The new defined contribution pension system will only survive if you increase mandatory contributions and introduce a pro-rata mechanism to smooth the transition from the “old” to the “new” pension system.

OECD Secretary-General Angel Gurría
POLICY RECOMMENDATIONS TO IMPROVE THE MEXICAN PENSION SYSTEM

This review assesses the Mexican pension system on the basis of OECD best practices in pension design and presents various proposals to improve the Mexican pension system and guarantee its sustainability in the long term.

The defined contribution system of individual accounts introduced in the 1990s has been successful

The new defined contribution (DC) system of individual accounts, introduced in 1997 for private-sector workers and in 2007 for public-sector workers, has been relatively successful in increasing the capacity of the Mexican economy to finance pensions.

At the end of 2014, the system had assets backing-up pension benefits equivalent to 14.1% of GDP, putting Mexico in the middle range in the OECD area, after only 17 years of having the system in place. Moreover, private pension funds (AFORE), which manage the workers’ savings that will finance their pensions, have achieved a performance of 12.5% on average annually since their introduction (6.2% in real terms).

The regulation and supervision of the system by the National Commission of the Retirement Savings System (CONSAR) has worked properly according to the best practices of OECD countries.

Mexico’s pension fund assets in an international context, 2014

Pension funds' assets as a % of GDP

*Preliminary data
However, it needs important improvements

While these achievements are noteworthy, the OECD review has identified a number of areas that need improvements. The most important ones are:

- the transition process from the “old” to the “new” system;
- the level of mandatory contributions;
- the old-age safety net; and,
- the fragmentation of the pension system.

The review also recommends reforms in the regulatory framework of CONSAR and the National Insurance and Surety Commission (CNSF), especially regarding investment strategies and investment restrictions of AFORE and life annuities.

The review also highlights the low density of contributions resulting from informality as another important challenge facing the Mexican pension system. Reducing the size of the informal sector is a policy challenge that is out of the scope of this review, one that needs to be addressed by a range of labour market, tax and structural economic policies.

The transition process from the old to the new system needs to be smoothed to avoid disillusionment and opposition to the new system

One of the main challenges facing the Mexican pension system does not come from the DC system of individual accounts per se, but rather from the transition process from the old defined benefit (DB) pay-as-you-go (PAYG) system to the new funded DC system.

This transition process establishes that all individuals who were working or had contributed to the system at the time of the reform, retain the right to choose upon retirement whether their pension benefits are calculated based on the formula of the old DB system or based on the value of the assets accumulated in their retirement account in the new DC system. As this review shows, the DB formula of the old system provides a pension benefit that is not fully backed by contributions. It is much larger than what the accumulated savings can grant. Therefore, an individual who worked and contributed to the pension system one month before the introduction of the new system will receive a pension benefit much larger than that for an individual who entered the system one month later, although both individuals contributed the same and have the same work experience. This difference will obviously lead to disillusionment and opposition to the new DC pension.

The review proposes a pro-rata mechanism to address this problem. All the rights acquired by workers up to today would be guaranteed, and from tomorrow onwards all workers would accumulate pension assets in the new system. Therefore, the pension benefit of a transitional worker would have two components, one based on the rights acquired...
under the DB formula, and the other one based on the assets accumulated in the DC individual accounts. This would smooth the convergence from the old system (generous and financially unsustainable) to the new system (balanced and financially sustainable).

Contributions to the system have to increase

Contributions to the system are too low to guarantee pension benefits of more than 50% of final salary. According to OECD calculations, a contribution rate of 6.5% may lead, in the best case scenario, to a replacement rate of only 26% for the average worker. This low replacement rate is mostly the result of the low mandatory contribution rate. As this review shows, a 50% replacement rate can be achieved with a 75% to 90% probability by contributing on average 13% to 18% over 40 years.

Therefore, the review recommends increasing the mandatory contribution rate, but gradually. This increase could be linked to salary increases in such a way that the worker would not suffer a reduction in disposable income.

Improve the old-age safety net by integrating and expanding it

Like all pension systems in OECD countries, the Mexican pension system has a non-contributory old-age social protection component for those individuals who, for various reasons, have been unable to accumulate enough rights or assets. This old-age safety net provides these individuals with a pension that puts them above a certain income threshold.

The review proposes to increase the level of the non-contributory benefit in order to alleviate poverty in old-age. Moreover, it highlights the importance of improving the link between the non-contributory safety net (Pensión para Adultos Mayores) and the minimum guaranteed pension (Pensión Mínima Garantizada).

It recommends, as well, improving the coordination of safety net programmes between different levels of government by conditioning part of the transfer to local governments on the adoption of the national scheme.

