PROJECT ABSTRACT

MEXICO

October 30, 1996

PROJECT NAME:	**CONTRACTUAL SAVINGS DEVELOPMENT PROGRAM**
PROJECT NUMBER:	**ME-0197**
BORROWER:	**Banco Nacional de Obras Públicas (BANOBRAS)**
EXECUTING AGENCY:	**Secretaría de Hacienda y Crédito Público (SHCP)**
FINANCING PLAN:	**IDB: US$300 million** **World Bank: US$400 million** **Total: US$700 million**

I. BACKGROUND

A. Macroeconomic background

1.1 In 1995 Mexico responded with a strong adjustment program to deal with the financial crisis that erupted in December 1994. The Government of Mexico's (GOM) program was supported by a large international financing package. As a result of this effort, substantial progress was achieved in stabilizing the economy during 1995. The central challenge that Mexico now faces is to foster a return to economic growth while consolidating the gains in macroeconomic and financial stability.

1.2 A key means to strengthen the banking system, enhance capital market development, and improve the allocative efficiency of domestic savings will be contractual savings reform, the focus of the proposed loan.

B. Current state of Mexico's Old Age Insurance System

1.3 Mexico's old age security system consists of three basic pillars.

The First Pillar: Public Pay-as-you-go Pension Plan. The Mexican social security system as it evolved for almost fifty years through 1992 consisted essentially of two areas of support:

a. retirement and disability pensions based on payroll contributions of 8.5 percent of wages for private sector workers, administered by the IMSS, and 7% of wages for public sector employees administered by the ISSSTE; and

b. pensions financed from individual employee accounts in two specialized housing funds, based on a contribution of 5% of wages for private sector employees administered by INFONAVIT, or 6% of wages for public sector workers administered by the FOVISSSTE.

1.4 The IMSS also provides private sector workers with health care coverage under its own hospital system based on a contribution of 12.5% of wages. Health care coverage for public sector workers is based on contributions of 9.5% of wages to ISSSTE. In addition, the IMSS and ISSSTE health services schemes have been subsidized with funds from the retirement and disability contributions to these systems.

1.5 The Second Pillar: The Retirement Saving System. In 1993, a new system of Individual Retirement Accounts (or SAR accounts) was established for both public and private sector workers. The SAR accounts are funded with additional employer contributions equivalent to 2% of wages and are guaranteed by law a real rate of return of 2%. These funds are collected by commercial banks and channeled to the Central Bank. By mid-1995, accumulated balances of the SAR accounts totalled US$5.2 billion.

1.6 The Third Pillar: Voluntary Occupational Pension Plans. A number of private companies in Mexico have established voluntary pension plans for the benefit of their workers. Most of these plans provide for employee contributions of between 2 and 6 percent of annual wages. The operations of these plans have essentially been unsupervised.

1.7 Deficiencies of the present system. The current administration has recognized that Mexico's current contractual savings system suffers from several weaknesses. The key weaknesses are: (i) considerable financial disequilibrium, (ii) high evasion and low population coverage (40% of the workforce), and (iii) substantial institutional inefficiencies of current providers of old age insurance.

C. Contractual savings development program: Objectives

1.8 To address the weaknesses of the present contractual savings system, the GOM has embarked upon a series of major policy initiatives that have been grouped together under the title of "Mexico: Contractual Savings Development Program" (CSDP). The main

objectives of the CSDP are to: (i) increase the equity, efficiency and sustainability of the old age security system, and gradually lead to greater coverage; (ii) establish a financially viable pension system; (iii) ensure transparency of the fiscal costs of the transition; (iv) raise the allocative efficiency of long-term domestic savings; and (v) enhance financial market development and increase the array of financial instruments and contracts available. Mexico's youthful demographic profile makes the timing of the reform appropriate as early action lowers the fiscal cost of the reform.

II. KEY FEATURES OF THE REFORMED CONTRACTUAL SAVINGS SYSTEM

2.1 In December 1995, legislation was passed reforming the contractual savings system for workers in the formal private sector from the current PAYG system to a defined-contributed system. A second legislative package on the implementation of the reforms was submitted to Congress in April 1996. The reform, however, does not contemplate changes to the ISSSTE and other state and public enterprises' pension plans.

