

Risk Regulation and Supervision in Mexico

Istanbul, November 2006



www.consar.gob.mx

The Mexican system has particularities which have to be considered to understand the authorities' involvement

MANDATORY RETIREMENT SAVING

- Implies lack of concern by many contributors with respect their individual retirement account.

PUBLIC GUARANTEES

- Transition generation and minimum pension guarantees imply a large fiscal cost.

RELEVANCE OF THESE ASSETS

- For many workers, it is a substantial part of old-age income.

SOCIAL EXTERNAL EFFECTS

- Ensuring old age income increases social welfare.

All of these imply the need for authorities' participation to limit the risks of pension funds' operational and financial management

There are 2 tools which the regulator/supervisor must use to contain risks while restraining efficiency costs:

Tools:

Risk-based regulation



Set regulatory limits to risk taking while restricting agency problems through certification of proper operational procedures.

Risk-based supervision



Measure risks being taken (off-site) and supervise that the proper operational procedures are being followed (on-site).

Proper measurement of the risks taken and self imposed compliance with basic operational procedures to manage them are necessary to deregulate the pension industry.

In Mexico, risk based regulation has been imposed following international practices

Overall risks

- A risk committee must exist.
- An independent unit must measure risks.
- Methods and methodologies to measure risks must exist.
- Best practices must be followed to reduce risks.

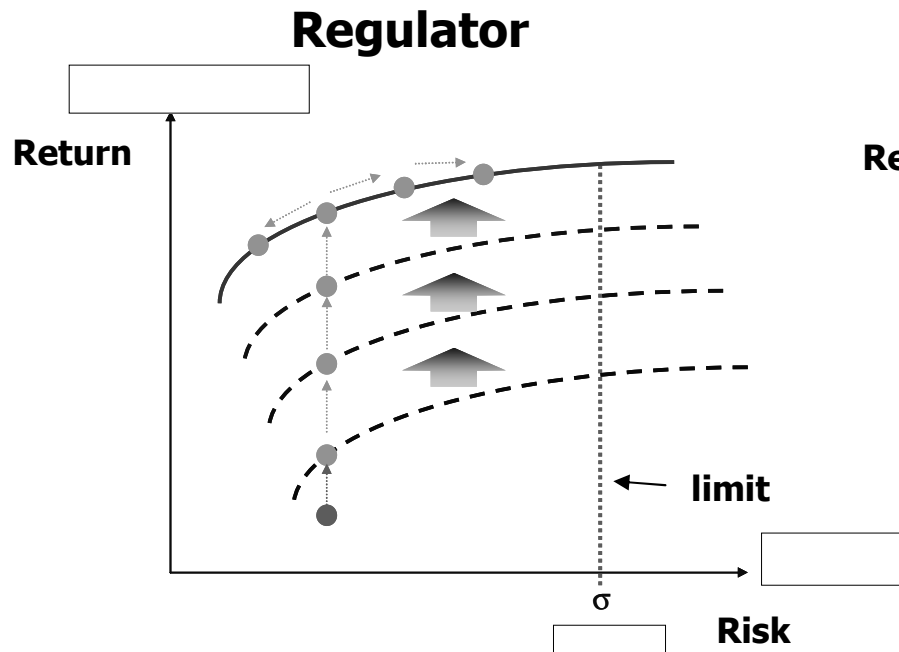
Investment risks

- An investment committee must exist.
- Managers must have automatic systems for operation, payments, and registry of investments.
- Human resource improvement plans must exist.
- Mechanisms which guarantee that contributors are paying market prices for financial services.
- An ethics code which prohibits using information for personal benefit must exist.