Eliminate the fragmentation of the system

Finally, the review recommends harmonising the rules for all pension plans, with the ultimate goal of establishing a truly national pension system equal for all Mexicans. This harmonisation should include the pension plans for private and public-sector workers, as well as the special regimes (for states, municipalities and universities, among others).
The largest pension systems in Mexico have been reformed from a defined benefit (DB) to a defined contribution (DC) scheme. The main reforms so far include private-sector workers (Instituto Mexicano del Seguro Social, IMSS), federal government employees (Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado, ISSSTE) and some other government agencies. These reforms aimed at mitigating the growing liabilities of the DB system given pension promises and contribution rates. However, by allowing transitional workers to choose to retire with pension benefits determined by the old DB formula or the DC accumulation, and setting contribution rates in the new DC system as low as pre-reform rates, the fiscal adjustment is postponed.

The substantial and fast demographic changes, the long transition of the past reforms and the numerous schemes that have not been reformed yet may lead to strong fiscal pressure for a long period, which may require a large financial effort starting in the mid-2030s.

The fragmentation of the Mexican pension system is deeply entrenched and goes far beyond the striking difference between public and private-sector workers’ schemes. Retirement conditions and benefits, as well as contribution rates, social quotas and government matching, are indeed different between public-sector workers affiliated to ISSSTE and private-sector workers affiliated to IMSS. Moreover, there are still many state government pension schemes and other occupational plans, such as the ones for the state oil company PEMEX and for state universities’ employees that have very different terms of retirement conditions and benefits. This is a source of large inequalities.

The combination of a relatively high level of the minimum pension in relation to contributions paid and wage conditions with a relatively short contribution period provides little incentive to contribute longer than the eligibility period, especially for low-wage workers.

Mexico is among the three OECD countries offering the lowest old-age safety net for individuals not covered by the contributory pension system.
There is an overlap between the federal non-contributory pension for old-age and the additional non-contributory pensions or aid programs offered by many local states without fiscal resources backing them up.

The sharp drop in pension benefits to be expected after the transition period from the old DB system to the new DC systems ends, may lead to disillusionment and opposition to the new DC pension system in the population. This sharp drop is the result of low aijiccontribution rates, which were set at similar levels than before the reform, and high promises to transitional workers based on the old DB formula. Moreover, the low coverage rates and contribution periods compound this problem.

The current investment regime of SIEFORE is too restrictive. Workers have very limited choices in the multi-fund system. Despite increased diversification, Mexico’s pension funds are still significantly concentrated in debt relatively to other OECD countries. The investment limits for equity and foreign securities are binding for most basic SIEFORE and thus prevent diversification and negative correlation between investments.

Current mechanisms are not fostering enough competition among AFORE. Although fees charged by AFORE in Mexico have declined by more than 70 basis points in the last decade, they remain high in an international context. The incentives embedded in the registration, assignment and transfer processes are not enough to foster competition.

There are large pots of assets that can be taken as lump sums instead of being used to finance retirement, which it will affect negatively retirement income adequacy and increase public pension liabilities.

The lack of a thriving annuity market is due to a lack of demand. The demand for annuities will increase as the transition period ends.

Annuity providers are ring-fenced subsidiaries of insurance companies. They cannot diversify risks (e.g. mortality) with other products or use the normal life business of the parent insurance company, and are subjected to a more restrictive investment regime. This increases the cost of annuities and reduces the pension payments for individuals. However, ring-fencing these annuity providers may increase the security that they will be able to fulfil their promises and obligations. Security has a cost.

Insurance companies can only offer one annuity product, the traditional immediate life annuity.

Mortality tables used by annuity providers sufficiently provision for expected mortality improvements. However, recent improvements in mortality have been slowing and Mexico currently has low life expectancy compared to other OECD countries. If this were to change and life expectancy were to catch up with other OECD countries, longevity risk could become a problem.

Occupational DB pension funds are not subject to any minimum mortality requirements, including using tables accounting for future improvements in mortality.
MAIN RECOMMENDATIONS

Improve the design of the public pension schemes

- Improve financial sustainability.
  1. Implement parametric changes: increase contribution rates; reduce the matching contribution for public-sector workers; lower wage ceiling for private-sector scheme from 25 to 10 times the minimum wage; and scale back survivor’s pension.
  2. Increase the effective age at which people could retire: link the statutory retirement age to gains in life expectancy; continue to tighten early-retirement schemes; increase the contribution period required for a full pension in the old public-sector DB scheme and close the gender gap in the contribution period; and increase the age limit to get a full pension in the public sector faster and beyond 2028. However, consideration should be given to the fact that mid to low income individuals, as well as individuals with low educational attainment, have lower life expectancy at retirement and their improvements tend to be lower.
  3. Harmonise the rules and ensure portability between the special pension schemes (e.g. state-owned companies, state pension schemes and public universities), with the ultimate goal of establishing a truly national pension system. Condition part of the transfers to local governments to the adoption of the national scheme and to the replacement of existing schemes. Make the level of the minimum pension under the 1973 Law converge with the minimum contributory pension (Pensión Mínima Garantizada, PMG, in the DC system) and delink it from the minimum wage.

