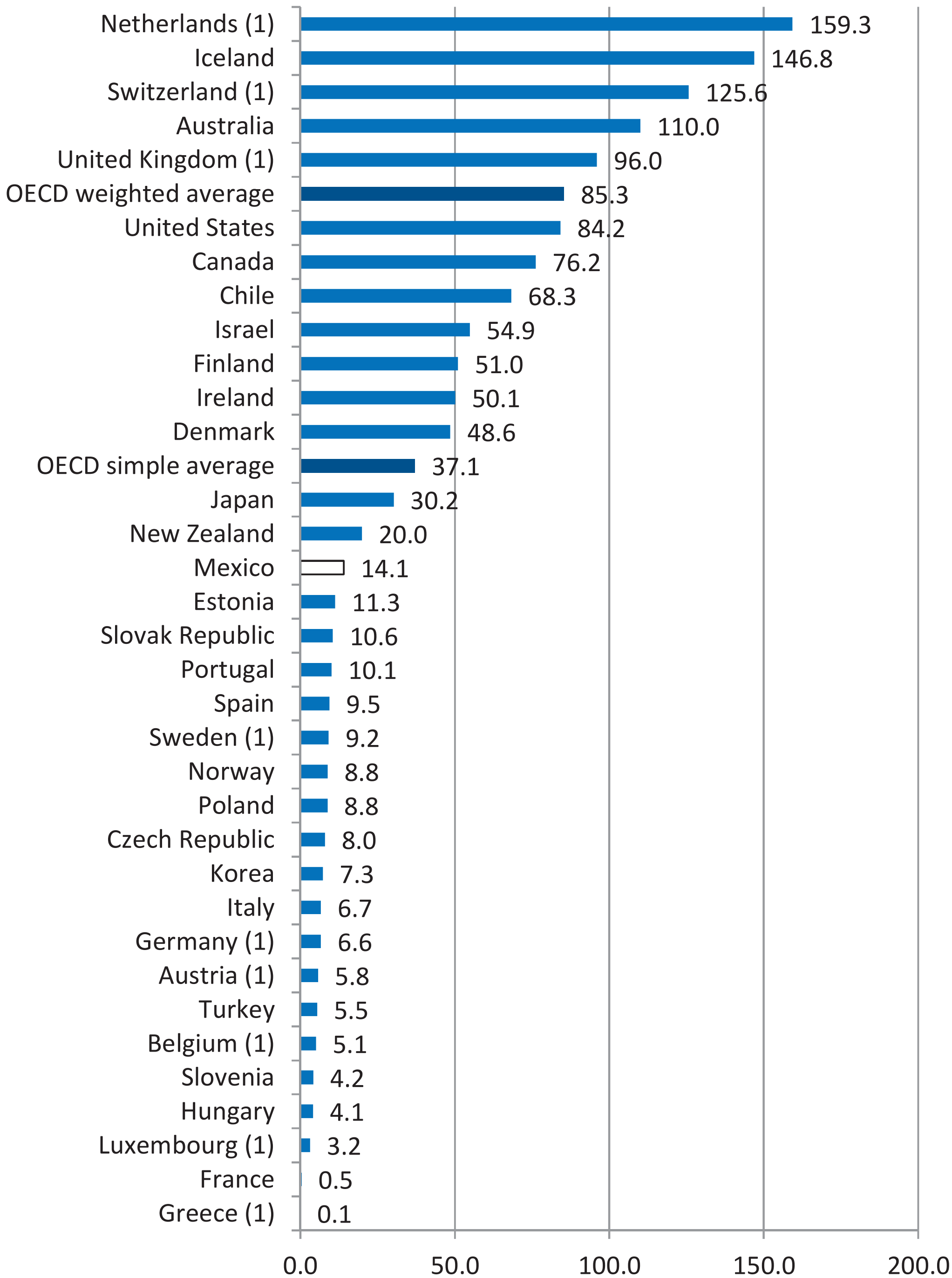
AFORE manage individual retirement accounts placing contributions in SIEFORE that invest the assets accumulated in those accounts. At the end of 2014, the net asset of SIEFORE was MXN 2 373 381 million, representing 14.1% of GDP (see Figure 5.1), which puts Mexico in the middle range of OECD countries after only 17 years of existence of the funded pension system. Over those 17 years, the assets managed by SIEFORE have grown on average by 41.9% annually (Figure 5.2). In addition, the Retirement Savings System (SAR) has yielded on average a nominal annual rate of return of 12.53% and a real annual rate of return of 6.20% since 1997.

According to the Mexican pension regulation, each AFORE must have four SIEFORE for investing the compulsory savings, called basic SIEFORE (SB), and they may have additional SIEFORE for voluntary contributions and occupational pension plans. Each basic SIEFORE has a specific investment regime that depends on the age of the worker. The basic SIEFORE are classified by the following employee's age brackets:

- SB4: up to 36 years old;
- SB3: between 37 and 45 years-old;
- SB2: between 46 and 59 years-old;
- SB1: 60 years-old or older.

Figure 5.1. **Mexico's pension fund assets in an international context, 2014**

As a % of GDP

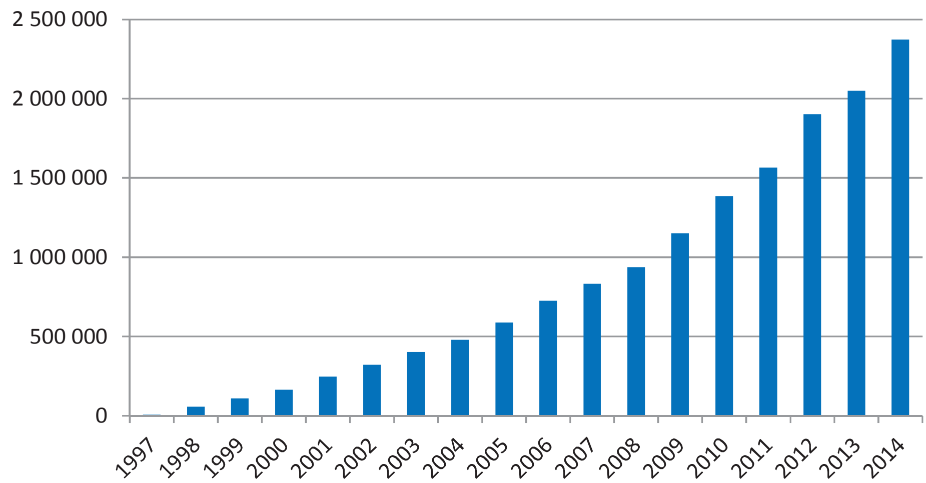


1. Preliminary data.

Source: OECD Global Pension Statistics.

Figure 5.2. **Net assets managed by SIEFORE**

In millions of pesos

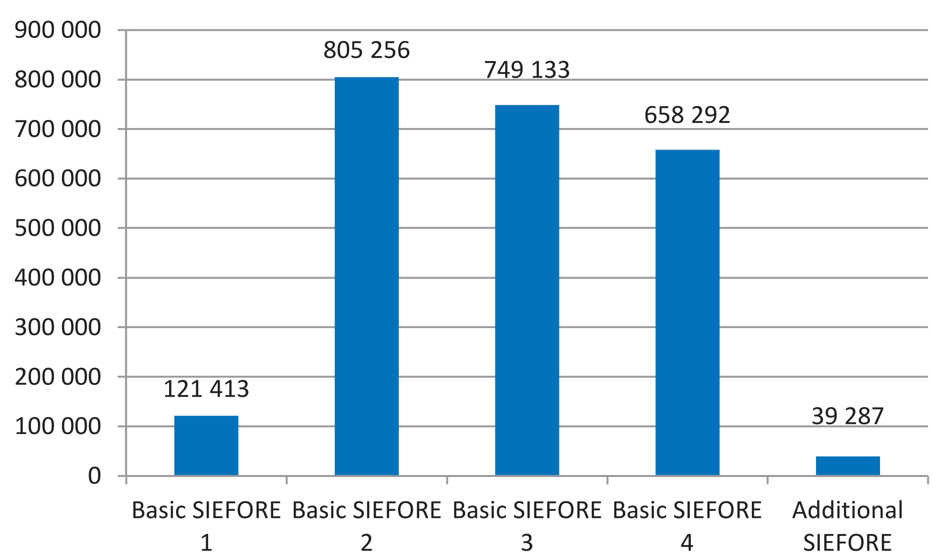


Source: CONSAR.

Figure 5.3 shows the distribution of assets among SIEFORE. The much lower amount of assets managed by the basic SIEFORE 1 reflects the fact that, upon retirement, private-sector workers of the transitional generation (who were working and contributing to the old DB system before 1 July 1997) can choose to get their benefits according to the old DB formula, in which case the assets are transferred to the federal government.

Figure 5.3. **Net assets of SIEFORE, December 2014**

In millions of pesos



Note: The additional SIEFORE invest the voluntary savings of workers, as well as the social provision funds of public and private entities administered by AFORE.

Source: CONSAR.

Net returns in SIEFORE compare well with returns in other OECD countries. Table 5.1 shows net returns by AFORE and basic SIEFORE over the last five years, while Table 5.2 shows the average nominal and real returns of the SAR over the same period in an international context.

