TEXAS

BUSINESS ◆ REVIEW

Bureau of Business Research • College and Graduate School of Business • The University of Texas at Austin

OCTOBER 1998

"The Great Pension Reform"

AFOREs and the Future of Privatized Retirement in Mexico

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In 1997 a new privatized, government-mandated retirement system came into existence in Mexico. Within this system, private companies called *Administradoras de Fondos de Retiro* (AFORE) manage pension funds for workers who joined the labor force on or after July 1, 1997. Each worker chooses an AFORE to receive the 6.5 percent of wages paid by his/her employer. The government contributes another 5.5 percent of the indexed minimum salary on behalf of each worker. Funds are generated by accumulation of contributions by the individual and by the yield from investment by the AFORE. Thus, the contribution and the performance of the fund determine each person's pension benefit. In this sense, the new system is fully funded.

This individual pension scheme contrasts sharply with the existing pay-as-you-go plan administered by *Instituto Mexicano del Seguro Social* (IMSS), a division of the Mexican government. Upon retirement, workers already participating in the IMSS before July 1, 1997, can choose to collect their benefits according to either the old system or the new accumulated funds system, whichever is larger.

A Long-Term Solution?

The "Great Pension Reform" has generated great expectations from policymakers. But will it deliver?

The first priority is that the system be actuarially solvent. It will be used by all the new labor force entrants because, by law, they will not be allowed to enter the old system. The AFORE system is a fully funded (defined contribution) plan. Hence, any change in the population structure (or equivalently, any change in the rate of evasion) will not affect the benefits.

Second, it is expected that the new system will increase the national saving rate. However, it is not clear that this will indeed be the case. Certainly, it will increase involuntary saving, and evidence from other countries (Chile and Singapore) in-dicates that such a privatized system does increase total saving.[1] However, it should be noted that in Chile, sweeping changes—such as financial market reform—were undertaken concurrently, making increased saving due to pension reform possible.

Third, policymakers anticipate that the new system will bring more long-term capital into the market. Undoubtedly, it will: by definition, retirement plans are long-term investments because most people lock in their investment until they retire. Mexico has traditionally lacked long-term capital in the market. For example, 28-day CETES (short-term government bonds) represent 80 percent of current investment in the market. Bonds of more than five years duration are very rare indeed. The AFOREs market will lead to considerable securitization, bringing depth to the market.

Why such a rapid enrollment rate? Research suggests that workers in the pay-as-you-go plan do not trust the system (and, by implication, the government).

Fourth, the new system is expected to bring larger capitalization to the stock market. At present, by law, AFOREs cannot invest in any assets other than CETES. But eventually, as in Chile, investment in other types of assets, including blue chip stocks, will be allowed. Thus, market capitalization of the Mexican stock market will increase. It is important, however, to keep in mind the Chilean experience: the limit of investment by AFPs (Administradoras de Fondos de Pensiones) in the stock market was raised to 37 percent of the portfolio, and most fund managers invested the allocated capital in fewer than ten companies, most of which were newly privatized state companies. During the first four years (1991–1994), these companies yielded very high real rates of return, but the 1995 stock market downturn in Latin America (the so-called "Tequila Effect") proved disastrous. The lesson there is simple: investing in a few (risky) companies is a recipe for ruin in the long run.

Taking Stock After One Year

What has happened in the year since the introduction of the new privatized pension scheme? Have all expectations been met?

AFOREs in Mexico: A Breakdown by Affiliates and Activities

AFORE	Affiliates	% of existing	% of total	% of investment
Atlántico-Promex	186,649	1.49	1.26	1.17
Banamex	1,444,004	11.50	9.74	22.03
Bancomer	2,018,846	16.08	13.62	28.06
Bancrecer Dresdner	573,430	4.57	3.87	2.38
Banorte Generali	1,040,983	8.29	7.02	3.68
Bital	1,149,970	9.16	7.76	5.61
Capitaliza	51,079	0.41	0.34	0.28
Confía-Principal	87,770	0.70	0.59	0.67
Garante	1,401,689	11.17	9.46	7.73
Génesis	140,162	1.12	0.95	0.53
Inbursa	307,679	2.45	2.07	9.90
Previnter	304,732	2.43	2.05	1.79
Profuturo GNP	1,536,761	12.24	10.37	5.50
Santander	1,818,778	14.49	12.27	4.27
Tepeyac	102,877	0.82	0.69	0.42
Siglo XXI	357,381	2.85	2.41	5.64
Zurich	28,544	0.23	0.19	0.34
Total	**12,551,334**	**100**	**84.66**	**100**

Note: Atlántico-Promex was sold to Confía-Principal, which has been renamed Principal. Génesis was sold to Santander and Previnter, to Profuturo.

It is likely that within the next three to five years many of the smaller AFOREs will be sold to bigger companies.

The table shows that, of the approximately 14.8 million workers in the formal sector of Mexico,[2] 12.5 million, or nearly 87 percent, have so far enrolled in one of the AFOREs. Workers (also called "affiliates") who have not chosen an AFORE are assigned to a "consolidated" account, maintained in Banco de Mexico, the central bank of Mexico.