- Increase safety-net levels, and better link the non-contributory components (including the Pensión para Adultos Mayores, PAM) with the PMG:
  1. The level of the non-contributory benefit is too low to efficiently fight income poverty at older ages.
  2. The link between the non-contributory PAM safety net and the minimum contributory pension PMG should be smoothed by: topping up the PAM by a new contribution-based minimum pension; setting the minimum pension benefit in line with contributions paid or as a function of the contribution period - the full rate should be reached with a longer than 1 250 weeks period; using the accumulated assets to finance the new integrated benefit rather than allowing lump sums; and progressively withdrawing the minimum pension until the
pension assets are sufficient to finance the full-rate minimum contributory pension. The withdrawal rate should be relatively low to limit disincentives to contribute.

**Smooth out the transition period and increase coverage, contribution levels and contribution periods**

- The first step to attenuate the sharp fall in replacement rates after the last transitional worker retires is to increase contribution rates, at least for private-sector workers. Everything else being equal, this would increase the pension income of workers who are fully in the DC system. This goal could be achieved through: (i) increasing the mandatory contribution rate; (ii) earmarking for retirement part of the contributions to the National Housing Fund Institute for Workers (INFONAVIT); (iii) introducing automatic voluntary contributions with an opt-out option; and/or (iv) improving incentives for voluntary pension savings. The last option depends on the fiscal space available.

- To avoid that the increase in mandatory contribution rates would lead to a reduction in take home pay, which may affect disproportionately the low income, increases in mandatory contribution rates could be linked to increases in wages.

- The fall in replacement rates could be smoothed out further by applying a pro rata system from today onwards for workers who can retire under the old DB formula. All the pension rights earned under the old DB formula would be kept, but from today onwards, workers would only earn pension benefits under the DC formula, so their retirement pension benefits would comprise two components, DB and DC.

- Consider introducing mandatory contributions for self-employed workers to increase coverage and lengthen contribution periods as part of informality is the result of workers moving in and out of self-employment. One of the main sources of low coverage is labour market informality.

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**Contribution rates in mandatory pension plans**

Selected OECD and non-OECD countries

2012 or latest available data

*The contribution rate to mandatory occupational pension plans varies across age groups, from 7% between 25 and 34 years old to 18% beyond 55 years old. The graph uses the rate of 10% for people aged 35 to 44.

**Numbers for Mexico include state contributions and the social quota for workers with a wage equivalent to 3 times the minimum wage.
Public understanding and confidence in the pension system could be improved by better aligning public- and private-sector pensions; improving the information provided in pension statements; and organising well-designed National Pension Communication Campaigns to better promote pension savings and increase financial literacy.

**Improve the design of the accumulation phase**

- Allow more choice on investment strategies while keeping the default life-cycle strategy to protect those close to retirement against extreme negative outcomes (e.g. large falls in equity markets).
- Address high charges and increase competition among AFORE by improving the incentives in the registration, assignment and transfer processes. Consider other mechanisms to introduce competition and reduce charges like tender mechanisms (e.g. allocate new entrants to low cost pension providers).

**Improve the design of the pay-out phase**

- Early use of retirement savings should be avoided. Any exception should be allowed only under specific and exceptional circumstances. The general practice in most OECD countries is to allow early use of retirement savings in situations of extreme financial hardship, like long-term unemployment, and not once every five years when unemployed as it is the case in Mexico now. All the assets accumulated in the pension system should be combined with other retirement assets to buy a life annuity or get programmed withdrawals, or a combination of both.
- The operation of the annuity market should be improved by allowing additional annuity products that provide different types of guarantees, for example deferred life annuities. Different types of annuities bring in different levels of risks. In this context, the regulatory framework should align reserving and capital requirements with the different levels of risk, so that higher risks to fulfil promises require higher reserves.
- Encourage annuitisation as a protection against longevity risk. The OECD Roadmap for the Good Design of Defined Contribution Pension Plans suggests combining programmed withdrawals with deferred life annuities bought at the time of retirement to achieve flexibility and liquidity, as well as protection from longevity risk, as an appropriate default, as long as there are enough assets accumulated to have an annuity above the poverty threshold.
- Establish a specific regulatory framework to limit pensioners’ choice of the insurance companies providing disability and survivors’ benefits so that it balances premiums to be paid (by the social security institutes) and the extent of the protection provided. As a result, pensioners could not choose insurance companies that provide the same coverage at a higher cost.
- Assess the cost and benefits of having annuity providers ring-fenced from their parent insurance company.
- Occupational DB pension funds should be subject to minimum mortality requirements and should use mortality tables accounting for future improvements in mortality. At a minimum, they should use the same tables that annuity providers have to use, and ideally adjusted to their specific sub-population.
- Update regularly mortality tables and monitor closely mortality experiences for changing patterns, and especially for an acceleration of mortality improvements, to ensure that the mortality tables used by the industry remain adequate.
- Better account for future improvements in mortality and life expectancy and improve the management of longevity risk, following the recommendations in the 2014 OECD publication, Mortality Assumptions and Longevity Risk.
This booklet reproduces highlights from the 2015 OECD Reviews of Pension Systems on Mexico report. It assesses the Mexican pension system on the basis of OECD best practices in pension design and presents various proposals to improve the Mexican pension system and guarantee its sustainability in the long term.