Table 5.1. **Net nominal returns, by type of basic SIEFORE and by AFORE**

As of December 2014

Basic SIEFORE 1	Net return 58 months
PensionISSSTE	8.05%
Invercap	7.77%
SURA	7.38%
Profuturo GNP	7.27%
Banamex	7.03%
XXI-Banorte	6.64%
MetLife	6.56%
Principal	6.36%
Azteca	5.94%
Coppel	5.43%
Inbursa	4.87%
Simple average	6.66%
Weighted average (1)	7.01%

Basic SIEFORE 2	Net return 60 months
SURA	9.58%
PensionISSSTE	9.54%
Banamex	8.94%
Profuturo GNP	8.80%
XXI-Banorte	8.46%
Invercap	8.26%
MetLife	8.26%
Principal	7.80%
Azteca	7.18%
Coppel	6.98%
Inbursa	5.04%
Simple average	8.08%
Weighted average (1)	8.49%

Basic SIEFORE 3	Net return 62 months
SURA	10.91%
PensionISSSTE	10.73%
Banamex	9.90%
Profuturo GNP	9.69%
Invercap	9.50%
MetLife	9.44%
XXI-Banorte	9.29%
Principal	8.76%
Azteca	8.15%
Coppel	7.59%
Inbursa	5.72%
Simple average	9.06%
Weighted average (1)	9.51%

Basic SIEFORE 4	Net return 62 months
SURA	12.19%
Banamex	11.22%
Profuturo GNP	11.06%
PensionISSSTE	10.90%
MetLife	10.47%
Invercap	10.47%
XXI-Banorte	10.11%
Principal	9.71%
Azteca	8.51%
Coppel	7.85%
Inbursa	6.20%
Simple average	9.88%
Weighted average (1)	10.38%

Notes: The net return indicator represents the long-term historical performance of SIEFORE, net of fees.
(1) Weighted by assets under management.

Source: CONSAR.

Table 5.2. **Nominal and real 5-year average net returns of SIEFORE in an international context**

As of December 2014

	5 year-average	
	Real	Nominal
Netherlands	7.8	9.8
Denmark	7.1	8.9
Canada	6.9	8.7
New Zealand (1)	6.3	8.6
Australia (2)	6.0	8.8
Norway	4.9	6.6
Israel (3)	4.8	6.5
Iceland	4.5	8.0
United States	4.5	6.2
Mexico (4)	4.1	8.2
Chile	3.7	7.1
Spain	2.9	4.4
Slovenia	2.7	4.2
Austria	2.5	4.7
Italy	2.4	4.0
Korea	2.1	4.2
Japan	1.8	2.5
Portugal	1.3	2.9
Estonia	0.9	3.6
Czech Republic	0.6	2.3
Slovak Republic	0.3	2.1

Notes: The average net returns have been calculated following a common methodology for all countries.
1. The 5-year average returns have been calculated over the period March 2009 - March 2014.
2. The 5-year average returns have been calculated over the period June 2009 - June 2014.
3. Data refer to new pension plans only.
4. Data refer to the Retirement Savings System only (occupational plans are not included).

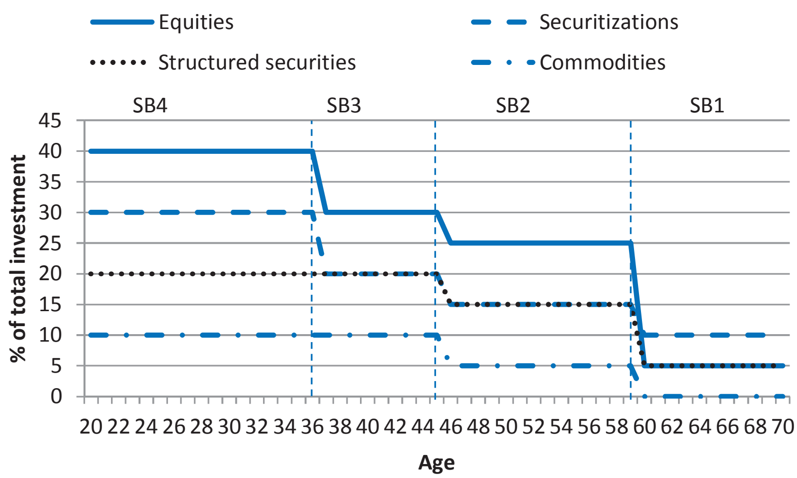
Source: OECD Global Pension Statistics.

The investment regime of Mexico is in accordance with the OECD guidelines. The OECD Roadmap encourages establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes. In this regard, each basic SIEFORE has a specific investment regime that depends on the age of the worker. For instance, the SB4 (for young workers) has the most aggressive investment regime and SB1 (for workers near to retirement) has the most conservative one. As members get older, their pension assets are invested in a more conservative investment regime, with lower exposure to equity and a greater proportion of fixed-income instruments, to reduce the volatility of their returns. Thus, a young affiliate will gradually move from basic SIEFORE 4 (SB4) to SB3, SB2 and finally SB1. Nonetheless, any affiliate may opt to invest his/her resources in a more conservative fund than the default option. The glide-path of risky investments along a worker's career is illustrated in Figure 5.4, according to the maximum limits allowed by regulation for each basic SIEFORE (see Table 5.3).

However, the Mexican investment regime does not fully follow the OECD guidelines as it does not provide choice between investment options with different risk profiles and investment horizons. Indeed, workers have very limited choices in this multi-funds system. They cannot have resources invested in more than one basic SIEFORE and have no say on the investment strategy of their resources within that fund. The investment strategy of each basic SIEFORE is decided by the AFORE, within the limits established by regulation (see Table 5.3). Despite those limits, there is a great heterogeneity of investment strategies implemented by AFORE for each basic SIEFORE. For example, at the end of December 2014, equity investment of basic SIEFORE 4 varied from less than 20% for PensionISSSTE (15.6%) and Inbursa (16.9%) to more than 34% for XXI Banorte (34.3%) and Invercap (36.3%), with a regulatory limit of 40%. This heterogeneity in investment strategies is reflected in the net returns in Table 5.1. The only options given to workers are to select the AFORE of their choice, based on returns and investment strategies information provided in their pension statement and in CONSAR's website, and to invest their resources in a more conservative fund than the default option.

Figure 5.4. **Multi-funds schemes by age**

Investment limits as a % of total investment



Source: CONSAR.

When workers reach the age limit between two SIEFORE, the regulation allows AFORE to carry out the transfer of the assets in cash or by transferring a proportion of the portfolio from the ceding SIEFORE to the receiving SIEFORE. The second option allows the AFORE to send assets from one SIEFORE to another without the need to sale financial assets. This aims at preventing any distortion in prices in the financial markets as well as eliminating the brokerage and market costs for the worker. CONSAR establishes the date of the transfer of the assets. The valuation of funds is done in the usual way, i.e. using the official prices vectors provided by the authorised rate providers. The prices used to value the assets leaving the ceding SIEFORE are the same as those used to value the assets of the receiving SIEFORE.

The Mexican pension system establishes strict investment requirements.[2] The investment regime of the basic SIEFORE is characterised by its differentiated quantitative limits and qualitative requirements. The quantitative limits are established depending on the permitted asset class (equity, currency, securitizations, inflation protected securities, commodities), the nationality of the issuer, the credit rating of the issuer, holdings in a single issuance and conflicts of interest limits and provisions. The investment and risk management limits are summarised in Table 5.3.

Table 5.3. **Limits contained in the investment regime applicable to SIEFORE (1)**

			SB1	SB2	SB3	SB4
Market and liquidity risks		Value at Risk (2)	0.70%	1.10%	1.40%	2.10%
		Difference of the Conditional Value at Risk (2)	0.30%	0.45%	0.70%	1.00%
		Liquidity coverage ratio (3)	80%	80%	80%	80%
Risk by issuer and/or counterparty (4)	Local (5)	Debt from mxBBB to mxAAA or int'l currencies BB to AAA	5%	5%	5%	5%
		Subordinated debt mxBB+ to mxBBB- or int'l currencies B+ to BB-	1%	1%	1%	1%
	Int'l	Foreign securities from BBB- to AAA from one issuer or counterparty (6)	5%	5%	5%	5%
		Holding of a single issuance (7)	Maximum {35%; $300mdp}			
Asset class limits		Foreign securities (4)	20%	20%	20%	20%
		Equity (4,8)	5%	25%	30%	40%
		Foreign currency (4)	30%	30%	30%	30%
		Securitizations (9)	10%	15%	20%	30%
		Structured securities (4,10)	5%	15%	20%	20%
		Infrastructure or housing	NA	10%	13%	13%
		Others	NA	5%	7%	7%
		Inflation protected securities (11)	Yes	No	No	No
		Commodities (4)	0%	5%	10%	10%
Conflict of interest (4)		Securities by related entities	15%	15%	15%	15%
		Securities by entities with patrimonial affiliation with the AFORE (12)	5%	5%	5%	5%
Vehicles and derivatives		Investment mandates	Yes	Yes	Yes	Yes
		Derivatives	Yes	Yes	Yes	Yes

Notes: This is a summary table of the Basic SIEFORE's current regulation. Additional SIEFORE (e.g. voluntary savings) can determine different parameters according to their objective and in compliance with the SAR Law. NA = not applicable; Int'l = international.

1. All the limits are maximum percentages, except the inflation protection limit.
2. As a percentage of the Assets Under Management (AUM) directly managed by the SIEFORE. The Value at Risk will no longer be a regulatory limit once the AFORE satisfies the criteria set up in the Financial Provisions (CUF). The limits of the Difference of the Conditional Value at Risk were determined by the Risk Analysis Committee (CAR), which may be stricter than the limits set up in the Investment Regime Provisions.
3. As a percentage of the High Liquid Assets of the SIEFORE. It is defined as the ratio between the Value of the SIEFORE's reserves for derivatives exposure and the Value of High Liquid Assets.
4. As a percentage of the Total AUM of the SIEFORE, including the assets managed by the Specialised Investment Manager ("Mandatario").
5. Rating of the medium- and long-term issuances, as well as the issuer and/or endorser, in the corresponding proportion. Repos and derivatives are computed in these limits as well.
6. The regulation permits investments in foreign securities with a credit rating below A- and equal to or greater than BBB-, nevertheless the AFORE must abide by the Investment Regime Provisions and the Financial Provisions (CUF).
7. Applies to the asset holdings of all the pension funds by the same fund manager (AFORE), and for debt and structured securities. A CKD may exceed this limit if the issuance meets certain conditions.
8. Includes individual stocks, IPOs, domestic and international equity indexes listed in the Index Lists, and mandatory convertible debt into share from Mexican issuers.
9. Securitizations fulfilling the Eighth Transitory Provision of the Investment Regime Provisions are computed in this limit and are considered as being issued by an independent issuer.
10. Includes CKDs, REITs, Mexican REITs (FIBRAS) and Debt in which the income source comes from real assets. The regulation prohibits the investment in CKDs for the Basic SIEFORE 1.
11. Minimum investment limit in securities that ensures a return equal to or greater than the inflation rate in Mexico. The minimum is 51% for the basic SIEFORE 1.
12. The limits is written down in the SAR Law, Art 48, paragraph X. In exceptional cases it could be increased up to 10%. The limit is 0% for financial entities with patrimonial affiliations.

