

X. PENSION FUNDS SUPERVISORY METHODS IN MEXICO

by
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Introduction

Overview of the Mexican Private Pensions System

The genesis of the new Pension System for the private sector dates back to 1992 with the introduction of individual accounts as a complementary defined contribution program to the Pay-Go system. This program was known as the Retirement Savings System (SAR 92). Each individual account consisted of two sub-accounts — retirement and housing — and the contributions to these accounts were 2% and 5% of the worker's salary respectively, which were paid by the employer on behalf of the worker.

The retirement sub-account savings were invested in Federal Government credits through deposits in the Central Bank, and the rate of return was set by the Ministry of Finance at prevailing market levels, whereas the housing sub-account resources were transferred to the Housing Institutes.

Whenever a worker is granted a pension, he/she receives the total amount of his retirement sub-account as a lump sum. As for the housing sub-account savings, they are used to amortize the mortgage loan that the worker may have acquired with the Housing Institute. Otherwise, the worker is entitled to withdraw them in a lump sum payment at the same time as the retirement sub-account.

On 1 July 1997, the SAR 92 program was transformed into a full fledged mandatory defined-contribution pension system for the private sector workers affiliated to the Mexican Social Security Institute (IMSS). This replaced the old Pay-Go scheme.

This new scheme relies on individual capitalization accounts and a minimum pension guarantee by the Mexican Social Security Institute (Federal Government). Consequently, the pension of a worker depends on the savings accumulated in his individual account and the returns generated by them. If the worker does not meet the requirements to get a pension, he/she will withdraw the accumulated savings at the retirement age (65 years). It is worth mentioning that the 5% contribution for the housing sub-account remains administrated by the Housing Institute for the private sector workers (Infonavit).

The individual accounts are then managed by the Pension Funds Managers, called *Administradoras de Fondos para el Retir*, (AFORES), that compete in a free market for the workers' preferences. The AFORES are specialized financial entities responsible for administrating the individual accounts and the investment of the savings through an SPV called *Sociedades de Inversión Especializadas en Fondos para el Retiro* (SIEFORE)s.

The AFORES and SIEFORES are two legally separate entities with their own paid-in capital. Both need the approval of the National Retirement Savings System Commission (CONSAR) to begin operations.

CONSAR is the entity in charge of the regulation and supervision of this new pension system. Its core activities include: regulate and supervise the system, grant, modify and revoke authorizations to operate AFORES and SIEFORES, impose fines and sanctions when the regulation is breached, inform Congress about the system status, and disseminate relevant information to the public.

CONSAR is part of the Ministry of Finance, although it has technical and executive autonomy. It is financed partially by the supervision quotas, which are collected from all the supervised entities. Additional funding is requested to the Federal Government by means of the Ministry of Finance.

CONSAR has two governing bodies: the Board and the Surveillance Committee. Both bodies have representatives of the government, the employees and the employers. This *tripartite* representation gives equal voice to all stakeholders of the pension system and legitimizes all structural decisions taken at CONSAR.

The Board is the top governing entity, and it is presided by the Minister of Finance. The other 15 members of the Board include two representatives of the workers, one representative of the employers, and representatives of several governmental agencies, especially those related to social security and financial themes. The President of CONSAR is directly appointed or removed by the Minister of Finance.

The Surveillance Committee is the other governing body integrated with equal representation by federal government officials, unions leaders, and employers. This Committee is in charge of the surveillance and development of the Retirement Savings System.

One distinguishing feature of this pension system is its collection model: it is a centralized, *hub and spokes* model. The key player in this model is the National SAR Database Operator Company (Procesar). The owners of PROCESAR are the AFORES and the banks that managed the SAR 92 recordkeeping.

The collection process consists of three main parts: first, the employers deposit the contributions in the authorized banks, which in turn transfer the information to PROCESAR and the money to the Central Bank. Second, PROCESAR cross-checks the information received, reconciles it with the deposits and generates files with the details of the contributions that will be distributed to each SIEFORE from the concentration account at the Central Bank.