2.2 Old age and severance reform. The reform separates the old age and severance scheme from the disability and life insurance scheme. The old age and severance scheme shifts from the current public PAYG system, which is discontinued for all private sector workers, to a defined contribution system with a minimum pension guarantee. The backbone of the new fully-funded pension system is constituted by individual retirement funds (SIEFORES). These funds will be managed by investment management firms (AFOREs) to be established by the private sector (domestic and foreign), IMSS, and trade unions. IMSS will continue to have a role as: (i) the legal enforcer of all collections; (ii) provider of benefits to all existing pensioners; (iii) the entity responsible for delivering benefits to transition workers choosing benefits under the old PAYG system at retirement; and (iv) the provider of the minimum pension guarantee.

2.3 Under the reform, contributions to old age and severance in the AFOREs' individual retirement accounts will equal 6.5% of a worker's salary, including the 2% of wages currently contributed to the SAR account (paragraph 1.6). In addition, the reform introduces a government contribution of NP$1 per day (equivalent to 2% of the current average workers' wage). Contributions equal to 5% of a worker's salary will continue to be made to INFONAVIT, but individual retirement accounts will be established for these contributions.

2.4 Benefits. Under the reform, benefits to new workers (entering the system after January 1, 1997) will consist of the accumulated balances in the individual retirement accounts (AFOREs plus post-reform INFONAVIT accounts). In addition, new workers will be entitled after 25 years of contributions to a minimum pension

guarantee equal to the minimum wage as of the end of 1996 indexed to the C.P.I.. After January 1, 1997, transition workers (those presently in the system) will also start contributing to new individual retirement accounts. However, they will retain the option at retirement to choose the greater between acquired benefits under the current system and accumulated benefits of the individual retirement accounts under the new system. Under the old system, the minimum pension guarantee consisted of: (i) benefits accrued under PAYG system equal to a percentage of the average of their last five years' nominal wage or a minimum pension guarantee equal to the minimum wage in effect at the time of retirement, indexed to changes in the minimum wage; (ii) accumulated balances in the INFONAVIT retirement sub-account; and (iii) accumulated 1992-96 balances in the SAR retirement sub-account.

2.5 Disability and life insurance reforms. The reform separates disability and life insurance coverages from the other lines of insurance which IMSS continues to manage. As a result, funds can no longer be commingled. Total contributions for disability and life insurance are 4 percent of wages since they include 1.5 percent for reserves for pensioners' health expenses. IMSS will retain responsibility over the management of this line of insurance, but private insurance companies will provide benefits through annuities.

III. PROJECT OBJECTIVES

3.1 The proposed loan would support the Mexican reform of the contractual savings system for formal private sector workers, which is designed to: (i) increase the equity and efficiency of the old age security system and ensure its financial viability, (ii) improve the allocative efficiency of savings and (iii) enhance the development of longer-term financial instruments and the deepening of capital markets. In addition, the program will promote the transparency of the fiscal costs of the transition to encourage fiscal discipline.

IV. PROJECT DESCRIPTION

4.1 The Program will support the GOM's actions to facilitate the adequate implementation of the new pension scheme and ensure that maximum benefits are obtained from the reform. These actions will encompass:

(i) assessing and funding appropriately fiscal transaction costs;

(ii) designing the legal framework to regulate pension fund administrators and investment management rules;

(iii) strengthening the monitoring and enforcement of the new scheme (including the AFORES, SIEFORES and INFONAVIT) and implementing proper disclosure procedures to foster sound returns on the different components of the returement accounts;

(iv) Strengthening of the IMSS in its ability to manage the operational scheme for the new pension system; and

(v) encouraging public confidence through education.

4.2 In addition, the GOM will undertake complementary financial market reforms, to promote the availability of an adequate supply of quality financial assets for pension fund investments and ensure adequate returns to pension funds.

4.3 Project financing. The project is a fast disbursing operation in the amount of US$300 million from the Bank's Ordinary Capital (OC). The Program is to be released in two equal tranches over a period of a year. Disbursement of each tranche is contingent upon compliance of tranche specific objectives and maintenance of a macroeconomic framework consistent with the objectives of the Program. Loan funds will finance CIF costs of eligible imports.

V. PROJECT IMPLEMENTATION

5.1 The United Mexican States would be the Guarantor for the loan made to Banco Nacional de Obras Públicas (BANOBRAS), a state-owned development bank (the Borrower). Execution of the Project would be coordinated by the SCHP with support from other public agencies, particularly CONSAR.