Source: CONSAR.

The pension regulator, CONSAR, has relaxed gradually restrictions on certain asset classes over time. Table 5.4 shows the changes in investment restrictions since 1997. For example, SIEFORE are allowed to invest in equities (with restrictions on the level) since 2005, and swaptions and REITs are only allowed since 2013.

Table 5.4. **Adjustments to the investment regime of SIEFORE since 1997**

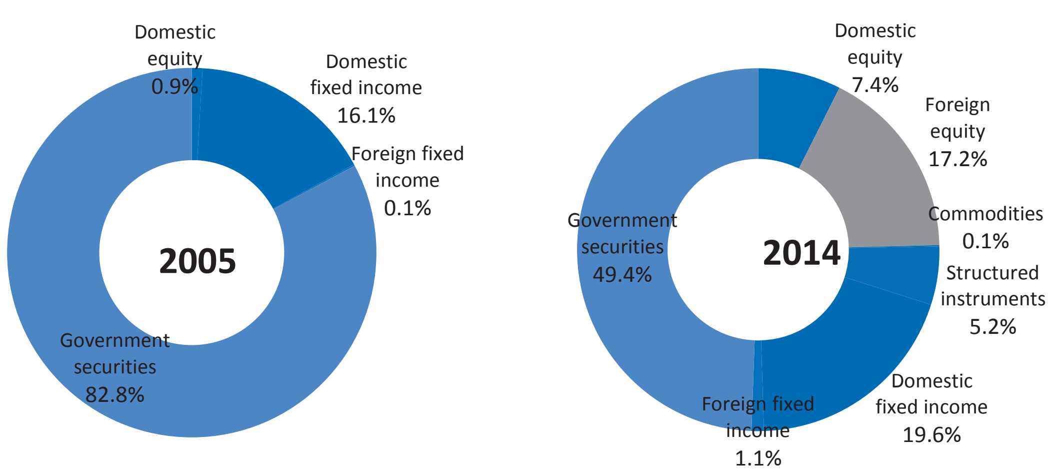
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Debt	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Currencies	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Equity	×	×	×	×	×	×	×	×	√	√	√	√	√	√	√	√	√	√
CKDs & FIBRAS	×	×	×	×	×	×	×	×	×	×	√	√	√	√	√	√	√	√
Structured assets	×	×	×	×	×	×	×	×	×	×	√	√	√	√	√	√	√	√
Commodities	×	×	×	×	×	×	×	×	×	×	×	×	×	×	√	√	√	√
Swaptions	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	√	√
REITs	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	√	√

Notes: CKDs and FIBRAS are Mexican private equity funds and real estate funds respectively.
REITs = Real Estate Investment Trusts.
Source: CONSAR.

The main effect of relaxing investment restrictions has been an increase in the diversification of SIEFORE's portfolios. Figure 5.5 shows that SIEFORE have reduced their concentration in government securities, from 82.8% in 2005 to 49.4% in 2014. Investment in domestic equity has increased from 0.9% to 7.4% over the period and foreign investment (equity and fixed income) represented 18.3% of total investment at the end of December 2014.

Figure 5.5. **Asset allocation of SIEFORE in September 2005 and December 2014**

As a % of total investment

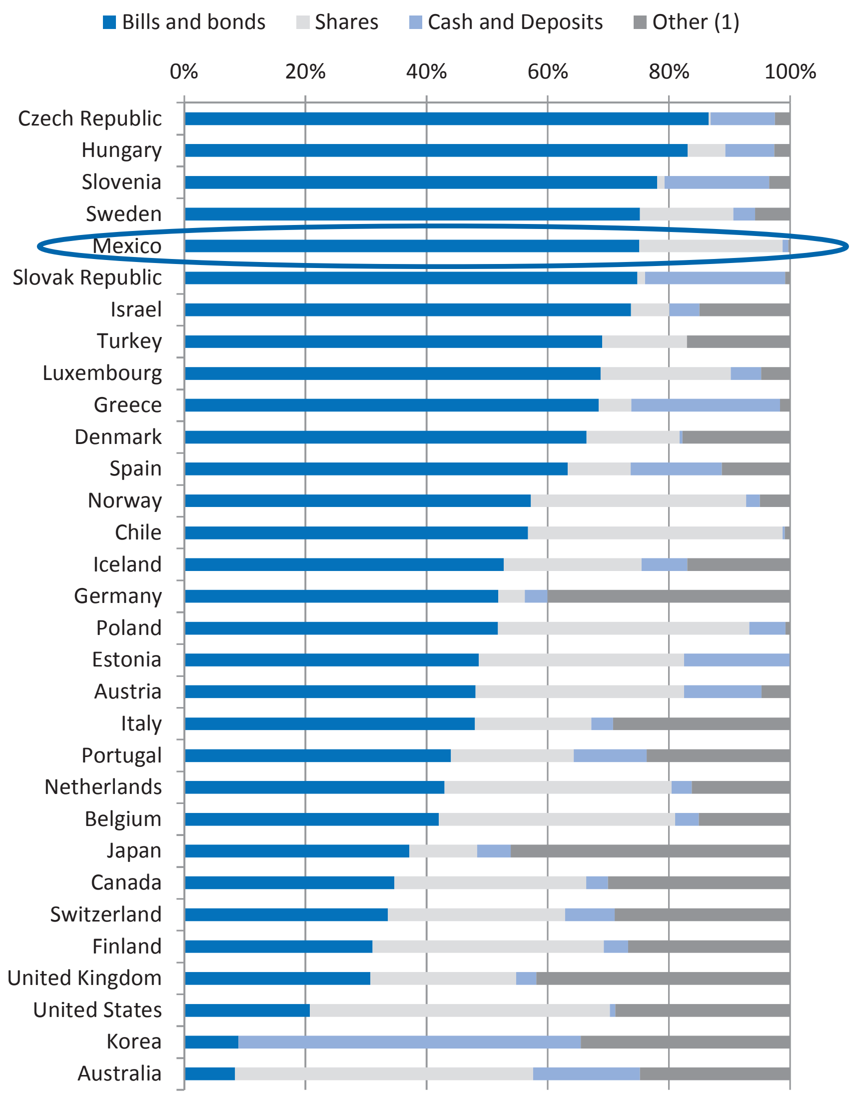


Source: CONSAR.

Despite the increased diversification, Mexico's pension funds are still significantly concentrated in debt relatively to other OECD countries. At the end of 2013, SIEFORE had 75.1% of their portfolio invested in bills and bonds (public and private). Only four of the 31 OECD countries with available data in Figure 5.6 had a larger exposition to bills and bonds: Sweden (75.2%), Slovenia (78.1%), Hungary (83.1%) and the Czech Republic (86.5%).

Figure 5.6. **Pension funds' asset allocation for selected investment categories in selected OECD countries, 2013**

As a % of total investment



1. The "Other" category includes loans, land and buildings, unallocated insurance contracts, hedge funds, private equity funds, structured products, other mutual funds (i.e. not invested in cash, bills and bonds, or shares) and other investments.

Source: OECD Global Pension Statistics.

In addition, Mexico is still among the OECD countries with the stricter investment limits on equities and foreign securities. At the end of 2014, 19 OECD countries had no quantitative limit on the equity investment of pension funds (see Table 5.5). Among the 15 other OECD countries, Mexico is at the bottom of the ranking, with limits between 5%

and 40% depending on which of the basic SIEFORE is considered. Chile, the Czech Republic and the Slovak Republic, like Mexico, have different limits for different types of funds. However, in the three countries, the most dynamic funds are allowed to invest up to 80% of the assets in equities, as compared to 40% in basic SIEFORE 4. With respect to foreign securities, only Chile and Mexico have specific limits applying to the overall foreign investment of pension funds. Limits for Chile vary from 35% for the most conservative fund to no limit for the most dynamic fund, all Chilean limits being higher than the 20% limit applying to all basic SIEFORE in Mexico.

