Mexican Pensions in the 21st Century

Wil J. Gaitán and José Luis Salas

Wil Gaitán is a Principal of Buck Consultants in Chicago and an International Consulting Actuary. He recently returned to the United States after a three-year assignment in Brussels co-ordinating the firm's global services in Europe. Mr Gaitán is a Fellow of the Conference of Consulting Actuaries, an Associate of the Society of Actuaries, a Member of the American Academy of Actuaries, an Enrolled Actuary and a Certified Compensation Professional with WorldatWork. In his 28-year career, he has provided advice in the actuarial, benefits, compensation, pension investment and HR fields while based in Asia, Europe, the USA and Latin America. Mr Gaitán has a BSc degree in Mathematics and a Master's degree in Actuarial Science from Roosevelt University in Chicago.

José Luis Salas has been Senior Partner and President of Consultores Asociados de México, S.A., a pension and actuarial consulting firm, and of Lorant Martínez Salas y Cía, an insurance brokerage, since 1980. Mr Salas has 33 years' professional experience in both actuarial and employee benefits consulting and 23 years' experience of insurance broking. He has a Bachelor's degree in Actuarial Sciences from the Universidad Nacional Autónoma de México and a Master's degree in Business Administration from the Instituto Tecnológico de Estudios Superiores de Monterrey. Since 1994 Mr Salas has been a Co-ordinator of the Mexican Committee for International Actuarial Practice and a Certified Expert of the Mexican Academy of Actuaries.

Priests from the great Maya civilization envisioned the end of the world in December of 2012. It seems as if the powers that be in the Mexican pension world are working hard of late to accelerate the coming of age of their industry well in time for the predicted judgment day.

While the seeds of the Mexican private pension sector were sown back in 1917 (the date the Mexican Constitution was established), private pension plans weren't set up until the 1960s and their popularity is still restricted to multinationals and to large, progressive, domestic employers. The much-needed nurturing has only begun to trickle through in the last 10 years, following the privatization of the social security program.

The main objective of this article is to discuss the major developments affecting occupational retirement and long-term savings programs in Mexico. We believe that the effects of the privatization of social security in 1997, combined with recent pronouncements by the tax authorities and a change in Mexican accounting standards, will invigorate the development of private pension programs as well as increase the savings rate of the country. Before delving into the specifics of the changes, we would like to offer some words of caution.

Mexico has a very close social, political and economic relationship with the United States of America, its neighbor to the North. Success in Mexico is increasingly measured with reference to a US yardstick. The fact that Mexico is consistently the highest or one of the highest consumers of Coca-Cola outside of the USA should not be surprising. Indeed, the original social security pension system of Mexico was patterned after the US system, and the private pension tax qualification framework looks fairly close to that of the USA pre-ERISA*. Looks, however, can be very deceiving and this is no exception.

Hot dogs and tacos are made out of grain and meat. The condiments inside each look strikingly similar – ketchup in one and red hot chili pepper sauce in the other. Ignorance of this simple difference can burn the uninitiated consumer at first bite. A proper understanding of the basic ingredients would therefore be well-advised.

In a similar vein, in order to provide a suitable context to the specifics of the latest developments, we would like to offer a panoramic view of the Mexican pension environment, starting with a general background on the country.

GENERAL BACKGROUND

Mexico is a large country – 1.9 million square kilometers, more than the combined territory of Spain, France, Germany and Italy. The government is organized as a federal republic with 31 states and Mexico Federal District (D.F.) as its capital.

The population stands at 107 million, the most populous Spanish-speaking country in the world and the

* Employee Retirement Income Security Act of 1974

second-largest country in Latin America (after Brazil). Population growth has stabilized at around 1.2% p.a. Mexico's population is fairly young (the median age is 25 and only 5.6% of the population is over age 65) but it is projected to age rapidly.

Mexico has a total labor force of 45 million. The official unemployment rate is 3.6% but there is a very large underemployment rate, estimated to be a minimum of 25%.

