

**MULTILATERAL INVESTMENT FUND  
PROJECT ABSTRACT**

**Equity investment in Afore de La Gente**

**I. BASIC PROJECT DATA**

Country/Region: Mexico (ME-1017)  
Program Name/Number:  
Team Leader/Members: Edgar Rivera (MIF/INV) project leader; Hyeonjin Cha (MIF/INV); Antonio Gaspar (MIF/DVE); Carlos Roa (IIC); Alberto Bucardo (COF Mexico); Lissette Barbero (MIF/INV).  
Date of Request: December, 2005  
Beneficiaries: (i) Approximately 37 million low and medium-low income individuals (80% of active economic population) who have inadequate access to financial products and services (ii) 19 million migrants living abroad with no financial services of any kind (iii) over 500 local Saving and Popular Credit Institutions (“*Cajas*”) gaining wider financial products and competitiveness through *Afore de la Gente*.  
Executing Agencies: *Afore de la Gente* and BANSEFI  
Financing Plan: Equity Investment

MIF :	US \$ 2,000,000
IFC :	US \$ 1,900,000
Local <i>Cajas</i> :	US \$ 1,200,000
<u>BANSEFI, S.N.C</u>	<u>US \$ 4,900,000</u>
Total	US \$ 10,000,000

Tentative Dates: POC December 2005.  
Cesi: January ~ February 2005  
Due Diligence: March 2006  
Donors Committee: April 2006  
Classification: SMF/SMED

**II. BACKGROUND AND PROBLEM STATEMENT**

**A. Background and Problem Statement**

- 2.01 One of the distinctive features of the financial system in Mexico is the accessibility gap of people to the financial services and products in terms of income and size. The traditional banking sector is open mainly to large and medium enterprises and high-income individuals, while SMEs, medium/low-income, and self-employed workers are far from the banking services. Currently,

only 35% of the economically active population has access to the commercial banking system.

- 2.02 As a result, individuals of limited means are often forced to rely on informal financial markets with very high interest rates. Also, a large number of community savings and loans informal organizations serve the demand for financial services in some large sectors and regions in Mexico. Their legal status varies, but most are not regulated or supervised by the authorities. The informal financial institutions' potential vulnerability to financial problems has been a concern of the authorities.
- 2.03 Against this backdrop of “*dichotomized*” financial structure, the Mexican government designed a strategy to : (i) expand efficient financial services to the population not served by traditional banking, and (ii) institutionalize, promote, regulate and supervise the community of savings and loan institutions. The idea was embodied by the Community Savings and Loan Act (LACP) in June 2001. According to the law, BANSEFI (*Banco de Ahorro Nacional y Servicios Financieros, Sociedad Nacional de Credito*, National Savings Institution), a government-owned development bank, was established.
- 2.04 As of September 2005, there were some 34.6 million affiliates<sup>1</sup> registered with the Afores and some US\$51.3 billion of pension savings at the Afores. The net savings have earned a real return of 7.08% since initiation of the system; 6.65% in the most recent 12 months. New monthly deposits to the pension savings (excluding Infonavit) were US\$6.5 billion in the 12 months to September 2005. Thus, including those deposits and the return on the portfolio, these savings are currently growing by about US\$10 billion per year. Today, there are 15 Afores operating in Mexico, down from the 17 at the start of the system but up from the low point of 12 in 2001.
- 2.05 BANSEFI's main goal is to provide support to the Savings and Loans organizations in terms of banking services, offering them access to the Payment System and economies of scale in banking operations. BANSEFI, also provides to the *Cajas* a technological platform that allows connectivity on-line and efficiency in their data management and reporting. On October 25, 2005, the Congress passed the law to establish the *Afore de la Gente*, a subsidiary of BANSEFI for pension fund management.

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<sup>1</sup> The published figures for the percent of affiliates with current contributions are misleading. Probably only 48% or so of these 35 million affiliates are reasonably current as to contributions.