Table 5.5**. Limits on equity investment in OECD countries at the end of 2014**

As a % of total investment

Countries with no limit on equity investment	Australia, Belgium, Canada, Finland*, Hungary, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Turkey, United Kingdom, United States	
Countries with limit on equity investment	Chile (Fund A)	80%
	Czech Republic (dynamic fund)	80%
	Slovak Republic* (non-guaranteed fund)	80%
	Estonia*	75%
	Austria	70%
	Denmark	70%
	Greece	70%
	France	65%
	Chile (Fund B)	60%
	Iceland	60%
	Portugal	55%
	Switzerland	50%
	Poland	47.5%
	Chile (Fund C)	40%
	Czech Republic (balanced fund)	40%
	Mexico (SB4)	**40%**
	Germany (Pensionskassen)	35%
	Mexico (SB3)	**30%**
	Slovenia	30%
	Mexico (SB2)	**25%**
	Chile (Fund D)	20%
	Chile (Fund E)	5%
	Mexico (SB1)	**5%**
	Czech Republic (conservative fund)	0%
	Slovak Republic* (guaranteed fund)	**0%**

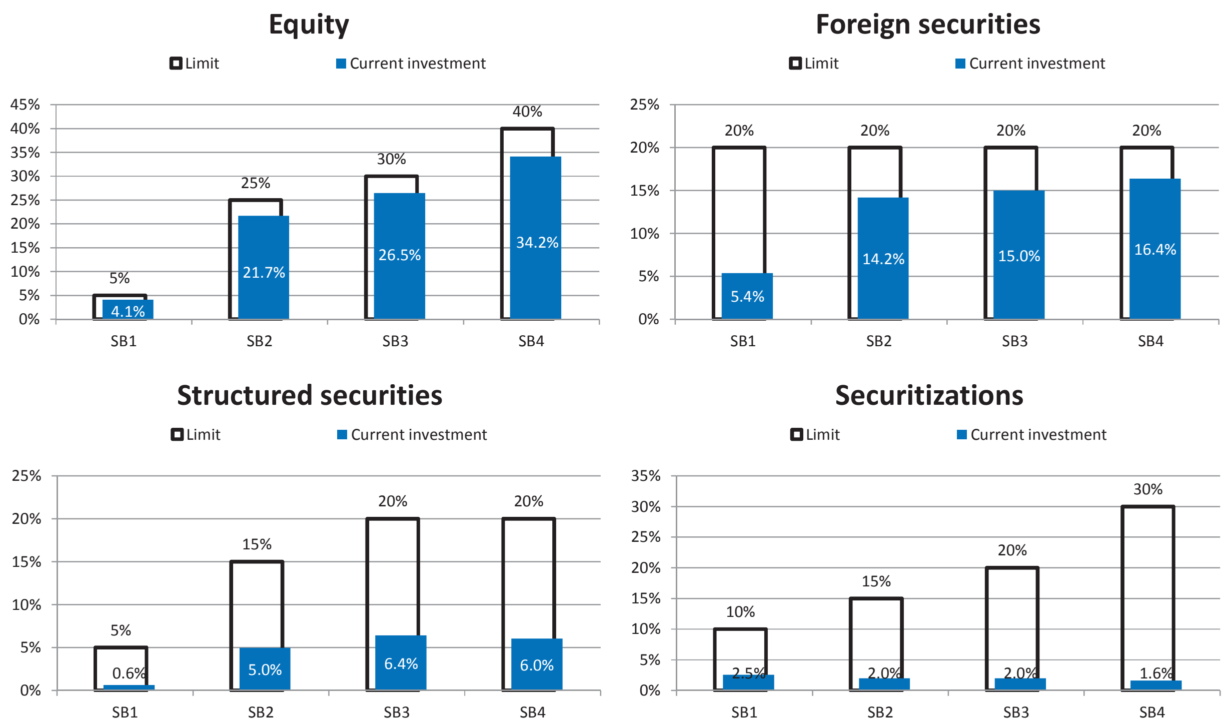
Note: * Data refer to mandatory pension funds.

Source: OECD Survey of Investment Regulation of Pension Funds.

The investment limits for equities and foreign securities are binding for most basic SIEFORE. As shown in Figure 5.7, equity investment is near its regulatory limits for all basic SIEFORE. It is not necessary to have current investment exactly at the limit to consider the limit as binding. Indeed, pension funds need room below the limit to allow for market upswings and avoid being in a situation to be forced to sell equities when markets are going up. Except for basic SIEFORE 1, the 20% limit on foreign securities can also be considered as binding.

Figure 5.7. **Investment in equity, foreign securities, structured securities and securitizations versus limits, December 2014**

As a % of total investment



Note: The current investment of SIEFORE includes derivative exposures, while the regulatory limits exclude them.

Source: CONSAR.

Finally, Figure 5.7 also shows that SIEFORE do not use the whole range of financial instruments allowed by regulation at their full potential. Indeed, investments in structured securities and securitizations are far from the respective regulatory limits for each basic SIEFORE. In addition, while commodities are allowed by regulation since 2001, only the basic SIEFORE of one AFORE (Banamex) invest in commodities at levels between 0.2% and 0.4% of total investment (far below the limits allowed). There is therefore room for even more diversification in SIEFORE's portfolios if AFORE build appropriate investment teams with the skills to invest in non-traditional asset classes.

5.2. Fees charged by AFORE are still high when comparing with other countries despite current mechanisms to foster competition

The Mexican regulatory system uses different mechanisms to foster competition among AFORE in order to reduce fees charged to members and thus increase net retirement income. There are three main mechanisms implemented by CONSAR aiming at fostering competition among AFORE: (i) the diffusion of comparative information to members about net returns through the pension statement; (ii) the approval process of fees charged by AFORE by the Governing Board of CONSAR; and (iii) the incentives embedded in the registration, assignment and transfer processes.

As already shown in Chapter 4 (Section 4.5), the pension statement is the document that should help workers select the AFORE that best suits their needs. However, not all workers receive their pension statement regularly. In addition, low financial literacy leads to a lack of interest in the pension statement, which fails at engaging members and encouraging them to take active steps to increase their retirement savings. As a result, members do not always choose the pension fund with the highest net return as shown below.

Since 2008, every year in December, the Governing Board of CONSAR must approve the fees proposed by the AFORE, that they will charge during the following year. The Governing Board of CONSAR has the power to refuse permission for fees, considering the following factors: (i) the revenues of the AFORE given the assets under management; (ii) the use of economies of scale by the AFORE; (iii) the financial profitability; (iv) the competition scheme; (v) the ability to attract new accounts; (vi) the operating results; (vii) the performance; and (viii) the efforts from the AFORE to improve its future operative and financial performance. If the proposal is rejected, the AFORE has to charge a fee equivalent to the average of the market authorised for that year. AFORE not submitting a proposal have to charge the minimum fee authorised for the following year. The authorised fees for 2014 and 2015 are as follows.

Table 5.6. **Fees for Basic SIEFORE, 2014 and 2015**

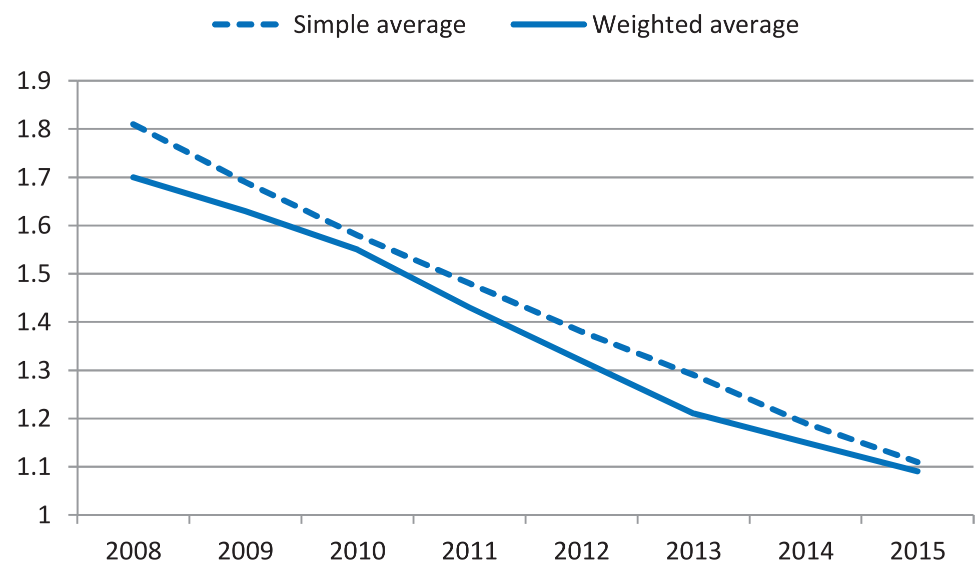
As a % of assets under management

AFORE	2014	2015
PensionISSSTE	0.99	0.92
XXI Banorte	1.07	1.04
Banamex	1.09	1.05
Inbursa	1.14	1.08
Profuturo GNP	1.17	1.11
SURA	1.15	1.11
Principal	1.24	1.17
Invercap	1.32	1.18
Metlife	1.25	1.18
Azteca	1.31	1.19
Coppel	1.34	1.20
Simple average	1.19	1.11
Weighted average	1.15	1.09

Source: CONSAR.

This mechanism has favoured a reduction in fees, as shown in Figure 5.8. Between 2008 and 2015, the simple average fee has declined from 1.81% of assets under management to 1.11%.

Figure 5.8. **Average fees charged as a percentage of assets under management, 2008-2015**

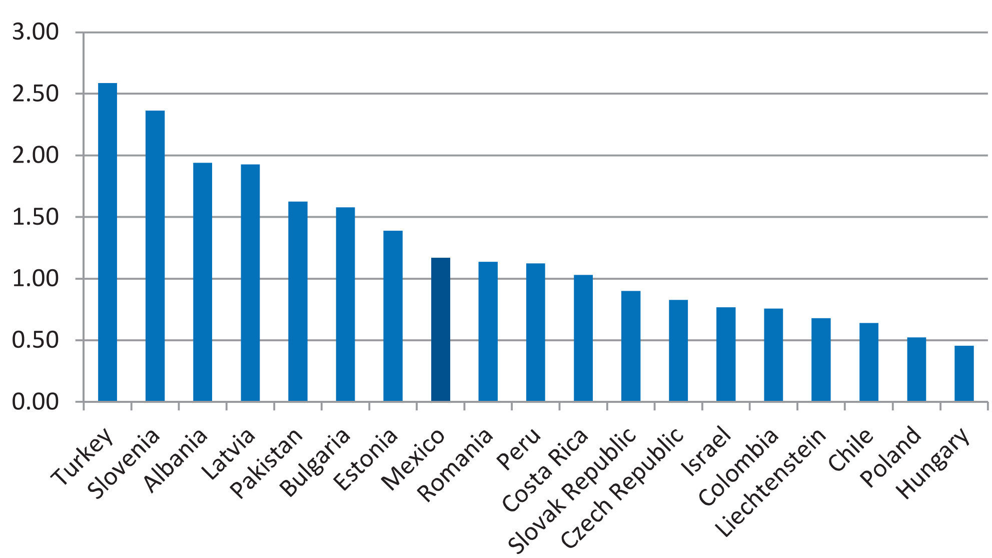


Source: CONSAR.