Independence from Spain took place in 1810, giving birth to a constitutional monarchy. Throughout the rest of the 19th century, Mexico's government and economy were shaped by contentious debates among republicans and monarchists and various other polarized groups, such as federalists and proponents of a strong central government. Periods of revolution followed in the early 1900s, resulting in the 1917 Constitution.

The Institutional Revolutionary Party (*PRI*[*]), which was formed in 1929, emerged as a coalition of interests in the aftermath of the revolution, representing a political compromise. For 71 years, Mexico's national government was controlled by the *PRI*, which won every presidential race until the election of Vicente Fox of the National Action Party (*PAN*[†]) in July 2000. Elections are scheduled this year and social security is a visible theme in prospective candidates' campaigns.

Article 123 of the 1917 Constitution established labor rights, including social protection by the Federal Government upon employees' disability, death, retirement and employment termination, but it wasn't until 1943 when the Social Security Institute (*IMSS*[‡]) was actually set up to formally fulfill the spirit of the Constitution.

The North American Free Trade Agreement (NAFTA) has greatly increased trade between Mexico and the USA, accounting for almost a quarter of Mexico's GDP[§] and 88% of its total exports. Top US exports to Mexico include electronic equipment, motor vehicle parts, and chemicals. Top Mexican exports to the USA include petroleum, cars, and electronic equipment. There is considerable intra-company trade, particularly through low-cost assembly and production sites called *maquiladoras*. The result is that the Mexican economy is strongly linked to the US business cycle.

Since the 1994 devaluation of the peso, Mexican governments have improved the country's macroeconomic fundamentals. Inflation and public sector deficits are both under control. The results have been steady economic growth and currency stability, bringing Mexico's economy to the forefront of Latin America, overtaking Brazil. Mexico's gross domestic product (purchasing power parity) in 2005 was slightly over one trillion US dollars, making it the 12th largest economy in the world.

SUMMARY OF PENSION LEGISLATION

The most important programs to consider in understanding the role of private pensions in Mexico are:

– the social security system,

– a set of mandatory programs (seniority premium, profit sharing and the *Infonavit*[¶] housing fund),

– the legal severance benefits entrenched in labor law, and

– savings funds.

The key features of the social security program are as follows:

- It covers all salaried employees.
- It provides medical care, disability and survivor pensions, and maternity and other benefits.
- Total employer contributions are between 10.4% and 24% of covered pay (limited to 25 times the minimum wage).
- Employee contributions range between 2.3% and 3.3% of covered pay.

A schedule of the contributions effective from July 1, 2006 is provided in TABLE 1 overleaf.

Social Security Retirement Benefits

The original social security program created in 1943 provided defined benefit (DB) retirement annuities based on final five year average salaries and covered service. This program was amended in 1996, introducing a compulsory defined contribution (DC) retirement system funded by employers, employees and government. The total contribution under the DC system is 14% of covered salary. This includes a contribution of 5% of covered salary paid by the employer to the housing fund (*Infonavit*), which if not used for financing a house is accumulated for retirement benefits. The new program is administered by the private sector. The custody and plan administration functions are performed through private pension fund managers called *AFOREs*[**]. The investment function is carried out through separate legal entities known as *SIEFOREs*[††] which are managed by *AFOREs*. Benefits under the new DC system are payable as indexed annuities fully insured by private insurers.

As a transition measure, the social security program guarantees all of those individuals covered at the effective date of the conversion (July 1997) a benefit under the DC system no lower than the one available under the prior DB system.

Both the old and the new social security programs have a cap on covered salaries, which is expressed as a function (currently a multiplier of 25 times) of the minimum wage in Mexico D.F.