Why such a rapid enrollment rate? Preliminary research suggests that workers in the pay-as-you-go plan do not trust the system (and, by implication, the government).

The table also shows the difference in market share as measured by the proportion of market captured in terms of affiliates and in terms of the value of contribution by the affiliates. The Mexican government has set up a separate division to oversee the activities of the AFOREs: Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR). According to the rules of CONSAR, until the year 2001, the maximum market share of each AFORE will be 17 percent in terms of the *number* of affiliates, with no restriction on the market share in terms of the value of contributions. Thus, while Bancomer, the largest AFORE, has 13.62 percent of the total number of affiliates, it claims 28.06 percent of contribution value. On the other hand, other large AFOREs such as Profuturo GNP and Santander also have significant market shares in terms of the number of affiliates but not in terms of investment. Evidently these companies have captured the low income market, and these affiliates tend to contribute more sporadically than high income affiliates because many low income affiliates hold temporary jobs and experience disproportionately higher spells of unemployment.

Quo Vadis, AFOREs?

What are the prospects for AFOREs? Three mergers are in the offing and awaiting approval by CONSAR. Other mergers are rumored, and it is likely that within the next three to five years many of the smaller AFOREs (less than 5 percent of the market share) will be sold to bigger companies. Due to larger start-up costs, a very clear economy of scale prevails in this industry. Hence, consolidation will continue.

The other important development will be affiliates switching AFOREs. Under a similar system in Chile, almost 25 percent of affiliates switch to different private pension plans every year. Will this happen in Mexico? Preliminary survey results suggest that a smaller percentage will change plans in Mexico because: 1) it is more difficult administratively to switch in Mexico, and 2) affiliates are not yet fully aware of the ensuing costs and benefits of switching.[3]

Whether AFOREs will produce real reform in the pension system remains to be seen. It is, however, reasonable to expect that this new system will play an important role in the expansion of capital markets in Mexico, an increase in industry mergers and acquisitions, and the continuation of fairly high transaction costs.

Notes

1. K. Schmidt-Hebbel, "Does Pension Reform Really Spur Saving and Growth?" conference paper, Oaxaca, Mexico, 1997.
2. This number excludes federal and state government employees, PEMEX workers, the police, and the military.
3. T. Sinha, "Factors for Choosing AFOREs: Some Preliminary Results from a Survey," unpublished paper, 1998. ◆

Lessons from Mexico

The Role of Financial Institutions in Market Crises

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The financial sector promotes a nation's economic growth and performance. By facilitating the transfer of funds from surplus income units to deficit spending units, financial intermediaries foster expansion of the economic system. But do financial markets and institutions merely facilitate the real forces driving development or do they play a more prominent, causative role in the growth process?

Increasingly, economists realize that the development of financial institutions and markets can be critical to the performance of a nation's economy. For years, conventional wisdom held that basic economic indicators (inflation, government budget trends, current account trade balance, level of international reserves) could anticipate or explain an economic crisis. This traditional model has been augmented to allow for domestic political and external economic shocks (an assassination, a key country raising interest rates, an increase/decrease in oil prices) as explanatory variables.

Even this modernized model, however, has proved inadequate for analyses of the majority of economic crises occurring in the 1990s. As a nation's financial sector evolves and interacts with global money and capital markets, a variety of vulnerabilities can develop. Such weaknesses can contribute to or even precipitate a financial sector-driven crisis. This can be the case even when the traditional economic indicators appear to be sound. A review of Mexico's debt crisis in 1982 and the financial crisis of 1994/1995 offers valuable insights into how financial sector conditions, especially in the banking industry, can influence economic performance.

The 1982 Debt Crisis

Prior to 1982, commercial banks in Mexico were privately owned but highly regulated, with interest rates set by the Banco de Mexico. The government established, for example, forced lending programs, requiring banks to loan a specified percentage of deposits to firms in government-determined "priority" sectors, and significant reserve requirements (50 percent or more). Financial innovations—such as working capital and equipment loans and residential and consumer lending—were left to nonbank intermediaries, such as *financieras*[1] and mortgage lending firms. Even with these developments, however, financial markets were very thin, marked by an abundance of short-term deposit and debt instruments and dollar-denominated accounts.[2]

This financial structure did not, in itself, cause the 1982 debt crisis, but it did increase the vulnerability of an economy already weakened by fiscal deficits and foreign debts. (See table, p. 6.) When oil prices dropped in 1980 and 1981, the Mexican economy experienced falling export revenues, large and increasing government deficits financed externally or via monetization, and a deterioration in the international reserve position. An overvalued peso generated a flight to the dollar by both Mexican nationals and foreign financial investors. In August 1982, Mexico declared it could not meet scheduled foreign debt obligations, suspended the transfer of "Mexdollar" accounts abroad (and converted them to pesos), outlawed any new dollar-denominated accounts, announced the imposition of exchange rate controls, and nationalized banks. The peso depreciated approximately 95 percent over the 1982–1983 period.