However, fees charged by AFORE in Mexico are still high in international comparison. With fees paid in 2013 worth 1.17% of the total assets under management at the end of 2013, Mexico ranks in the first half of Figure 5.9, in which countries with available information are sorted by descending fees. Among the countries listed, fees range from 0.45% of assets under management for Hungary to 2.59% for Turkey.

Figure 5.9. **Total fees charged in 2013 as a percentage of assets under management at the end of 2013, in selected OECD and IOPS countries**

As a % of assets under management

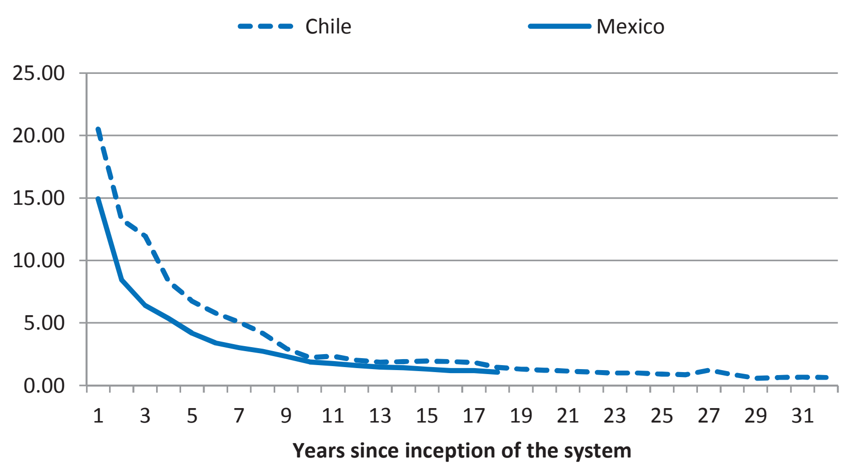


Source: OECD Global Pension Statistics.

The maturity of the funded pension system may partially explain the still relatively high fees in Mexico. Figure 5.10 compares fees charged by pension administrators in Chile and Mexico according to the number of years passed since the inception of each system. It shows that Mexico follows a similar pattern to Chile so far. Eighteen years after the inception of the system, fees represent 1.07% of total assets under management in Mexico, which is actually lower than in Chile, where fees represented 1.43% of total assets under management after the same number of years.

Figure 5.10. **Evolution of fees charged in Chile and Mexico since the inception of each system**

As a % of assets under management



Source: Chile: Superintendence of Pensions; Mexico: CONSAR.

However, the current approval process of fees provides little incentive to further lower fees for AFORE with charges already below the average. For example, between 2014 and 2015, AFORE over the average have reduced fees by 11 basis points on average, as opposed to a reduction of only 5 basis points for AFORE below the average (see Table 5.7).

Table 5.7. **Fees' reduction between 2014 and 2015**

	AFORE	Fees 2014 (%)	Fees 2015 (%)	Reduction (percentage points)	
AFORE above the average	Coppel	1.34	1.20	0.14	Average decrease of 11 basis points
	Azteca	1.31	1.19	0.12	
	Invercap	1.32	1.18	0.14	
	Metlife	1.25	1.18	0.07	
	Principal	1.24	1.17	0.07	
AFORE below the average	Profuturo GNP	1.17	1.11	0.06	Average decrease of 5 basis points
	SURA	1.15	1.11	0.04	
	Inbursa	1.14	1.08	0.06	
	Banamex	1.09	1.05	0.04	
	XXI Banorte	1.07	1.04	0.03	
	PensionISSSTE	0.99	0.92	0.07	

Source: CONSAR.

Finally, the incentives embedded in the registration, assignment and transfer processes are not enough to foster competition. The account registration is a way to secure the right of workers of getting benefits from the pension system. Through the registration process, the worker selects the AFORE that best suits his/her own interest and designates beneficiaries. This is the primary vehicle to access to information about the account (for example, reception of the pension statement).

When the worker does not register his/her individual account with an AFORE, there is an assignment process following two modalities:

- Assigned workers with money deposited in the Bank of Mexico: This refers to inactive accounts. In that case, there is only one services provider (*Prestadora de Servicios*) that keeps track of and control the accounts, the AFORE XXI Banorte. It charges a commission of 0.10% of the balance since July 2014 for assigned accounts. The resources are deposited in the Bank of Mexico in a pooled account and are invested in securities or loans issued by the federal government, or if applicable by the states. The performance is determined by the Ministry of Finance. Inactive accounts include accounts initially assigned to an AFORE (see following point) but that were returned to the Bank of Mexico because the condition of receiving contributions during at least six consecutive two-month periods is not fulfilled.
- Assigned workers with money deposited in a SIEFORE: The active accounts of the services provider are assigned to the AFORE with the highest net return indicator. The assignment is realised once a year, according to a calendar set by CONSAR.

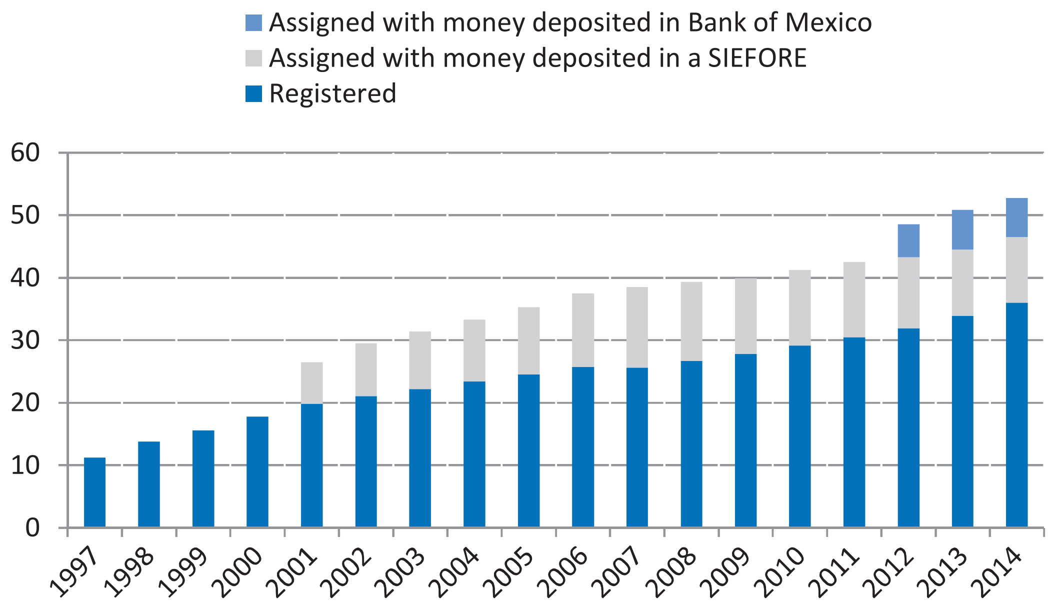
The AFORE have the obligation to provide the same services to registered workers and to assigned workers with money deposited in a SIEFORE. However, assigned workers may not be able to make use of these services because they do not necessarily know which AFORE is managing their account. For example, they may not receive their pension statement because the AFORE has no information on their domicile. In any case, the worker can decide at any moment to register his/her account.

To increase the level of registration of assigned accounts and foster competition, only AFORE with net returns in the last three deciles of the distribution can receive assigned accounts. In turn, those with the largest amount of registration of assigned accounts get the largest proportion of assigned accounts. In addition, if an assigned account with active contributions is not registered after two years, it gets re-assigned to a new AFORE.

At the end of 2014, there were 52 728 388 individual retirement accounts, of which 36 028 527 (or 68%) were registered, 10 492 588 (20%) were assigned accounts with money deposited in a SIEFORE and 6 207 273 (12%) were assigned accounts with money deposited in the Bank of Mexico. Figure 5.11 shows the evolution of the number of individual retirement accounts since 1997.

Figure 5.11. **Evolution of the number of individual accounts, by type of account**

In millions



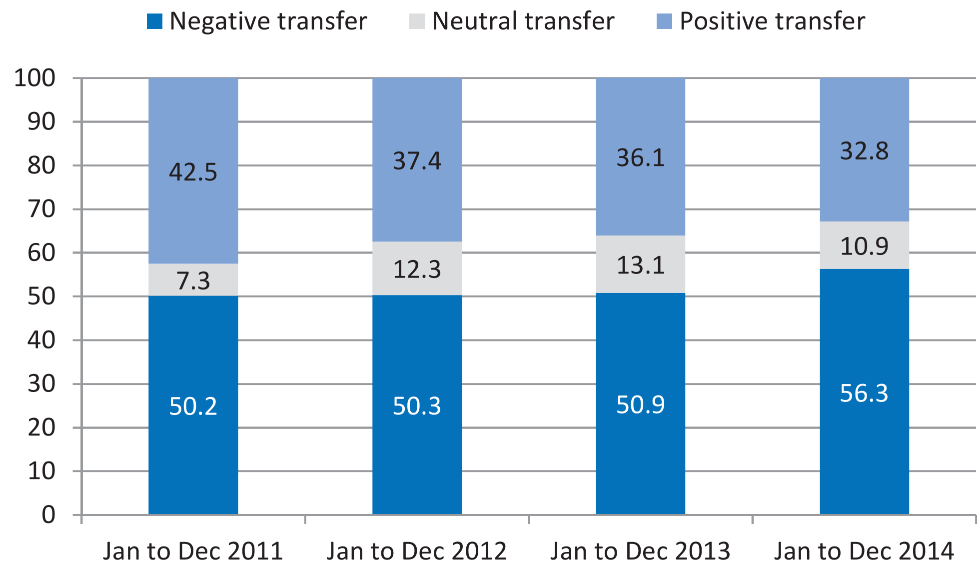
Note: The services provider started operating in January 2010. However, CONSAR only began to collect information on assigned accounts with money deposited in the Bank of Mexico in 2012.

Source: CONSAR.