* *Partido Revolucionario Institucional*
† *Partido Acción Nacional*
‡ *Instituto Mexicano del Seguro Social*
§ gross domestic product
¶ *Instituto del Fondo Nacional de la Vivienda para los Trabajadores*
** *Administradoras de Fondos para el Retiro*
†† *Sociedades de Inversión Especializadas en Fondos para el Retiro*

TABLE 1 **Contributions to the Social Security Program in Mexico**

Type	*Maximum wage base*	*Employer contribution*	*Employee contribution*	*Total contribution*
		%	%	%
Old age	24 x minimum wage	3.150	1.125	4.275
Retirement (*SAR**)	25 x minimum wage	2.0	–	2.0
Death and disability	24 x minimum wage	1.750	0.625	2.375
Sickness, medical and maternity	1 x minimum wage plus *SBC*† (maximum 25 x minimum wage) – (3 x minimum wage)	19.75 plus 1.59	0.56	19.75 plus 2.15
Sickness pay	25 x minimum wage	0.70	0.25	0.95
Pensioners' medical expenses	25 x minimum wage	1.050	0.375	1.425
Day care center	25 x minimum wage	1.0	–	1.0
Work injury (depending on risk)	25 x minimum wage	0.5-15	–	0.5-15
Infonavit (housing tax)	24 x minimum wage	5.0	–	5.0

* *Sistema de Ahorro para el Retiro*
† *Salario Básico de Cotización*

NOTE: The current annual minimum wage for Mexico City is Ps 17,764.55.

Source: Infonavit

Less than 2% of all individuals covered by the social security system are affected by (exceed) the salary cap.

The normal retirement age is defined as age 65. Reduced benefits are available at earlier retirement ages beginning at age 60. A minimum of 1,250 weeks of contributions is required.

A comparison of the benefits estimated, subject to reasonable actuarial assumptions, is provided in TABLE 2. The unmistakable conclusion is that the new DC program provides lower benefit expectations relative to the old DB program.

TABLE 2 **Comparison of Benefits on the Old DB and New DC programs**

Age joining social security system	*Life pension as percentage of last covered salary*	
	Prior DB program	*New DC program*
	%	%
20	88	49
25	78	41
30	68	34
35	58	28
40	48	22
45	38	17
50	28	12

Key Statutory Benefits

Seniority Premium

The seniority premium is an important program applicable to all employers, and all employees must participate. The benefits are financed exclusively by the employer. The benefit is payable in the event of in-service death or total and permanent disability, retirement, dismissal or voluntary termination of employment after 15 years of service.

The benefit is a lump sum equivalent to 12 days of final salary (capped at two times the minimum wage) times years of service with the employer.

Mandatory Profit Sharing

Every employer has to distribute 10% of pre-tax profits to all employees. There are pre-established formulas for distribution which favor the lower paid employees. Of significance is the fact that the basis for the determination of the profit is the statutory tax return. Thus, any private pension plan expenditures that are not tax deductible are not applied against revenue for profit sharing determination. This makes it crucial to organize the annual accounting of pension programs, including the seniority premium, under a tax deductible framework.

Infonavit Housing Fund

The *Infonavit* Housing Fund is a mandatory program financed by the employer through contributions of 5% of covered pay which are destined for housing assistance. The funds are managed by a government agency and accumulated in individual accounts. The funds of any workers not availing of housing loans are to be aggregated to the social security account balances and be used for enhancing retirement benefits under the new DC system. As very few workers qualify for housing loans, the *Infonavit* balances are expected to provide a significant source of employer-paid retirement income. As these funds are mainly invested in loans to the disadvantaged, the rates of return have historically been very low.

Legal Severance

Let's start by clarifying that the concept of "employment at will" is illegal in Mexico since the employee's job tenure is a constitutional right. Once a job position has been granted to an employee it cannot be taken away. This means that employees cannot be terminated for any reason except for just cause, which is limited to a handful of extreme situations, such as gross insubordination and physical abuse of other employees. Curiously, lack of performance is not specifically mentioned. In practice, it is difficult to establish just cause or to sustain it in court. Additionally, mandatory retirement (i.e., termination on account of old age) is not allowed.

An employee whose job has been terminated (ostensibly for just cause) can sue his/her employer in the Labor Court to contest the dismissal. In practice, unless the breach was flagrant, employees invariably win in Court. In such cases, the employer must either pay a severance indemnity, as outlined below, or put the employee back on the payroll.