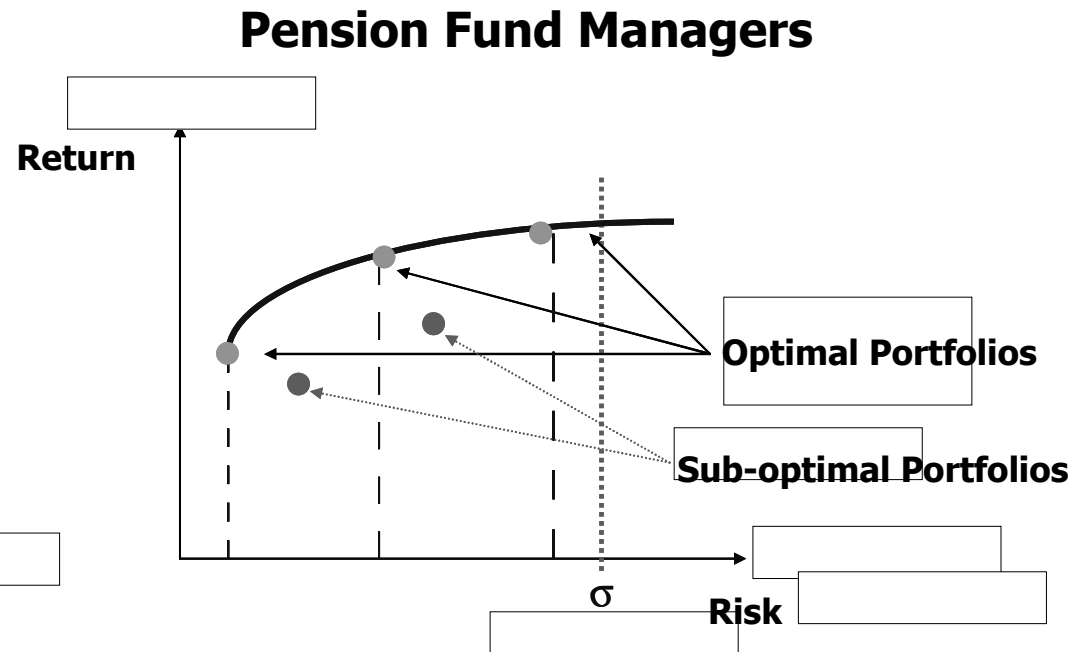
The infrastructure that allows financial risks to be appropriately measured and managed takes time and resulted from the authorities' concern.

For example, the portfolios' investment regime should allow returns to be as high as possible while limiting the overall portfolio risk

In such a way the efficiency cost imposed by the regulator is minimized



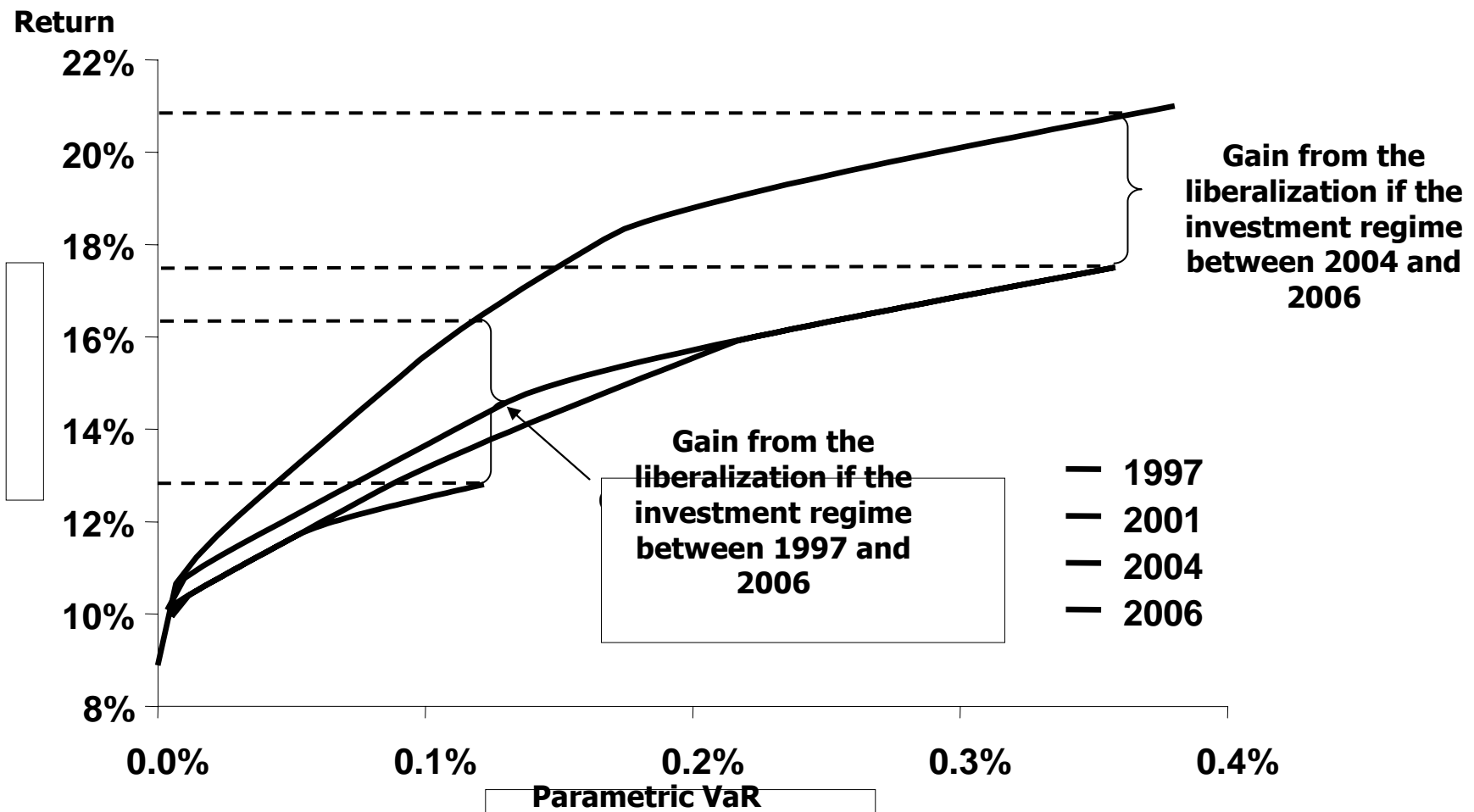
The regulator should define a maximum risk level



