Chapter 1

Introduction to the Review of the Mexican pension system

This chapter briefly describes the objectives of the review of the Mexican pension system. It presents a brief historical background to the changes experienced by the Mexican pension system since the 1990s. This review provides recommendations, using OECD best practices in pension design, on how to improve the Mexican pension system with the ultimate goal of ameliorating the retirement income that people may receive from the pension system.

1.1. Objectives of the review

The National Commission of the Retirement Savings System (*Comisión Nacional del Sistema de Ahorro para el Retiro*, CONSAR), the Mexican pension regulator, requested the OECD to conduct a short and focused review of the Mexican pension system. The main motivation of the Mexican authorities for conducting this review is to understand the challenges facing the Mexican pension system, assess the system in light of the most common practices in the design of pension systems in OECD countries, and ultimately, increase awareness among different stakeholders of the challenges faced by the Mexican pension system.

The purpose of the review is therefore to provide recommendations, using OECD's best practices in pension design, on how to improve the Mexican pension system with the ultimate goal of ameliorating the retirement income that people may receive from the pension system. The detailed terms of reference for the review are reproduced in Box 1.1 below.

Box 1.1. **Terms of reference for the OECD review of Mexico's retirement income provision**

The National Commission of the Retirement Savings System (*Comisión Nacional del Sistema de Ahorro para el Retiro*, CONSAR), the Mexican pension regulator, requests the OECD to conduct a short and focused review of the Mexican pension system based on the OECD's best practices in pension design. The review will take account of current proposals to reform the current SAR Law (*Modificación de la Ley del SAR*).

Particular aspects for examination include:

- The adequacy of pensions given current levels of mandatory contributions, retirement age, voluntary savings, and short contribution densities.
- Mechanisms to increase coverage and the amount of contributions, in order to ensure adequate income in retirement with a particular focus on lower- and middle-income groups, independent workers and informal workers.
- Tax system and retirement savings. Fiscal and other incentives to promote participation and higher retirement savings.
- Improving the design of the overall pension system:
  - Improving the interaction between the labour market and the pension system, including mechanisms to work longer.
  - An analysis of the best way to design the basic pension to protect low-income groups in the light of the funded private pension system.
  - The need for two different sets of rules in the mandatory funded defined contribution system, one for public-sector workers (ISSSTE) and another one for private-sector workers (IMSS). Should they converge?
  - The convenience of maintaining a defined benefit pay-as-you-go system for State and public university employees.

Box 1.1. **Terms of reference for the OECD review of Mexico's retirement income provision** (cont.)

- Improving the design of the accumulation phase:
  - Approaches to promote low-cost retirement savings instruments.
  - Default investment strategies and life cycle strategies.
  - The wisdom of investment restrictions, in particular on foreign securities.
  - Risk-based supervision and the Value-At-Risk.
- Improving the design of the pay-out phase:
  - Different mechanisms to allocate assets accumulated at retirement: lump-sums, programme withdrawals and life annuities.
  - Pay-out phase and annuity markets.
  - Managing longevity risk (mortality tables, financial instrument to mitigate longevity risk, including longevity bonds).
- Policies to increase public understanding and the public's confidence in the pension system:
  - Strengthening the regulatory framework and governance of private pension funds (AFORE).
  - Pension statements and National Pension Communication Campaigns.

The review should also take account of the views of relevant stakeholders by way of a targeted consultation process.

A mission to Mexico took place 19-22 January 2015.

In addition, the review of the Mexican pension system considers current reform proposals under discussion. President Peña Nieto sent to Congress a reform proposal for the Social Security in 2013, which has three components:

- Universal pension;
- Unemployment insurance;
- Improvements to the Retirement Savings System (*Sistema de Ahorro para el Retiro*, SAR).