The minimum legal severance is a lump sum consisting of two elements: three months' final pay (which is akin to a mandatory notice period) plus 20 days' final pay per year of service. Pay has no cap and it includes all items in the employee's remuneration.

Once the Labor Court has found a dismissal unjustified, the employer has direct liability for the legal severance.

Despite this legal framework, in practice a significant proportion of employee turnover (in particular, terminations that would normally be executed or "induced" by the employer on account of the employee's poor performance), stems from negotiated severance. Furthermore, employers almost invariably "retire" older workers (starting as early as age 50) through a process inevitably leading to a severance payment equivalent to at least the legal minimum indemnity. It should also be mentioned that the accrued seniority premium benefit is payable in addition, upon an employee's unjustified dismissal.

Thus, most Mexican employers have a *de facto* defined benefit pension plan, covering virtually all employment terminations of older employees (after age 50) and a substantial number of pre-retirement age terminations.

Even when the employment terminations are negotiated in friendly terms, the process used for the final settlement is often that of formal dismissal since the legal severance payment is eligible for sizable tax exemptions.

Savings Funds

A source of confusion for international benefit professionals is a program in Mexico called "savings fund", which allows employees and employers each to contribute up to 13% of salary (limited to 1.3 minimum wages) on a tax advantageous basis. Savings funds may appear to be a good vehicle for long-term savings which should be included in pension planning. However, the Achilles heel of these programs is the fact that accumulated savings can be withdrawn once a year without penalties or taxes. In practice, balances are invariably withdrawn every year; therefore, savings funds are nothing more than revolving doors for tax free salary delivery.

OCCUPATIONAL RETIREMENT PLAN PRACTICE

There are structural reasons for employers to want to offer private pension plan benefits, as follows:

1. As seen above, there is a genuine need to supplement pension income from social security, especially among the above-average compensated employee group.

2. There is already a *de facto* pension plan imposed by a combination of legal requirements and traditional practice for weeding out older, less productive staff.

3. The government offers tax concessions to pension plan sponsors and participants.

Indeed, most subsidiaries of multinational companies and large domestic employers in Mexico offer a formal retirement program.

The pension plans that exist predominantly have a defined benefit format and feature long vesting schedules (or none at all). The benefit levels are pitched toward the legal severance.

Although the benefit formula is generally expressed as an annuity, benefits are almost always payable as lump sums. Since these plans are designed to deliver benefits equivalent to the legal minimum severance, most plans are financed exclusively by the employer.

The pension plan rarely provides benefits upon employment termination on account of death or total and permanent disability. Group insurance benefits are often available in those circumstances.

It is important to mention that pension plans pay benefits only when employees leave voluntarily (i.e., without any legally mandated severance). This is designed to avoid the possibility of employees "double dipping" pension benefits and severance payments, which are only payable upon involuntary separation of employment.

Defined contribution plans, contributory plans and other forms of long-term savings programs are not at all common in Mexico. However, while most *progressive* employers maintain a pension plan, the vast majority of private companies operating in Mexico do not offer any pension coverage other than social security.

In the remainder of this article, we wish to focus on three key factors that have been inhibitors of the development of pension plans and long-term savings, and which have been recently removed and/or modified, as follows:

1. Until recently, there had been no pronouncements from the tax authorities with respect to the tax treatment of defined contribution plans. A Revenue Ruling (*Disposición Complementaria* No. 3.4.16) issued in April of 2004 has provided badly-needed guidance on the tax deductibility of company contributions to DC plans.

2. Mexican accounting standards had prevented employers from adopting accrual accounting methods for the cost of legal severances paid as a matter of practice in order to systematically remove older employees. Instead, the costs were required to be recognized as contingencies at the time the severance payments were made to the employees. This in fact denied the existence of substantive pension commitments on account of the severance payment practices. Effective January 1, 2005, Mexican GAAP* has been amended in order to require the annual recognition of the costs through an accrual accounting methodology of formal or informal practices of providing indemnities to remove, or induce the retirement of, employees of older ages. Additionally, these practices will be required to be disclosed as a footnote to the annual financial statements of the employer.