In order to further promote competition and to allow workers to choose the AFORE that best suits them, it is possible to switch between AFORE. Transfers are allowed once a year and even within a shorter timespan when changing to an AFORE providing a higher net return indicator. The transfer is free for the worker. However, according to Calderón-Colín et al. (2008), account transfers among AFORE in Mexico barely respond to price or return considerations and in general have not improved the workers' pension balance. Using 2006 data, they show that, instead of strengthening competition through lower fees and higher returns for the workers, AFORE switching had resulted in lower pensions for more than half of workers. Figure 5.12 shows that during the last four years, more than half of the workers who switched AFORE did so to an AFORE providing a lower net return (negative transfer). In addition, the number of transfers has increased, from 1 788 883 in 2012 to 2 128 947 in 2013 and 2 436 697 in 2014. Fund managers actually increase their market share through a larger commercial cost and a greater number of sales agents that try to convince workers to switch. This is illustrated in Figure 5.13.

Figure 5.12. **Quality of account transfers**

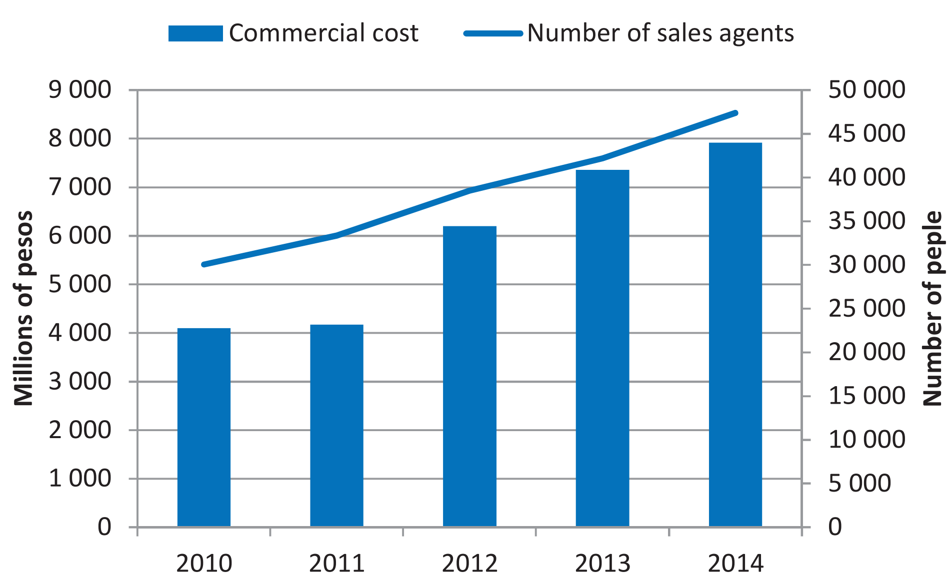
As a % of all transfers



Notes: A negative transfer is one to an AFORE offering a lower net return. A neutral transfer is one to an AFORE offering the same net return or a net return less than 5% higher than the one offered by the previous AFORE. A positive transfer is one to an AFORE offering a net return at least 5% higher than the one offered by the previous AFORE.

Source: CONSAR.

Figure 5.13. **Evolution of AFORE's commercial cost and number of sales agents between 2010 and 2014**



Source: CONSAR.

Besides AFORE's marketing methods, the proportion of negative transfers may also come from the lack of incentives for transitional private-sector workers to choose the best AFORE in terms of higher performance and lower fees. Indeed, these workers retain the right to choose at retirement the higher of the acquired benefits under the old PAYG DB system and the accumulated balances in their individual retirement accounts under the new funded DC system. As the old DB system is generally more generous (see Chapter 4) and provides benefits independently of the resources accumulated in the individual retirement account, most transitional workers have little incentives to maximise the resources accumulated at retirement in their individual account. The federal government is therefore the one suffering most from bad management and high fees as it receives a potentially lower amount from the accumulated balances to finance the promised benefits of the PAYG system.

Since 2 March 2015, new rules are in place to limit negative transfers. There is a stricter control of sales agents through the creation of a new electronic database and periodic examinations. Sales agents will also be subject to a new remuneration scheme in which transfers of accounts with less than 30 months in the current AFORE will only be remunerated 20% of the normal fee. In addition, AFORE are now allowed to retain a worker for more than one year by offering better services. Finally, workers have to sign a form when asking for a transfer of their account which highlights the consequences of the transfer. Therefore, in the case of a negative transfer, the form makes clear to the worker the fact that this means a transfer from an AFORE with a better net return to an AFORE with a lower net return. These changes are however too recent to see a positive impact on the number and quality of transfers.

5.3. Robust risk-based supervision but AFORE's corporate governance could be improved

Mexico introduced a risk-based supervision approach in 2004, based on the management of operational and financial risks. Both quantitative and qualitative risk controls are in place.

The primary quantitative financial risk supervision tool is the historical Value at Risk (VaR) of the portfolio. The VaR determines the maximum expected loss of an instrument or portfolio over a given time horizon and confidence level. To calculate the VaR, CONSAR uses the historical methodology, which consists in using the most recent information on the various risk factors, in this case the last 1 000 days given a 95% confidence level, in order to examine the possible values that a portfolio can reach, with the losses, with respect to the current value, assuming that what happened in the recent past can repeat itself. Therefore, information on risk factors for each day that passes is incorporated in the estimation of the VaR for the next 1 000 days, which gives a certain memory to this risk measure. Each SIEFORE has a different maximum VaR limit: 0.7% for SB1, 1.1% for SB2, 1.4% for SB3 and 2.1% for SB4, increasing with the risk profile of each SIEFORE (Table 5.3 above).

Losses caused by violations of VaR limits or any other breach to regulation by the AFORE must be compensated with special reserves kept by AFORE in each operating SIEFORE, equivalent to 0.8% of the assets under management. Furthermore, financial regulation imposes the re-composition of the portfolio when any quantitative limit is exceeded, including the limit on historical VaR.

AFORE must calculate and meet the VaR limit on a daily basis, as well as calculate the parametric VaR and the Monte Carlo VaR, in order to monitor risks and take investment decisions.

In 2010, as a result of the financial crisis, the governing bodies of CONSAR approved adjustments to the calculation of the VaR with the aim to incorporate exogenous volatility inherent in financial markets and to prevent pro-cyclicality. For each group of SIEFORE, CONSAR has set up a benchmark portfolio that replicates the investment conditions in the investment regime. When these benchmarks exceed regulatory VaR limits, the confidence level decreases, so that AFORE do not need to sell some of their positions because of the volatility in the market. When market conditions improve, the confidence level goes back to its original level. This allows the re-composition of portfolios to happen only under favourable market conditions. Such adjustment creates conditions to allow pension funds to be a fundamental element to stabilise domestic markets.

In October 2012, in order to limit the leverage generated by financial operations with greater sensitivity, the governing bodies of CONSAR approved the "difference of the Conditional Value at Risk" measure (ΔCVaR), which is the difference between the Conditional VaR of the portfolio of a SIEFORE and the Conditional VaR of the same portfolio excluding derivatives. The implementation of the ΔCVaR has been gradual and has encouraged a management approach based on stronger corporate governance. Each SIEFORE has a different maximum ΔCVaR limit, as shown in Table 5.3. At the same time, the regulatory VaR has been removed, subject to compliance with investment and risk rules.

In addition to the aforementioned quantitative limits, qualitative measures are in place. The AFORE must show that it has a robust corporate governance and internal investment/risks procedures in order to have the permission, granted by CONSAR, to operate with all different types of financial instruments and asset classes. It is worth mentioning that the corporate governance soundness and compliance with the investment regime is reviewed periodically by CONSAR through on-site inspections, focusing on the performance of the Investment and Risk Committees, the independent advisors, the compliance officer, and the involvement of the AFORE's board. For instance, if an AFORE wants to gain exposure to a specific asset class, it should show that the AFORE's Investment and Financial Risk Committees approved the investment, that it has performed an appropriate investment and risk analysis, and that it has an appropriate infrastructure to coordinate the operation. For instance, in the latter, if the investment is done through derivatives, the AFORE should have CONSAR's non objection to operate derivatives. CONSAR evaluates if the AFORE has the proper systems and human capital to manage them.

In order to ensure best corporate governance practices, CONSAR requires AFORE to manage investment and financial risks through different bodies: a Comprehensive Risk Management Unit (*Unidad para la Administración Integral de Riesgos*, UAIR), a Financial Risk Committee and an Investment Committee. Each AFORE is required to have the UAIR headed by a Chief Risk Officer who reports to the board of directors. This unit provides support to the Financial Risk Committee. It identifies, measures, monitors and informs the AFORE's board of directors of the risks faced by the AFORE and SIEFORE. The UAIR reports on a quarterly basis about the economic, financial and other consequences that the AFORE would face if risks should materialize.

The Financial Risk Committee must include one independent member of the board, one non-independent member and the person responsible for the UAIR. The General

Director of the AFORE chairs this committee. Those in charge of financial risk and the compliance office also attend the committee meetings. The Financial Risk Committee is responsible for determining risk tolerance levels and risk limits, for approving and reviewing models and measurement methods, ensuring policy and procedure manuals are up to date, checking compliance with risk policies and reviewing limit breaches and the corrective action taken. This committee is also responsible for the Financial Risk Management Policies and Procedures Manuals. The board must approve these policies, which must be sent to CONSAR for endorsement.

The Investment Committee must be composed by at least five members, among them should be considered an independent member, the AFORE's General Director and other members or officers appointed by the board of the pension fund. The Investment Committee is responsible for determining the investment policy and strategy within the limits proposed by the Financial Risk Committee.

Each AFORE is required to have a board of directors of at least five members appointed by shareholders, of which at least two members must be independent experts. The board has specific legal responsibilities and an important role in managing and controlling investment risks. It is responsible for the constitution of the Financial Risk Committee for the SIEFORE. The board also sets the level of financial risk tolerance for the AFORE within the limits allowed by regulation.