The manager should strive to be on the efficient frontier

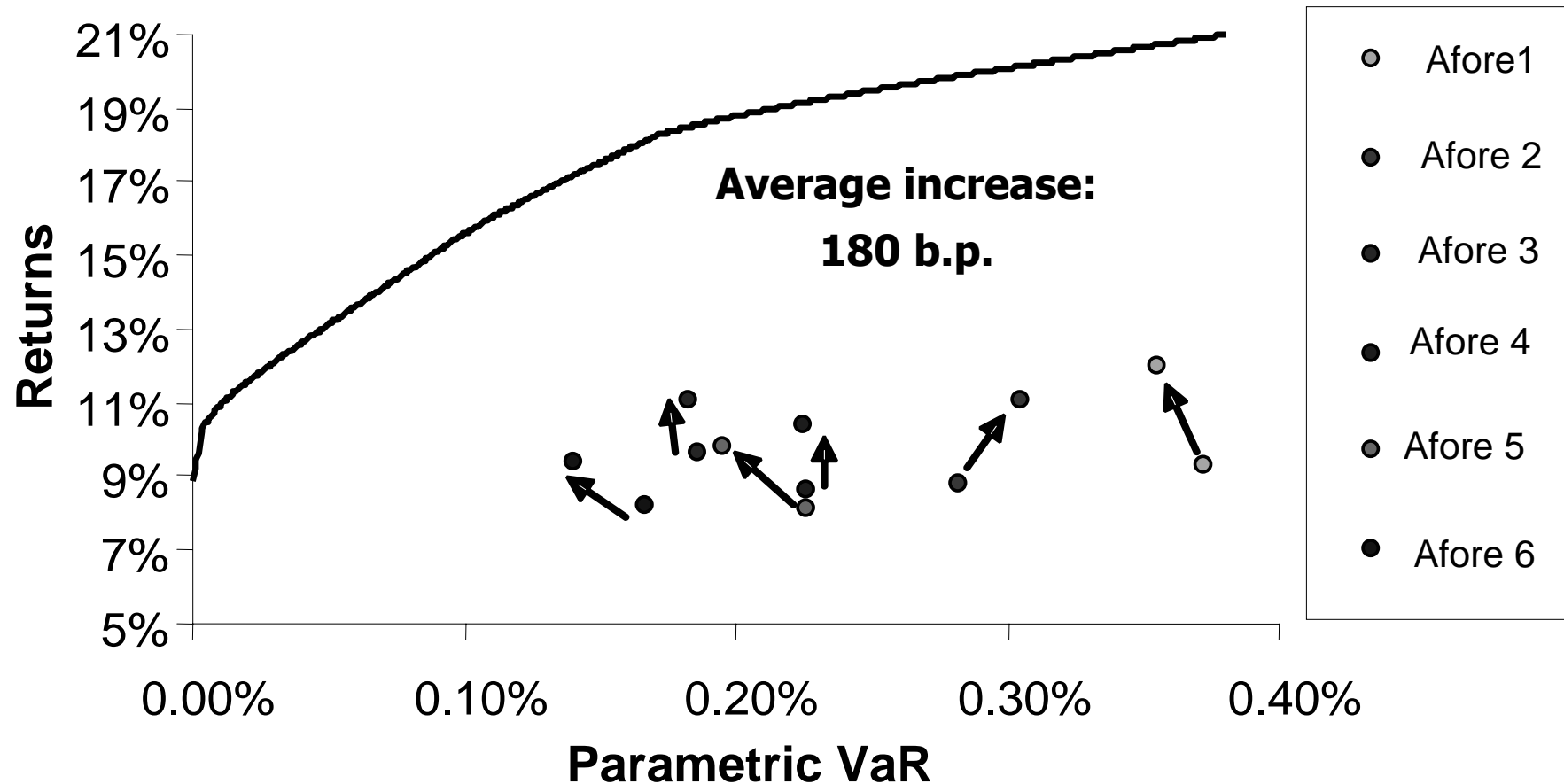
Potential returns are higher as a result of a more liberal investment regime which sets a limit on the portfolio risk