- 2.06 This start-up business model relies heavily on *L@Red de la Gente*<sup>2</sup>, the strategic alliance between local *Cajas* and BANSEFI. However, the local *Cajas*, given their historical development, could not enjoy the principle of sharing their territory. This territorial competition in their own business may create difficulties to cooperate among *Cajas* under *L@Red de la Gente* framework. Such difficulties may cause a major setback in the businesses for both, BANSEFI and *Afore de la Gente*.
- 2.07 In the meantime, the LACP in 2001 provides BANSEFI with a 4-year transition period beyond which the institution must turn into a private organization. According to the law, Mexican government has already announced the privatization plan of BANSEFI under which the equity placement will be exclusively open to local *Cajas* or federations of *Cajas* by the end of June 2006. However, BANSEFI, the largest development bank in Mexico, is too big to be owned by a limited number of small local *Cajas*. The two-digit growth rate of assets and recently positive earnings may seem not to compensate its huge cumulative capital losses for its successful IPO<sup>3</sup>. A catalytic role of international organizations like MIF and IFC can fill the vacancy of private investors, nervous , at this time to participate in a venture with the government.

## **B. Program Rationale and Additionality**

- 2.08 MIF's equity investment in *Afore de la Gente* seeks to giving access to the pension system to the medium-low and low income workers of Mexico, facilitating also the introduction of new products. Since the business model of *Afore de la Gente* relies on the innovative distribution channel, *L@Red de la Gente*, its operation will also help the Mexican pension funds system to enjoy economy of scale.
- 2.09 MIF's equity participation will also contribute to *Afore de la Gente*'s revenue, market share and profitability through its timely launching. Under Mexican's pension system, IMSS (Mexican Social Security Institute) collects contributions from all affiliates, and then assigns the *unregistered* contributions to only 4~5 pension fund management companies on the basis of competitive bidding. *Afore de la Gente* is expected to offer and absorb a large portion of new contributions<sup>3</sup>.

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<sup>2</sup> *L@Red de la Gente* allows the products distributed under a single trade name, business policy, and operating process through a shared network. Currently, *L@Red de la Gente* covers more than 1,144 branches, of which 26% are placed where no any other commercial financial institutions. To connect on-line with participants of *L@Red de la Gente* and conduct transactions in real time, BANSEFI provides and develops the advanced IT technologies. This model is expected to generate an *economy of scale*, reducing the operating costs.

<sup>3</sup> As of September 30, BANSEFI's capital is around US\$ 36 million, resulted from the cumulative losses of US\$ 36 million for the last 4 year-operation. However, it has recorded two consecutive earnings in 2<sup>nd</sup> quarter 2005.

<sup>3</sup> Among the 15 entries in current pension fund management market, 2 dominant companies capture 40% of the funds and 29% of the contributors. Pursuing more competitive market, the government is about to permit 3 new companies including *Afore de la Gente*, and it will favor them in contribution assignment.

Therefore, any delay in set-up to qualify the minimum capital requirement and proper corporate governance may cause substantial loss of its market share and corresponding revenue to other competitors.

### **III. PROGRAM OBJECTIVES AND DESCRIPTION**

#### **A. Objectives**

- (i) Contribute to increase the access to the pension system to the medium-low/low income workers of Mexico.
- (ii) To support the launching of a pension fund management organization through an equity investment in “*Afore de la Gente*”.

#### **B. Description**

*Medium-term equity investment in Afore de la Gente.* The capital of *Afore de la Gente* is to be about US\$ 10 million, the minimum requirement according to the regulation of the National Banking and Securities Commission (CNBV). The shares will be held by three groups in proportion to their roles in the company’s business model : BANSEFI (49%), the federations of Saving and Popular Credit Institutions (12%), and multilateral organizations (39%). Among multilateral organizations, MIF and IFC will take 20% and 19%, respectively. Receiving the approval from CONSAR by February 2006, *Afore de la Gente* is to finish the capitalization process by no later than April 2006. Under moderate financial assumptions, *Afore de la Gente* is not expected to go public before 2010, not to mention the first three years of losses. Once investing in the *Afore de la Gente*, therefore, MIF can exit in 2010 or later<sup>4</sup>. Detailed conditions for exit are under negotiation.

BANSEFI, the biggest shareholder of *Afore de la Gente*, is in a privatization process. It is expected that such process will conclude early February 2006. At that moment, MIF’s shares of *Afore de la Gente* may be, at MIF’s option, converted to shares of BANSEFI.

*Privatization-contingent put option.* In the event the BANSEFI Privatization Plan (“BANSEFI Socialization”) is not implemented by May 31, 2006 MIF could exercise a put option and exit from *Afore de la Gente* by August 31, 2006. In case BANSEFI is privatized, MIF will have the right to exchange *Afore de la Gente* to BANSEFI according to the negotiation of acceptable terms and conditions.