Risk officers, investment officers, independent board members, the compliance officer and the person responsible for the back office have to be certified to master general financial knowledge and have at least 5 years of relevant experience. This certification is performed by independent agencies, and has to be validated every 3 years. The General Director of an AFORE should reside in Mexican territory, have at least 5 years of experience in top finance positions, and not have worked in a regulatory agency or political institution for the last 2 years. An external auditor evaluates risk management on an annual basis.

Despite quite comprehensive risk management rules, following the OECD Core Principles of Occupational Pension Regulation (OECD, 2010), improvements could be achieved in AFORE's corporate governance, especially with reference to accountability, suitability and risk-based internal controls. The OECD Core Principles establish that the governing body of a pension fund should be accountable to the pension plan members and beneficiaries, calling for safe harbour rules that clarify the responsibilities and liabilities of the governing body. According to the SAR Law, the main objective of AFORE is to dedicate themselves to manage individual accounts and channel the resources of the sub-accounts in a regular and professional way, as well as to manage SIEFORE. However, the Law does not mention that the activities of the AFORE must be carried out in the best interest of plan members. Adding this broad objective into the Law may help addressing issues related to high fees, low returns and low services.

According to the OECD Core Principles, membership in the governing body of a pension fund should be subject to minimum suitability standards (such as "fit and proper" criteria) in order to ensure a high level of integrity, competence, experience and professionalism in the governance of the pension fund. The SAR Law defines minimum standards for risk officers, investment officers, independent board members, the compliance officer, the person responsible for the back office, the General Director of the AFORE and the external auditor. However, no specific qualifications and experience are required for non-independent board members.

Finally, it is important to identify and deal with conflicts of interest situations in a suitable manner. In certain cases, banning the concentration of functions in a single person or entity that would otherwise lead to conflicts of interest may be the preferred solution. In other cases, disclosure of the conflicts of interest to the governing body may suffice, who should be required to monitor these cases closely. It may be the fund's best interest to adopt policies which prevent even the appearance of a conflict of interest. In the case of Mexico, the independence and autonomy of independent board members and the compliance officer could be reinforced with respect to regulatory agencies, political institutions and different players in the Retirement Savings System.

5.4 Proposals to improve the design of the accumulation phase

5.4.1. Provide choice between different investment strategies while keeping default life-cycle investment strategies

The OECD Roadmap for the Good Design of Defined Contribution Pension Plans argues for the establishment of appropriate default investment strategies, while also providing choice between investment options with different risk profile and investment horizon. It also argues for establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes. The Mexican pension system as discussed previously already provides default life-cycle investment strategies. However, people can only choose the AFORE but do not have any choice as regard investment strategies.

The investment strategy is determined by the investment regulation applying to SIEFORE. Therefore, people willing and able to select other investment strategy may end-up with suboptimal choices given the current multi-funds scheme structure. The Roadmap argues that, if they wish, people should be allowed to choose the investment strategy best suited for them according to their risk profile and their level of risk tolerance, as well as their different overall pension arrangements.

Investment choice needs to go hand-in-hand with appropriate default investment strategies. Behavioural economics and the financial literacy research show that some people are either unwilling or unable to choose, let alone to actively manage their own portfolio investments. Given the low level of financial literacy in Mexico, a large proportion of workers may end-up in that category. Therefore, default investment strategies are necessary, as they incorporate the lessons learned from behavioural economics on the importance of inertia and passive decision making, to make sure that those people are assigned to appropriate investment strategies.

As argued in OECD (2012), default investment strategies should concentrate on reducing the risk of extreme negative outcomes on retirement income. Life-cycle investment strategies are appropriate defaults in this respect. The Mexican multi-funds system enters in that category, as pension assets are invested in a more conservative investment regime as members get older, by moving automatically from one basic SIEFORE to the next at specific ages.

There are two ways to adapt the current multi-funds system in Mexico to a system with investment choice and default investment strategies. The first consists in keeping the structure with basic SIEFORE and add lower and upper limits for risky assets, as is done in the case of Chile. This would allow individuals to choose their preferred allocation within the limits of each basic fund. The middle of the bracket between the lower and the upper limits could be used to define the default option.

The second way consists in allowing AFORE to provide different investment strategies as well as a life-cycle default investment strategy. The default life-cycle strategy should be common to everyone, especially in a mandatory system where low income and low education individuals also participate.

Finally, regulatory limits for equities and foreign securities could be gradually relaxed to further encourage portfolio diversification. The current law proposal also puts forward the expansion of alternative investments for SIEFORE by allowing investment in private securities registered in the National Securities Registry and including new types of instruments, such as lending and repurchase securities, different from those issued by the federal government, the Bank of Mexico and the banking institutions. However, AFORE do not use the whole range of financial instruments already allowed by regulation at their full potential. Increasing skills in AFORE's investment teams will therefore be essential to allow for appropriate diversification in SIEFORE's portfolios.

5.4.2. Address high charges and increase competition

The amount of fees that pension providers charge can have an important negative impact on pension benefits. Pension providers charge fees for the services they offer, such as account administration and investment management. Fees may be charged on contributions or assets under management or paid separately by the plan member (switching fees for example). They affect the benefits that plan members receive, as the higher the charge, the lower will be the benefits that members receive for a given contribution, or the higher will be the total contribution required to achieve the same level of benefits. Table 5.8 below shows the impact of different levels of asset management charges in terms of reductions in pension benefits, assuming a 40-year contribution period. Halving the management fees from a level of 1% of assets under management to 0.5% can raise pension benefits by about 10%. High fees may sometimes be worth paying for a better quality service or for higher risk-adjusted returns. However, more often, they are symptomatic of a seller-dominated pension industry, in which individual plan members have a clear informational and financial disadvantage compared to pension providers.

Table 5.8. **Fee levels and impact on pension benefits**

Fee as % of assets	Reduction of pension (%)
0.05	1.2
0.15	3.6
0.25	5.9
0.50	11.4
0.75	16.5
1.00	21.3
1.50	29.9

Source: OECD (2012).

Policy makers need to ensure that there are incentives in place to improve efficiency and reduce costs and fees in the pensions industry. Various policy solutions have been considered in OECD countries to address this issue, which can be divided into three main groups: disclosure-based initiatives, pricing regulations and structural solutions.

Disclosure-based solutions include ensuring that members receive timely information on the fees they pay, including comparisons between providers. This solution is already implemented in Mexico. Pension statements include information on commissions paid by the worker. Although they do not allow comparing fee levels across AFORE directly, comparisons are done between net returns, which represent the long-term historical performance of SIEFORE, net of fees. The main limitation of such initiatives, especially in countries that target lower income employees, is that pension statements do not always succeed in prompting members' action regarding their retirement savings.

Pricing regulations include allowing a single charge structure (only contribution-based or only asset-management charges) and setting ceilings on the fees that pension providers can apply. Such solutions can be effective in avoiding high fees, but they are not necessarily conducive to cost-reductions and efficiency improvements in the industry. Poland has successfully used price caps to lower fees. In 2004, Poland capped the management fee at 7% of contributions. In 2010, a new legal limit of 3.5% was introduced. Under the 2014 pension reform law, the maximum fee fell again to 1.75%. The United Kingdom has also recently introduced successfully caps on fees and charges.

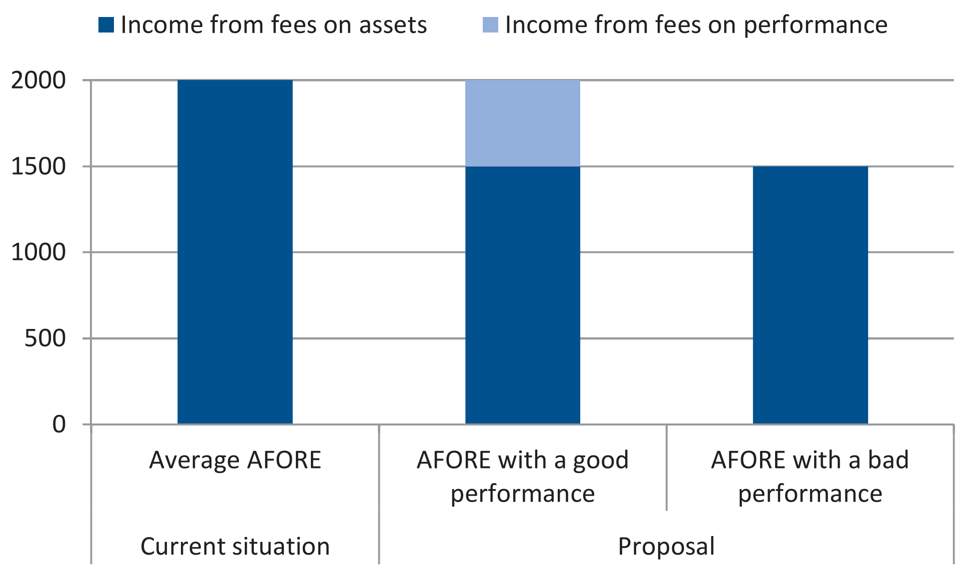
Mexico has pricing regulation as AFORE charge only fees on assets under management, but there is not a cap on fees charged. The main measure to control fees and charges is the power that the Governing Board of CONSAR has to reject fee proposals by AFORE and force them to apply the average of the industry. This may implicitly put a cap on fees and charges but it does not provide any incentive for AFORE that already charge fees below the average to lower them further. In addition, AFORE charge the same level of fees for all workers, whether they are registered or assigned, even though assigned workers get fewer services from the AFORE.

There are currently three reform proposals aimed at reducing fees and charges:

- Impose to AFORE for which the Governing Board of CONSAR has rejected the fee proposal for the following year to charge fees at 75% of the average of the market.
- Charge lower fees for assigned accounts. Only AFORE differentiating assigned accounts with lower fees would be potential candidates to get assigned workers. This proposal would encourage AFORE to register these assigned accounts (today, assigned accounts are maintained like this).
- Keep the current scheme of charging fees only on assets accumulated, but structure it into two components, one calculated as a percentage of the value of assets under management, and the other one calculated as a percentage of the performance of the fund. The second component could represent up to 0.3% of assets under management. This proposal aims at increasing competition in the system and aligning the interest of AFORE with the goal of generating higher returns in the long-term for the benefit of workers. In any case, the two-component fee would not exceed the current one-component fee (see illustration in Figure 5.14).