A wider range of instruments have been allowed and quantitative limits have been relaxed.



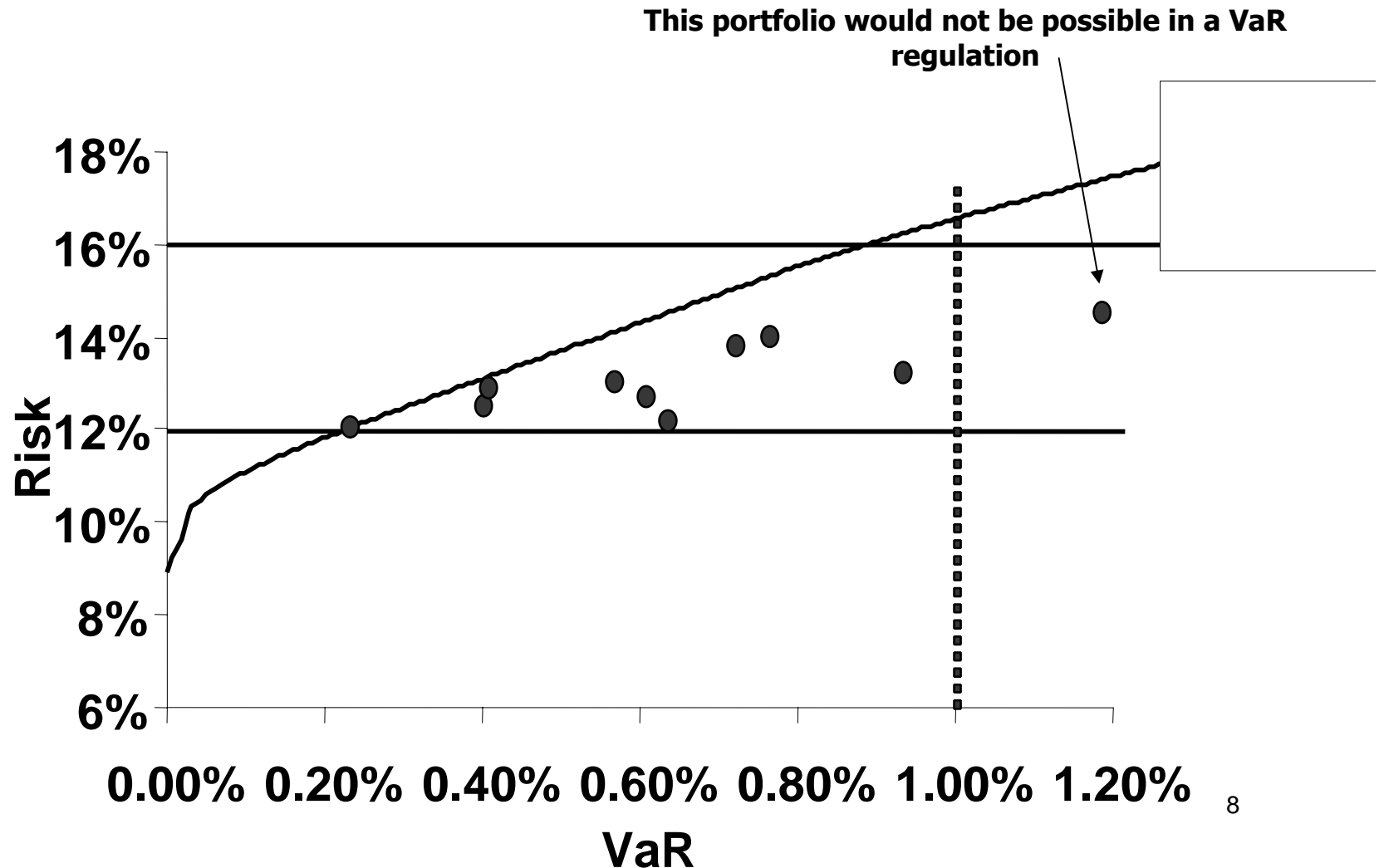
* Constructed with 2006 data and the investment regimes of 1997, 2001, 2004, and 2006.