Finally, the AFORE cross-checks the information with the money that the SIEFORE has received, determines the contributions to each individual account and the fees on those contributions. To complete the cycle, the SIEFORE then buys securities with the savings received.

As for the housing sub-account, AFORES act only as record-keepers for each individual account. However, the savings are transferred to the Housing Institute (*Infonavit*) and used for granting mortgage loans to contributing workers. Contributions not used by workers to repay a loan are withdrawn at retirement age together with the retirement sub-account to pay for an annuity or by means of programmed withdrawals.

As of December 2003, 13 AFORES operated in the system.

Summary of the supervision scheme

The framework for supervisory activities of CONSAR is defined by the Retirement Savings System Law (LSAR). In particular, Article 89 states that participants must be evaluated in terms of the risks that they are subject to, their internal control systems and the quality of their management.

CONSAR'S main objective is to protect the interests of the workers and their beneficiaries. CONSAR has technical autonomy and executive powers to make any decision regarding the participants of the pension system, including

the managerial intervention of an AFORE, and the revocation of its license. These decisions are submitted to the Board for ratification.

Regarding supervision procedures, CONSAR has established mechanisms to prevent risks in the AFORES and SIEFORES, instead of acting after the regulation has been breached. The pension system development and the existence of cheap and powerful information technology have enabled CONSAR to update its supervisory models: from the basic surveillance adequate accounting registries, to a surveillance of the processes that ensure that workers rights (savings and freedom of choice) are always respected. All the objectives and results of the inspection and surveillance processes of CONSAR are set forth in the respective Annual Programs.

CONSAR has a labour force of 150 persons of whom 31% are involved in front-line supervision activities, 31% are involved in supervisory support functions, and 38% are involved in corporate services. CONSAR'S annual budget for 2001 was USD 161.0 million pesos (USD 14.7 million dollars).

CONSAR informs Congress twice a year about its main activities and results. It also publishes and distributes an annual activities report.

Supervision scheme

Entry requirements

Requested documents

According to the Retirement Savings System Law (LSAR), anyone who wishes to apply to operate an *Afore* must fulfil the following requirements:

- Application to operate an AFORE and draft of the company's by-laws.
- Programs of: operations, information disclosure, self-regulation and capitalization.
- Five-year balance sheets of each of the AFORE's shareholders.
- Study that justifies the establishment of the AFORE and one or more SIEFORES.
- Background of the founding partners, Board members, and main staff.
- Organizational handbook.

After the application has been approved, applicants have 90 days to prove to CONSAR that they comply with the following requirements:

- Certified copy of the company's deed.
- Draft contracts of administrative services with its SIEFORE.
- Draft contract with an institution for securities deposit and custody.
- Registration of the company at the Ministry of Finance.
- Draft contract with one or more financial institutions or brokerage houses.
- Draft contract with PROCESAR.
- Information on the location of its main office and branch offices.
- On-site certification of the IT installations with the corresponding contracts to operate these systems.
- On-site certification of the correct functioning of the Risk Management and Portfolio Management units.

To evaluate all the documents and information presented by the applicants, CONSAR has created "Compliance Matrixes". With these matrixes, every single requirement is checked and given a grade. The beginning of operations is then contingent to the full and correct presentation of all the requirements and an acceptable number of points from the "Compliance Matrixes".

Capitalization

The minimum paid-in capital that every AFORE must have is MXN 25 million (USD 2.3 million). The first SIEFORE must have a minimum capital of MXN 4 million (USD 366 000) and each additional SIEFORE MXN 1 million pesos (USD 91 000). Moreover, the AFOREs must have a "special reserve" of the greater between MXN 25 million pesos (USD 2.3 million) and 1.65 times the VaR limit. The "special reserve" is design for two purposes: to cover any losses the SIEFORE may incur when the investment regime has been breached, and to align the incentives of the administrators with workers savings.

Board of Directors and Staff

Regarding corporate governance issues, the Board of Directors must have at least five members, and at least two of them must be independent counsellors.

The Surveillance Committee must approve the appointment of the independent counsellors and the comptroller.