Figure 5.14. **Illustration of the proposal for a new fees' structure**

Millions of pesos



These proposals may have some traction in reducing fees and charges but they may not bring them down to the most cost-efficient level. The first one, by increasing the penalty for AFORE that have their fee proposal rejected, may increase the quality of their proposal but not necessarily bring down the fees charged because the level of fees is not a direct criterion to reject the proposal. Moreover, AFORE with fees on the average or lower may not have any incentive to reduce them further even if they could. The second proposal is fair, different services, different costs, and then different charges. Finally, it is positive to introduce performance-based fees because it may force AFORE to improve their performance to be able to keep current fees. However, it will not reduce fees, let alone bring fees down to those determined by a competitive market.

The third type of policy solutions implemented in some OECD countries to reduce fees is structural in the sense that it involves a specific industrial organisation set-up. In personal plans, a structural solution may involve the establishment of a centralised institution that is in charge of either delivering the various pension services, directly or via an outsourcing arrangement, or of negotiating better terms (lower fees) on behalf of individual plan members (e.g. the Swedish PPM system or NEST in the United Kingdom). This policy solution can be very effective in achieving low fees as it ensures economies of scale and can avoid the marketing expenses of the retail model. However, it may be difficult to implement once a DC industry of competing providers is established, at least in a mandatory system. A centralised institution can also raise governance challenges that call for effective and independent oversight.

There are other structural solutions which can also be conducive to lower fees that may work better when a DC industry of competing providers is already established. This includes establishing a tender process, for example by the regulator, for assigning new or undecided workers to a single pension provider (e.g. Chile and New Zealand). For example in Chile, an auction mechanism was introduced in 2008 for new members who enrol into the system. The auction applies to the fees charged for the management of the individual accounts for new members. New members are automatically enrolled in the pension fund which charges the lowest fees and they are required to remain in this pension fund for 24 months. After that, members can freely transfer their accounts to another pension fund. There have been three auctions since the reform was enacted. The first auction took place in 2010 and it allowed a new pension fund to enter the market starting from August of that year, offering the minimum fee of the system equal to 1.14% of salary. The same pension fund won the second auction in January 2012, decreasing the fee offered to 0.77% of salary. As a result, another pension fund decided to lower its fees from June 2012, the first reduction by any of the incumbents since 2009. During the third auction, carried out in January 2014, the pension fund previously with the highest fee won the auction by lowering it to 0.47% of salary. Again, such a solution calls for strong public-sector governance and institutional capability.

The Mexican authorities could consider extending the assignment process to new entrants using a tender mechanism. In Mexico, there is no tender process, but non-registered accounts are assigned to one of the AFORE with the highest net return indicator. A tender process could be used to allocate all new entrants in the pension system to the AFORE with the best offer, not just members with non-registered accounts. In addition, using the net return (net of fees) as a criterion to select the AFORE that would receive all new entrants may be more appropriate than using the fees only, as long as providers do not increase the risk-return profile of their investment portfolio to obtain large returns. The possibility of creating a tender mechanism that uses fees and historical net return (net of fees) as the decision parameters in the auction process should also be explored, in order to incentivise not just the performance of the AFORE but the fee competition among them.

The assignment process does not seem to foster competition among AFORE. As of December 2014, there were 16.7 million accounts held without being registered. AFORE do not have enough incentives to register these accounts, even though the re-assignment process means that they can lose these members after two years. Of those 16.7 million accounts, 6.2 million were inactive (contributions have not been paid to the account during six consecutive two-month periods) and managed by the services provider. These accounts only get a minimum return, usually much lower than returns provided by SIEFORE to registered accounts and active assigned accounts.

The reform proposal would help increasing incentives to register assigned accounts. It suggests giving more powers to CONSAR to determine the characteristics and requirements to assign accounts. For example, it could be decided that accounts with some activity (to be defined by CONSAR) would be assigned to the AFORE that offers the best conditions, such as returns, services and registration efforts. The management of totally inactive accounts would still continue with the services provider. Assigned workers for whom an AFORE would register their account would have to stay at least three years with that AFORE. However, workers would still be able to transfer their account after one year to another AFORE with better returns, lower fees and better services. In addition, AFORE would be forced to charge lower fees for assigned accounts, thus reinforcing the incentive to register those accounts.

The bill also proposes initiatives to ensure that transfers of accounts between AFORE are done in an informed manner and are not only the results of commercial strategies from AFORE:

- Extend the period during which workers cannot transfer their account from one to three years, with the possibility of transferring the account after one year only if the AFORE receiving the account offers better returns and better services;
- Perform operational and regulatory reforms to ensure that workers gain more awareness of the importance of the choice of the AFORE, with information on returns and services delivered by each AFORE;
- Oblige AFORE to send workers an annual pension forecast report, giving information about their current retirement savings situation and the outlook for the pension income under various scenarios;[3]
- Introduce the concept of "re-certification" through which workers would receive a visit or a call from their AFORE annually to confirm their registration with it. This would be the occasion for the AFORE to improve the services provided to the worker. This process intends to avoid transfers for reasons like unifying accounts, correcting information, making withdrawals for unemployment or wedding, without considering the net return.
- Keep a record of sales agents through a comprehensive database. To be certified, agents would have to comply with the requirements established by CONSAR, which would have the ability to suspend or cancel the certification of sales agents.

Lengthening the period during which people cannot switch between AFORE from one to three years should help both to decrease the number of negative switches and to lower commercial costs, as less sales agents would be needed to contact a reduced number of potential clients. In addition, the new form that workers have to sign when asking for a transfer of their account should make clear the consequences of a negative switch and maybe discourage them. Unfortunately, transitional workers would have another incentive structure. Their pension benefits do not depend on fees charged or the performance of pension funds (i.e., returns) because they can choose to receive their pension according to the old DB formula which is not linked to the amount of assets accumulated in their DC account. The pro-rata system proposed in chapter 4 would help making all workers concerned about how their assets are invested.

The COFECE (*Comisión Federal de Competencia Económica*) recently proposed to limit marketing costs by imposing a maximum limit, either in absolute or relative terms (COFECE, 2014). Indeed, in 2013 nearly half of AFORE's spending was in marketing costs (affiliation and transfers), while only 4% was used for investment activities. In addition, those marketing costs have not translated so far in clear benefits for members, as illustrated by the fact that more than half of transfers over the last four years took place towards AFORE offering lower returns. Imposing a maximum limit on such costs should be considered. Some OECD countries, such as Sweden and Poland, have gone all the way to outlaw advertising in their mandatory pension system.

5.4.3. Improve AFORE's corporate governance

The OECD Core Principles of Occupational Pension Regulation (OECD, 2010) establish governance as a key element in maintaining sound, effective and compliant pension plans. Strong governance is essential as regulation alone cannot achieve the good practice necessary for integrity and effectiveness. Weak governance in pension funds is a serious problem with potentially major and damaging consequences for pension entities and plan members.

To achieve good governance, members of the governing body should have suitable knowledge, experience and training which allow them to understand and challenge advice they receive from outside experts. Additionally, conflicts of interest within boards and in relation to independent officers must be addressed, and there is a strong need to strengthen the fiduciary responsibility of pension plan providers in DC systems in order to ensure that plans are managed with the interest of the members in mind.

The current reform proposals pending in the Senate seek to align the corporate governance systems of the AFORE with best domestic and international practices. It would help addressing issues related to conflicts of interest. Regulations of CONSAR would define with greater precision the responsibilities and functions of the governing bodies, including directors, the administrators and key executives. The AFORE will be required to have an Audit Committee and a Corporate Practice Committee as well as adequate internal safeguards. The responsibilities of independent board members and the compliance function would be strengthened. In particular, independent board members and compliance officers may not have, simultaneously to their function, a position, a financial link or labour link with the AFORE to which they provide services, with any other financial intermediary (independently of whether the intermediary belongs to the financial or business group of the AFORE or not), with commercial entities controlled or subsidiaries of the corporate group of the AFORE, and with any other participant in the Retirement Savings System. In addition, it is proposed to establish a temporary four-year initial period, renewable once for an equal duration, for independent board members and the compliance officers in order to strengthen their autonomy. CONSAR would also co-operate with other supervisors in scrutinising the activities of financial groups when AFORE are part of such a group, in order to detect possible conflicts of interest and risks of contagion.

The fiduciary duty of AFORE would also be strengthened, as the new law would require AFORE to carry out all the steps necessary for obtaining adequate performance and secure investments in the SIEFORE they manage. In accordance with their functions, they should exclusively look after the interests of workers and ensure that all operations are carried out with this objective in mind.

The suitability of all members of the board of directors of AFORE may however still need to be improved, especially for non-independent members. Minimum suitability standards as the ones required for independent board members may be required, as well as regular training to ensure they can understand the decisions of the professionals that operate the fund.

Notes

1. Self-employed workers can also voluntarily choose to save in an AFORE.
2. See the OECD Survey of Investment Regulation of Pension Funds (*www.oecd.org/finance/private-pensions/annualsurveyofinvestmentregulationofpensionfunds.htm*) for international comparisons.
3. CONSAR actually requires AFORE to send an annual pension report which contains an estimate of the future pension level, as well as voluntary savings scenarios since 2014.

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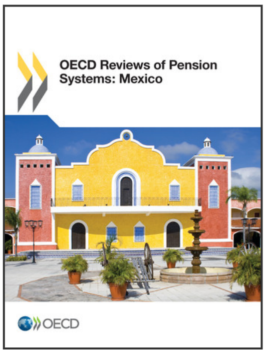

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