3. There is little tax advantage to employees earning less than Ps 300,000† p.a. for pension or long-term savings contributions. As real salaries in Mexico have significantly escalated over the last 10 years for professional and management staff, more and more employees are beginning to move into the higher tax brackets, thereby making pension contributions worth their while from a tax perspective. While this group of individuals as a proportion of the workforce is relatively small, their number will only continue to rise over time.

A brief discussion of the two main resulting changes follows.

Taxation of Pension Plans

Over the last 40 years, Mexico has enacted laws that vest certain tax concessions on pension programs that are organized as prescribed in the law. The key tax advantages of formally organized pension programs are the deductibility of company contributions, the tax free accumulation of plan assets and investment returns, and the preferential tax treatment of pension payouts to the participants.

The main conditions for tax preferred treatment of pension plans are as follows:

1. The plan benefits must be offered to all workers (the principle of generality). Pension plans may be offered to unionized or non-unionized employees exclusively and still be regarded as compliant with the principle of "generality" of coverage for as long as it is offered to all the employees of the selected group. Similar dispensations are available for employers with several unions.

2. The plan's benefits must be annuities complementary to the social security pension benefits. Convertibility to other forms of benefit payment is allowed. However, the benefits cannot be advanced prior to retirement or employment termination. An important aspect of this clause is that a maximum benefit is established equivalent to the pension plan annuity which, when added to the social security pension benefit, must not exceed 100% of the employee's final salary. This requirement represents some form of defined benefit integration between the pension plan and social security.

3. The financial resources to meet the benefits must be funded outside the sponsoring company under a *fideicomiso* arrangement (a civil law entity similar to a trust) devoted exclusively for this purpose and be managed by an insurer, a trust bank, an investment house or an *AFORE*.

4. The plan assets must be invested in securities approved by the Banking Commission (*Comisión Bancaria y de Valores*) and at least 30% must be invested in Federal Government debt or in approved fixed income securities.

5. The plan benefits must be financed in accordance with actuarial principles and the unfunded past service benefits must be amortized over at least 10 years.

Items 2 and 4 above presented a particular problem for defined contribution plans. The recent pronouncement from the tax authorities specifies a company contribution limit of 12.5% of the employee's net salary. Item 4 above was also revised in order to allow defined contribution plans to invest in the retirement funds created for the defined contribution feature of the social security system known as *SIEFORE*.

A kink was introduced in that any benefit forfeitures that may arise from time to time as a result of termination of non-vested participants must be reallocated to the remaining participants in equal amounts. This requirement did not exist and continues not to apply to defined benefit plans. This is being interpreted as calling for forfeitures to be used as credit against future company contributions. This liberal interpretation is reasonable but still somewhat risky. More precise clarifications are being sought via higher order law.

Accounting for Pensions & Termination Indemnities

In 1992 Mexico introduced its own accounting standards for cost recognition and disclosure of pension obligations. Bulletin D-3 of the Mexican Accounting Standards and Circular 50 set out the accounting and actuarial procedures for the determination and disclosure of pension plan costs for purposes of financial statements prepared in accordance with Mexican GAAP.

As mentioned above, the pension-related Mexican GAAP principles issued in 1992 specified that employers were

* generally accepted accounting principles
† £1 = Ps 19.40; €1 = Ps 13.50; US$1 = Ps 11.14 as at 7 April 2006

not allowed to account for the cost of informal severance programs for employees at older ages on an *accrual* basis. The severance costs that can be charged against revenue for Mexican GAAP purposes were severance payments actually made to terminating employees.

The new rules effective January 1, 2005 mean that virtually every company operating in Mexico has to include a provision for the cost of severance programs based on accrual accounting in the annual financial statements prepared in accordance with Mexican GAAP. These costs will not be tax deductible nor be allowed to be charged against revenue for the purpose of determining the annual statutory profit sharing distribution unless the benefits are organized under a tax qualified framework and properly funded, or otherwise, until the severance payments are made.