The Lower Chamber approved the reform proposal in April 2014. Its discussion and approval is since then pending in the Senate. The specific reform proposals related to the retirement savings system cover the following nine areas:

Reform proposal	Objective of the proposal
1. AFORE fee structure	Reduce fees and bring in more competition
2. AFORE switching model	Improve the quality of transfers and reduce business expenses of AFORE
3. Improve the assignment process of AFORE for new workers and non-continuous savers	Protect the interests of young workers and non-continuous savers
4. Incentives for voluntary pension savings	Encourage higher voluntary savings to reach higher pensions
5. AFORE's corporate governance	Strengthen investment decisions within AFORE to protect the savings of workers
6. Investment regime of SIEFORE	Introduce new investment alternatives to seek better returns
7. Facilitate the designation of beneficiaries	Make it easier for savers and their families to recover their savings in an AFORE
8. Better promotion and diffusion of savings for retirement	Better and more information for savers in the system
9. Better care and services to workers	Improve the experience of workers with their AFORE

1.2 Historical background to the changes experienced by the Mexican pension system since the 1990s

Mexico had a traditional defined benefit (DB) pay-as-you-go (PAYG) government run pension system until the mid-1990s.

The overhaul of the Mexican pension system started in 1992 with the creation of the Retirement Savings System (*Sistema de Ahorro para el Retiro*, SAR) for private- and public-sector workers affiliated respectively to the Mexican Institute of Social Security (*Instituto Mexicano del Seguro Social*, IMSS) and the Institute for Security and Social Services for State Workers (*Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado*, ISSSTE), introducing for the first time individual capitalisation accounts on a complementary basis to the DB PAYG public system.

In 1995, Mexico reformed its Social Security Law to address the growing actuarial deficit of the DB PAYG pension system for private-sector workers, and assure the system's financial sustainability. As a result, the IMSS DB system was definitely transformed into a defined contribution (DC) scheme, where workers own their accounts. Private-sector workers who were working or had contributed to the system at that moment still have the option at retirement of choosing their pension benefits according to the DB formula or according to the assets accumulated in their DC accounts.

In 2007, faced with large deficits as well the PAYG DB system for public-sector workers was also reformed, transforming the DB scheme into a DC scheme. The 2007 reform of ISSSTE gave public-sector workers who were working or had contributed to the system at that time the option to stay in the old DB system or to move to the new DC system. Those who chose the new DC system were granted a bonus that recognised their past tenure.

Mexico is consequently one of the few OECD countries that has reformed its mandatory pension system moving from DB PAYG to funded DC system and has made transparent its fiscal pension liabilities. The Mexican authorities argue that the reforms have led to substantial fiscal savings. Table 1.1 below shows fiscal savings of around 48.7 percentage points of GDP.

Table 1.1. **Actuarial deficit of reformed pension systems, as a % of GDP**

Institution	Before reform	After reform	Savings
IMSS	61.4	44.1	17.3
ISSSTE	45.6	23.0	22.6
Government companies (e.g. electricity)	8.6	6.0	2.6
IMSS workers (RPJ)	13.2	7.0	6.2
Total	**128.8**	**80.1**	**48.7**

Source: Mexican authorities.

1.3. Structure of the review

This review assesses the current Mexican pension system that has resulted from these reforms. The review also examines the period of transition between the old DB system and the new DC system that has resulted from allowing workers in the system at the time of the reforms to choose, either at retirement or at the time of the reform, between both systems.

The purpose of this review is therefore to identify areas that need to be improved and provide guidance on how to introduce these improvements to make the current Mexican pension system sustainable in the long term. Those improvements aim at ameliorating the fiscal sustainability of the system and the retirement income that people may receive from the system. The review uses the OECD's best practices on designing pension systems contained in the "OECD Roadmap for the Good Design of Defined Contribution Pension Plans" (OECD, 2012b), the *OECD Pensions at a Glance* (OECD, 2013), and the *OECD Pensions Outlook* (OECD, 2014b and 2012a).

The review is organised as follows. Chapter 2 describes succinctly the Mexican pension system. The Mexican pension system is mainly based on funded defined contribution individual accounts introduced in 1997. Therefore the "OECD Roadmap for the Good Design of Defined Contribution Pension Plans" (OECD, 2012b), endorsed and approved by pension regulators from OECD countries, is a key guide to assess the Mexican pension system.[1]

The Mexican pension system also has a public pension provision element. Public pensions first refer to the old defined benefit pension systems, which still cover workers who entered the labour market before the introduction of funded defined contribution individual accounts. The public pension provision also consists of a minimum guaranteed pension (*Pensión Mínima Garantizada*, PMG) and an alternative means-tested pension for people older than 65 (*Pensión para Adultos Mayores* or “65+”).