Actual returns have increased with practically the same risk-taking as before



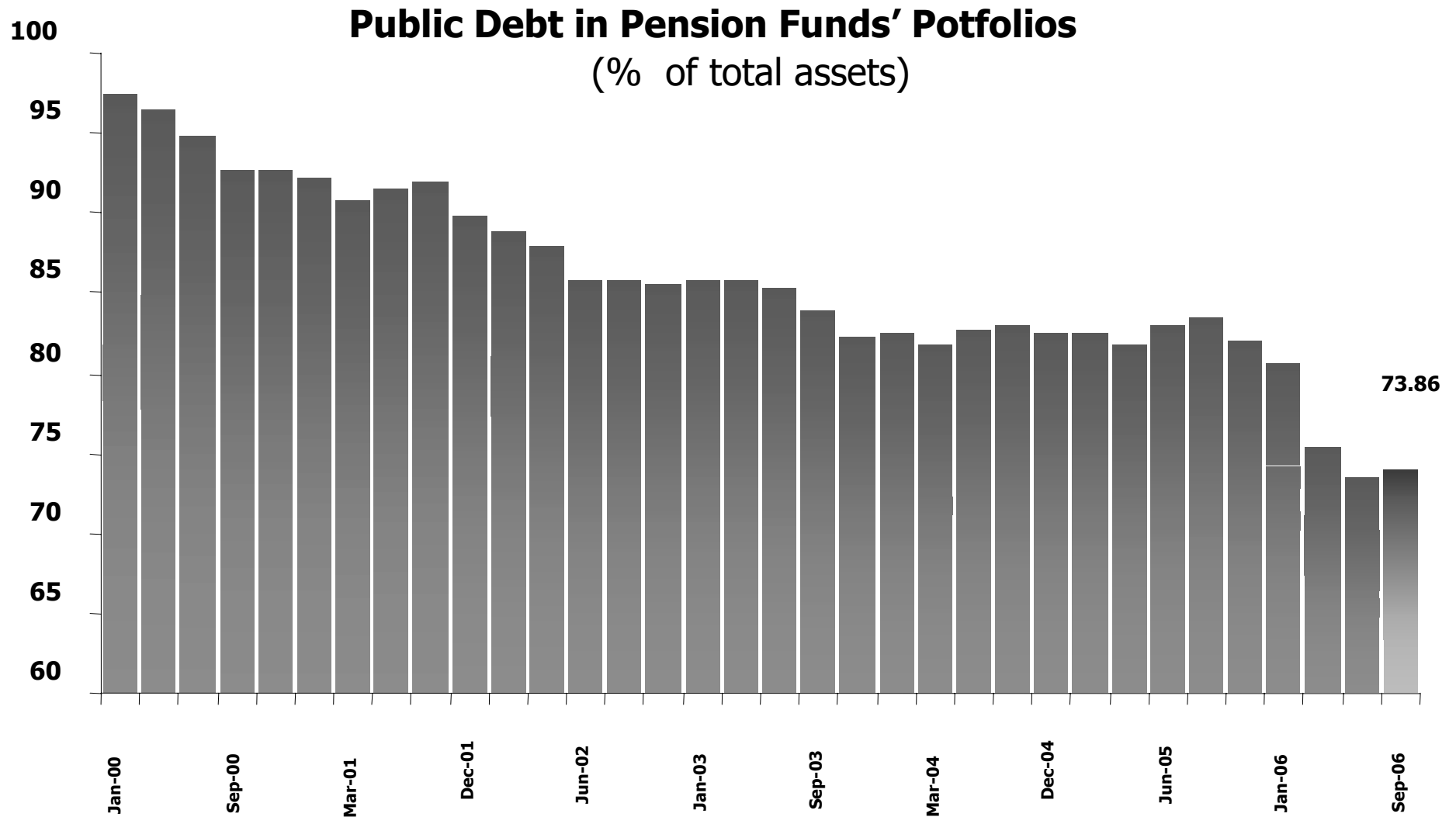
Portfolios are expected to continue to move towards the efficient risk-return frontier.