Other Developments

There are two other recent changes that are worth reporting, as follows:

1. Effective May 26, 2004, the *CONSAR** issued Circular 15-12 allowing pension funds (*SIEFORE*s) to invest in foreign vehicles, albeit within certain constraints. This is going to broaden the prospects of higher returns and global diversification.

2. In order for employer contributions to private retirement plans to avoid being treated as taxable for social security contribution purposes, the private plan must be registered with the *CONSAR* by April 30, 2006. This is a minor compliance requirement but it means more supervision and government oversight of employer-sponsored pension plans.

Although these rulings appear as potentially positive or at least harmless initiatives, they have their negative side. The foreign investment possibility is subject to many constraints (along with high transaction fees) and thus it is being approached with caution. Only large *AFORE*s are currently availing of this avenue. The registration requirement with *CONSAR* may have a built-in trap. An option subject to certain conditions is available to participants of registered occupational pension plans who may wish to cash in their *AFORE* balance prior to retirement eligibility under social security. Unsuspecting employees who elect to exercise this right may not be aware that this could result in the elimination of their ability to obtain benefits under the prior social security defined benefit pensions. Although the *CONSAR* has assured plan sponsors that this feature will not be enforced, plan sponsors should devote communication efforts in order to ensure that plan members avoid this pitfall.

IMPACT OF THESE CHANGES

We are already beginning to see hard evidence of the combined impact of these developments in the marketplace in the following forms:

- Severance benefit programs have been formalized as qualified pension plans.

- New DC plans have been established independent of the pension programs organized in substitution of the severance practice.

- Existing pension plans have been transformed into hybrid arrangements having separate defined benefit and defined contribution components in tandem, or a defined contribution feature with a minimum defined benefit guarantee equivalent to the legal severance.

- Contributory features in pension plans have been introduced, especially for defined contribution arrangements, with employee contributions generally made optional and set at a low level.

- There has been more interest in flexible benefit programs that include a salary sacrifice or bonus deferral features.

- Given the low levels of disposable income that can be set aside for pension savings, companies have been looking at redirecting existing resources (such as profit sharing bonuses, savings fund contributions, Christmas bonuses, etc.) toward contributions to pension programs. However, a great deal of employee education is a *sine qua non* condition for increased contribution levels and to avoid employee relation problems.

- Insurance products and more sophisticated financial securities suitable for pension fund investment have been rapidly developed as a result of new private pension activity.

These trends are emerging not only as a result of the recent changes in accounting and taxation. Mexican companies are finding it difficult to deal with the simultaneous effect of skill shortages (and the concomitant labor cost inflation) and the heat of global pressures for cost-containment, especially in light of the emergence of India and China as strong competitors of Mexico for low-cost production.

CONCLUSION

The Mexican pension industry is quietly undergoing revolutionary changes. Structural demographic and socio-economic changes dictate an aggressive strategy for rapid development of the private pension sector. Mexico's population will age rapidly – by 2040, it is expected to reach a mature demographic make-up similar to that of France. To put this in perspective, in 30 years or so, Mexico's population will undergo an aging process similar to that experienced in Western Europe over the last 250 years.

The privatization of social security pensions will inevitably produce lower pensions and add risks to each individual's long-term financial security plans. However, private pensions in Mexico can and should make a substantial contribution to increasing long-term savings so Mexican citizens can be assured of continuing improvements in income security and in the country's economic advancement. The recent changes discussed in this article are certainly a step in the right direction. Ω

* *Comisión Nacional del Sistema de Ahorro para el Retiro*

Copyright © Pension Publications Limited 2006.

Reproduced from *Benefits & Compensation International,* Volume 35, Number 9, May 2006.
Published by Pension Publications Limited, London, England.
Tel: + 44 20 7222 0288. Fax: + 44 20 7799 2163. Website: www.benecompintl.com
Produced by The PrintZone (www.theprintzone.co.uk).