1. The analysis supporting the Roadmap recommendations, contained in several chapters of the *OECD Pensions Outlook* 2012 and 2014 editions, would be also very useful.

Chapter 3 describes the Mexican public pension provision and presents proposals, based on best practices in other OECD countries, to reform the public pension system.

Chapter 4 addresses the implications of the transition period for the sustainability of the current pension system and provides recommendations. The transition period between the “old” DB system and the “new” DC system has resulted from allowing workers in the labour market or people having contributed to the system at the time the reforms were introduced to choose between both systems.

The coverage of the Mexican pension system as well as the level of contributions and the length of the contribution period, are the main factors explaining the potential problems with the amount of retirement income that the system may expect to deliver. Chapter 4 discusses how the combination of low contribution rates, low densities of contributions and high promises to transitional workers (those entitled to defined benefits) will lead to sharp declines in the amount of retirement income that people will receive once the last transitional worker has retired. The chapter then presents proposals based on OECD best practices on how to increase coverage and contribution levels (in both the mandatory and voluntary accounts). The review when discussing proposals to increase coverage/participation distinguishes among different types of informal workers. There are self-employed or independent workers who are not obliged to participate and other workers who despite having to participate and contribute they somehow fail to make contributions. The policies to increase coverage are different whether considering self-employed workers or workers who fail to make contributions.

Chapter 4 first looks at coverage distinguishing between people with active and inactive accounts. It provides information on mandatory and voluntary contributions and discusses the adequacy of having different mandatory contribution rates for private- and public-sector employees. The analysis also assesses the amount of contributions in an environment of uncertainty (financial market, labour market and demographic risks) necessary to achieve certain retirement income and/or replacement rates (*OECD Pensions Outlook 2012*, Chapter 6). The chapter then focuses on tax incentives to save for retirement. It describes the tax treatment of contributions, returns on investment and pension benefits and assesses different forms of implementing tax incentives and how current tax incentives combine with matching contributions. The chapter finally discusses options to increase coverage, contribution rates and contribution densities. Related to this, it discusses the pension statements and the National Pension Communication Campaigns.

Chapter 5 focuses on improving the design of the accumulation phase. The chapter addresses issues related to the costs and fees of pension funds and different approaches implemented to reduce these costs. The chapter also looks at different investment strategies, in particular the multi-funds age-related investment strategies of the AFORE and the defaults. It also discusses the different investment restrictions and the need for them. Other issues include risk-based supervision, governance and regulation in general. The chapter ends with some recommendations based on the OECD Roadmap for the Good Design of DC Pension Plans, the OECD Core Principles for Pension Fund Regulation, and the IOPS Principles for Supervision.

Chapter 6 discusses the current structure of the pay-out phase of the Mexican pension system and provides guidelines for improvements. The main recommendations are based on the OECD best practices contained in the "OECD Roadmap for the Good Design of DC Pension Plans" (OECD, 2012b), the *OECD Pensions Outlook* (OECD, 2014b) and the publication *Mortality Assumptions and Longevity Risk* (OECD, 2014a).

The chapter first introduces the main modalities that exist in Mexico to allocate assets accumulated in individual retirement accounts and thus finance retirement income. In this context, the chapter discusses the problems with the annuity market in Mexico and the type of annuity products available. The chapter also assesses the mortality tables used by annuity providers and pension funds, provides an assessment of the amount of longevity risk that they may be exposed to and discusses approaches to manage longevity risk in the context of the Mexican financial markets.

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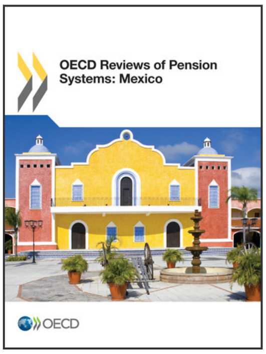

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