On-going supervision

The supervision of the retirement savings system participants is one of the main tasks of CONSAR. Our ultimate goal is to protect the workers' interests through the supervision of the system's processes and the correct management of the individual accounts.

CONSAR'S initial supervision model emphasized on the timely flow of information and money across the parties involved in the process. However, as the system has proven its effectiveness in that matter, improvement in other key areas has become the goal. Modernization guidelines for supervision are the following:

- *Emphasis on prevention.* CONSAR has established mechanisms to prevent risks in the operation of the AFOREs and SIEFORES instead of acting when the regulation has been breached.
- *Focus on processes that involve the worker.* The pension system development and the technological modernization has enabled CONSAR to redirect its supervisory model towards an integral surveillance that analyzes the processes in which workers interact with the AFOREs. This is important to ensure that workers' rights are preserved.
- *Deregulate and promote self-regulation.* At the beginning of the system, CONSAR issued the rules that dictated the way the participants had to operate, the controls and the timing of each process. Currently, CONSAR is modifying this policy to set only the main goals and some operating guidelines. With this shift in policy, CONSAR seeks to encourage AFOREs to prevent irregular situations through self-regulation programs.

CONSAR's supervision model rests on four pillars: self-regulation, surveillance, inspection and sanctioning.

Self-regulation practices

Self-regulation practices constitute an important complement in the traditional supervision because they allow for the development of surveillance activities that involve a wider range of issues than those the authority can supervise.

The Law requires that the AFOREs must have a comptroller that must report only to the Board. The comptroller verifies the compliance of the

AFORES' staff with the internal and external regulations and supervises the degree of fulfillment of the authorized self-regulation processes.

The comptrollers must correct any anomaly detected in the operating, accounting and financial processes through the self-correction programs, and inform CONSAR about any operative inconsistency identified and the preventive steps that will be taken to avoid any further inconsistencies. It is worth mentioning that the AFORES may only submit to CONSAR for approval the self-correction programs in those areas that are not covered by the current regulations, and when the violation of those programs does not affect affiliates' rights.

In the coming years, CONSAR's main challenge will be to reinforce the comptroller's independence and support the industry in the definition of its own regulation program.

Surveillance

Among CONSAR's supervisory activities, the surveillance of the system's operative transactions, the compliance with the Investment Regime and the calculation of a daily fair net asset value of the SIEFORE, play a central role.

b.1) Operative surveillance

Operative surveillance focuses on two themes, the contributions' collection process and workers' interaction with the system:

b.1.1) Contributions' collection process.

This surveillance focuses on making sure that flows of information and money among all parties involved are consistent and properly reconciled. That is, the money and information that flows among the banks receiving the payments from employers, the Central Bank that concentrates and then disseminates the money, PROCESAR that receives information from the bank and transfers it to AFORE and to individual accounts, must coincide across all stages and players.

In order to perform this surveillance, CONSAR receives electronic files from all parties involved and cross-checks them on a daily basis with IT systems. CONSAR also checks routinely that commissions, contributions and returns are correctly registered in each individual account.

Workers' interaction with the system

Workers must interact with the AFORES in several instances. The most relevant interactions are the following:

- registry with the initial Afore
- transfer to a different Afore
- withdrawal of savings at retirement
- deposit and withdrawal of voluntary savings

CONSAR's duty is twofold: i) provide a regulation that allows processes to be carried out in the most cost and timely efficient fashion for workers, and ii) make sure that workers' rights are respected in every process they are involved in.

This surveillance, especially the registry with and transfer to a different AFORE, is performed by mining large and complex databases. The goal is to detect trends by AFORE, salesman, type of worker, etc., that may signal unhealthy practices in the industry.

Violations to workers' rights and to the regulations may end up in large fines to the AFORES. However, it is CONDUSEF, a Federal Government agency which performs the role of Ombudsman for the financial services industry.

Surveillance of the Investment Regime.

As in other Latin American countries with a defined-contribution scheme, investments of retirement savings are subject to certain quantitative limits known as "Investment Regime" (IR). The main objective of an IR is to avoid excessive risk-taking by the portfolio managers given that the Prudent Person Rule is not applicable in the region. This is due to the lack of an adequate judicial system for that purpose.