The VaR regulation effectively limits risk taking and allows derivatives to be used to control it. Relative return bands, in contrast, do not guarantee limits on the losses of the pension funds.





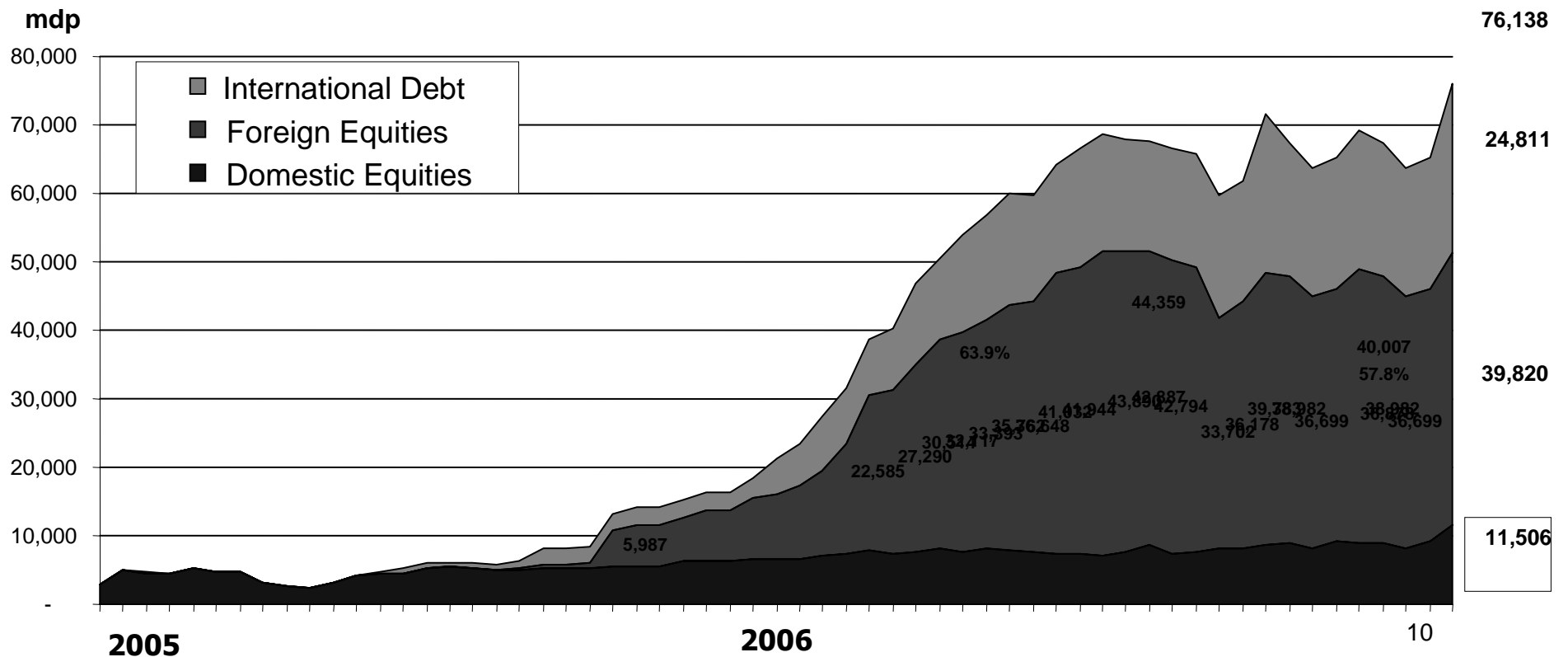
The risk-based financial regulation implemented in Mexico has allowed for a diversification of portfolios away from public debt.



