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"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) indicates 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.

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?

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.

AFORES in Mexico: A Breakdown by Affiliates and Activities

AFORE	Affiliates	Percentage of existing	Percentage of total	Percentage 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	357,381	2.85	2.41	5.64

XXI				
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 as been renamed Principal. Génesis was sold to Santander; Previnter, to Profuturo.

Go to: [Top](#) | [TBR Home Page](#) | [BBR Home Page](#) | [UT GSB Home Page](#)

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