CONSAR supervises on a daily basis that SIEFORES portfolios comply with all applicable limits and to avoid that a non-permitted transaction occurs. The surveillance begins with a cross check of the portfolio. This process is automated and it compares the portfolio provided by two different and independent sources of information: the AFORE and its securities custodian. The specific goal at this stage is to avoid misrepresentations of the true assets composition.

In the next step, the structure of the portfolio is compared to the various quantitative limits of the IR. An early warning system flags when a parameter is close to the limits. If any limit is exceeded, a fine is imposed to the AFORE. Moreover, if the IR is breached and the portfolio has a negative return in that day, the AFORE must cover the loss with its capital.

Surveillance of SIEFORES' daily fair net asset value

In the Mexican system, workers can switch AFORE at any given day once a 12-month period has elapsed. Thus, keeping a fair net asset value is paramount to avoid wealth transfers among workers entering or leaving an AFORE.

To that end, CONSAR reviews on a daily basis the SIEFORES net asset value (NAV) and their share price. In order to do that, AFORES must report every day their balance sheet, a NAV and a share price. An independent price vendor provides a valuation of every security of the portfolios and a NAV. CONSAR cross checks the information and performs its own calculations. Discrepancies are identified, reviewed, reconciled and corrected.

On-site inspections

On-site inspections are carried out according to the “Annual On-Site Inspections Program”, which contains the number of inspections to be performed, entities to be supervised, and processes that will be audited. This program defines the way and terms the inspection will be performed, as well as the activities calendar. It establishes at least one visit per year to each participant of the system.

The scope of the inspection varies according to the goals, which in turn are a function of new regulatory requirements, potential problematic areas detected at previous inspections, surveillance reports or problems detected by the comptroller. CONSAR may perform, at any time, additional on-site inspections to those considered in the inspections program.

Lately, inspections have emphasized AFORES' compliance with risk management regulation, investment best practices and operational requirements for derivatives.

Compliance enforcement and sanctioning

CONSAR imposes fines when it detects that an AFORE does not comply with the regulation. Fines imposed will never exceed the equivalent of 5% of

the paid-in capital and reserves of the company. It is worth mentioning that sanctions do not relieve the AFORE of its duties and responsibility to fix the situations that generated the sanction.

The President of CONSAR is empowered to dictate the necessary steps to fix the anomalies and impose deadlines. If the problem is not fixed before the deadline, the President must inform the Board, who can dictate the intervention of the AFORE or even the revocation of its license.

Conclusions

CONSAR is in charge of the coordination, regulation, supervision and surveillance of the Retirement Savings System and its main objective is to protect the interests of the workers and their beneficiaries. It has technical autonomy and executive faculties to make any decision and take action regarding the participants of the pension system.

CONSAR has two governing bodies: the Board and the Surveillance Committee. Both bodies have representatives of the government, the employees and the employers. This tripartite representation gives equal voice to all stakeholders of the pension system and basically legitimizes all structural decisions taken at CONSAR

As for supervision procedures, CONSAR has established mechanisms to prevent operating risks in the AFOREs and SIEFORES, instead of acting after the violation is committed. It has updated its supervision models from surveillance on adequate accounting registries to an integral surveillance, which analyzes the processes that ensure that workers' rights are preserved.

The supervision of the retirement savings system participants is one of the main tasks of CONSAR. Our ultimate goal is to protect the workers' interests through the supervision of the system's processes and the correct management of the individual accounts.

In upcoming years, CONSAR's main challenge will be to reinforce the comptroller's independence and support the industry in the definition of its own regulation program. This constitutes an important complement in the traditional supervision model because it allows for the development of surveillance activities that involve a wider range of issues than those the authority can manage.

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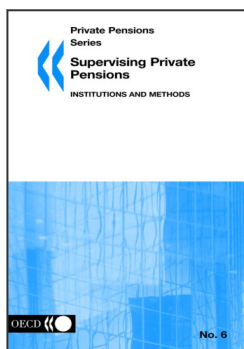
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