The 1994/95 Financial Crisis

From the 1982 crisis until the late 1980s, general financial repression characterized the banking industry. Although nationalization brought considerable consolidation to the sector, the Mexican government continued to force banks to lend to it, maintained interest rate ceilings on bank assets and liabilities, and mandated lending in high priority economic sectors. At the same time, the government continued to allow growth and innovation in the nonbank institution industry, especially with respect to brokerage firms and insurance companies. The securities market expanded rapidly during the 1980s, due in large part to the government's increased issue of short-term CETES. By the late 1980s, the Mexican money market was quite sophisticated and very liquid.

In 1988–1989, the government relaxed controls over the banking industry, removing interest rate restrictions, eliminating priority lending and reserve/liquidity requirements, and allowing banks to enter into other finance-related areas. The Salinas de Gortari administration reprivatized banks in 1991 and opened banking markets to new domestic entrants in 1993. This deregulation, however, was not balanced with safety and soundness regulation. This, combined with a general lack of accounting/information standards and a weak legal system in the area of debt collection, set the stage for excessive loan volume (funded by short-term and/or dollar-denominated deposits) and credit risk-taking.

Despite this fragility in the banking system, the Mexican economy continued to perform quite well. Real growth was generally strong, a disinflation trend was in place, the government budget appeared to be sound, and international reserves, relative to a rising current account balance ($7.5 billion in 1990 to $29.4 billion in 1994), surpassed 100 percent for the most part. An estimated $95 billion of foreign financial investment poured into Mexico.

While not unambiguously positive, these standard economic performance statistics remained strong in December 1994 when the financial crisis peaked. Other domestic political and key country factors, then, helped drive Mexico into crisis. The Chiapas rebellion, the Colosio assassination, and the nomination and election of Ernesto Zedillo, a relatively unknown political figure, had a cumulative effect: so-called country risk perceptions of the international community increased and international reserves decreased. Further, a series of upward adjustments in U.S. interest rates beginning in February 1994 increased pressure on Mexican interest rates. Finally, financial market participants began to question the credibility of fiscal and monetary policy authorities in the face of a crisis.

The results are well known. The peso depreciated more than 70 percent over the 1994–1995 period. The economy was in recession during 1995, and even now, banks continue to face significant problem, as well as defaulted, loans.

Lessons Learned

As the Mexican experience demonstrates, trends in real and monetary economic variables continue to contribute to the development of economic/financial crises, as do domestic political and external shocks. Increased global financial capital mobility mandates that the financial sector be monitored and managed carefully. In short, policymakers must couple macroeconomic stabilization measures with financial sector stabilization policies to promote sustained economic growth.

These lessons have not been lost on the Mexican government. Since 1995 the Mexican economy has performed well: real GDP has increased at a rate of 5 percent or higher, fairly restrictive fiscal and monetary policies have been implemented, inflation is trending downward, and the international reserve to current account balance is high.[3] Legislation has been introduced to grant the central bank complete control over monetary policy and increase its supervisory role. Further, steps have been taken toward adopting generally accepted accounting standards and lengthening the maturity structure of debt obligations. On the other hand, oil prices are depressed, political unrest is still present, the effects of the Asian flu threaten, and the health of the banking sector is of concern. It will be interesting to observe Mexico's ongoing design to achieve macroeconomic *and* financial sector stability.

Policymakers must couple macroeconomic stabilization measures with financial sector stabilization policies to promote sustained economic growth.

Notes

1. Development-type institutions making primarily long-term loans to the business sector.

2. For a detailed discussion of the evolution of the Mexican financial sector and banking industry, see John H. Welch and William C. Gruben, "A Brief Modern History of the Mexican Financial System," *Financial Industry Studies*, Federal Reserve Bank of Dallas, October 1993, 1–10.

3. J. P. Trevizo, "Mexico," *WEFA Group Latin America Economic Outlook*, March 1998, 8.1–8.25, provides an excellent discussion. ◆

Texas Business Review is published six times a year (February, April, June, August, October, and December) by the Bureau of Business Research, University of Texas at Austin. Subscriptions are available free upon request. Views expressed in this newsletter are those of the authors and do not necessarily reflect the position of the Bureau of Business Research.

Research and service activities of the Bureau of Business Research focus on the ways Texas industries can become nationally and globally competitive. The Bureau is policy oriented and dedicated to public service. The Bureau is located on the sixth floor of the College of Business Administration building.

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Basic Economic Indicators, Mexico

(percentages)

Indicator	1978	1980	1982	1990	1992	1994
Government budget deficit\GDP	2.9	3.0	12.0	2.8	surplus	0.7
Int'l reserves\current account deficit	n.a.	28.0	14.0	131.0	78.0	21.0
Annual rate of peso devaluation	0.0	2.1	27.1	10.3	1.4	41.7
Mexico vs. U.S. annual inflation rate differential	9.7	12.1	53.5	21.2	12.5	4.4
Annual growth in real GDP				4.5	3.6	4.5
Annual inflation rate				26.6	15.5	7.0

Sources: International Monetary Fund, *International Financial Statistics*. *Economic Report of the President*

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