### **IV. COST AND FINANCING**

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*Afore de la Gente* assumes to receive 20%, 17% and 14% of the assignments for the first 3 years, which varies upon when it starts business.

<sup>4</sup> BANSEFI hopes MIF and IFC to exit in 2012 or later. As an incentive for longer-term equity investment, BANSEFI offers 6% of annual return to MIF and IFC. Before IPO, MIF (and IFC) has the right to participate on a pro rata basis in any sale of *Afore* shares by BANSEFI.

The total requirement for the establishment of *Afore de la Gente* is US\$ 10 million. MIF's participation will represent up to 20% of it, or up to US\$ 2 million.

The proposed participation in *Afore de la Gente* follows:

	US\$	%
MIF	2,000,000	20
IFC	1,900,000	19
SPCI	1,200,000	12
BANSEFI	4,900,000	49
TOTAL	10,000,000	100

## V. EXECUTING AGENCY AND EXECUTION STRUCTURE

The executing agencies will be the *Afore de la Gente* and BANSEFI. *Afore de la Gente* will offer a distribution channel conformed by more of 1,100 points of sales (BANSEFI's branches and local *Cajas*) all over the country, promoting the medium/low-income workers' saving. In tandem with *L@Red de la Gente*, the thin operative and administrative structure of *Afore de la Gente* allows it to offer one of the lowest price/fees in the market and to expect faster growth of customers. Based on moderate assumptions, *Afore de la Gente* is expected to reach a net surplus by its 4<sup>th</sup> year.

Regardless of its corporate structure shift, BANSEFI's core business model will not experience any significant change. Therefore, BANSEFI will keep its competitive edge with a large nation-wide distribution channel (550 branches) and rapidly growing customers (276% increase for the last 4 years). The extended arm of *Afore de la Gente* will complement BANSEFI's existing financial services of insurance, mortgage, loans and remittances and it must strengthen BANSEFI's financial soundness.

## VI. MAJOR ISSUES

- 6.01 **Political Risk** : In Mexico, the privatization has been highly disputed issues and some plans were postponed or delayed due to socio-political climate. The Mexican government has showed its strong will to privatize BASEFI. However, the privatization process could be delayed in the Senate. Substantial part of this risk was mitigated when the Congress approved and sent to the Senate the "Transformation Act". Also, on top of the final legislation, a *put option* in MIF's share of *Afore de la Gente* will also effectively reduce the risk. According to the put option proposed, the Mexican government, through BANSEFI, must buy-out MIF's participation if the privatization is not implemented.
- 6.02 **Business Risks** : In projecting medium-term cash flows and earnings, *Afore de la Gente* assumes it will receive a substantial share of the contribution assignment from IMSS. However, the more competitive environment with new entries in pension fund management market may cause extreme price competition and *Afore*

*de la Gente*'s price advantage may not be dominant. *Afore de la Gente* also expects the persistency of the contributions of clients to drop only slowly (for example, 73%, 56%, 49%, 45%, etc). This assumption comes from the established statistics with high-income workers. Lower-income workers are, however, more vulnerable to economic fluctuations and easy to stop contributing. These business risks may impact the *Afore de la Gente*'s earnings and MIF's exit timing.

- 6.03 **Privatization Risk.** The pivotal factor determining the success of BANSEFI is the voluntary participation of, and the alliance with the local *Cajas*. Currently, a majority of the *Cajas* (84.3% in terms of asset volume, 85.2% in terms of customer base) is participating in the Consultative Committee for the equity placement, but their participation does not necessarily mean that they will join the BANSEFI's capitalization. This risk can be also effectively alleviated by MIF's technical assistance for the equity placement.

## VII. SOCIAL AND ENVIRONMENTAL IMPACT AND PROPOSED MEASURES

- 7.01 Through the strategic alliance among its equity holders, BANSEFI and/or *Afore de la Gente* is to commercialize financial products and services in a sector of the population that does not have access to them, and to distribute the aid from government programs designed for relieving poverty and foster development in several parts of the country. In addition, *Afore de la Gente* will provide the opportunity to promote the long term voluntary saving, particularly to the informal independent clients.
- 7.02 The team has reviewed and taken into consideration the environmental and social guidelines prepared by SDS/MSM specifically the treatment for microfinance and operations and the MIF Environmental and Social Guidelines for financial intuitions <http://www.iadb.org/mif/v2/envsocialguidelines.html>.