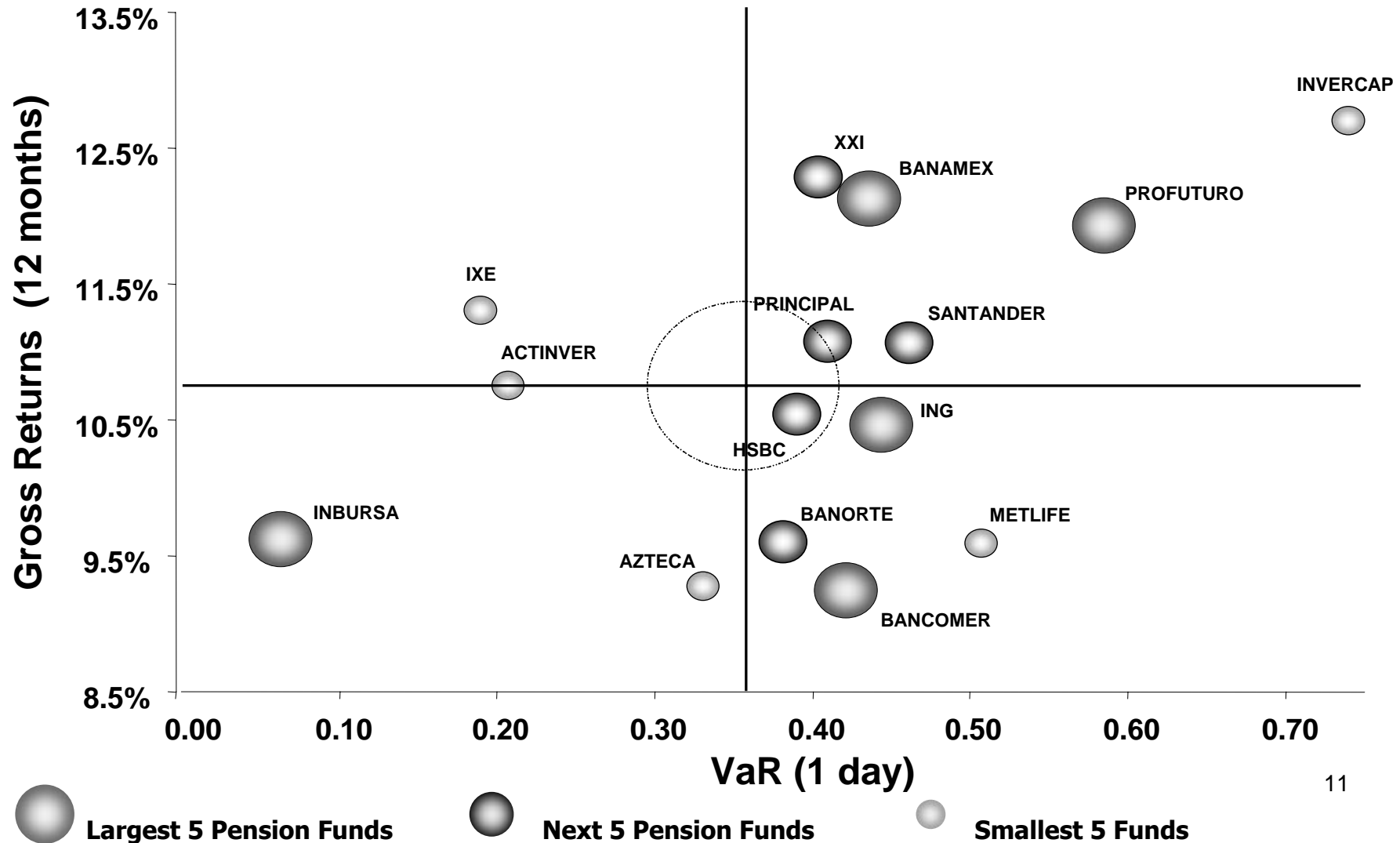
Fuente: CONSAR

The diversification has meant an increase in the portfolio's share of equities and international markets' debt.

Equities and International Debt in Pension Funds' Portfolios (millions of pesos)



Pension funds are also beginning to differentiate in their investment strategies and are expected to compete on returns.



In conclusion the VaR regulation has worked rather well....so far

- Portfolios are gradually diversifying and better returns are being obtained, without an increase in the risks being taken.
- Modern financial instruments are being used to take measured risks and will eventually be used to hedge excessive risk taking.
- The compliance regulatory burden will decrease as the new supervisory philosophy “grows” on the system and risk measurements begin to be used to focus supervisory efforts.
- Capital requirements should eventually reflect the risk assessment of every pension manager (financial and operational risks) to align incentives and adequately create reserves for an eventual bankruptcy.
- Focusing on risks should lead to regulation and supervision with less efficiency costs and higher social welfare.

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