Pension reform – Better conditions for workers and soothes investor confidence

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- **Today, during the morning press conference of president Andrés Manuel López-Obrador, the Executive branch announced they will submit to Congress a reform initiative to the National Social Security (IMSS) Law**
- **Broadly speaking, we highlight four key elements in today's initiative:**
  - **(1) It implies an agreement with the private sector, reflecting a renewed commitment of Mexican businesses with social justice;**
  - **(2) The reform will benefit workers;**
  - **(3) The project is progressive and in line with best international practices; and**
  - **(4) The proposal will increase confidence among both local and foreigner investors and is contrary to some ideas floated by individual legislators, offering greater certainty about the macroeconomic and institutional backdrop**
- **The initiative considers three main actions: (1) An increase in pension contributions; (2) a reduction in the number of necessary weeks worked to access pension benefits; and (3) a higher guaranteed pension amount**
- **We believe a reform of the current pension system is highly necessary to improve the livelihood of Mexican workers when compared to international standards, while also tackling welfare issues**

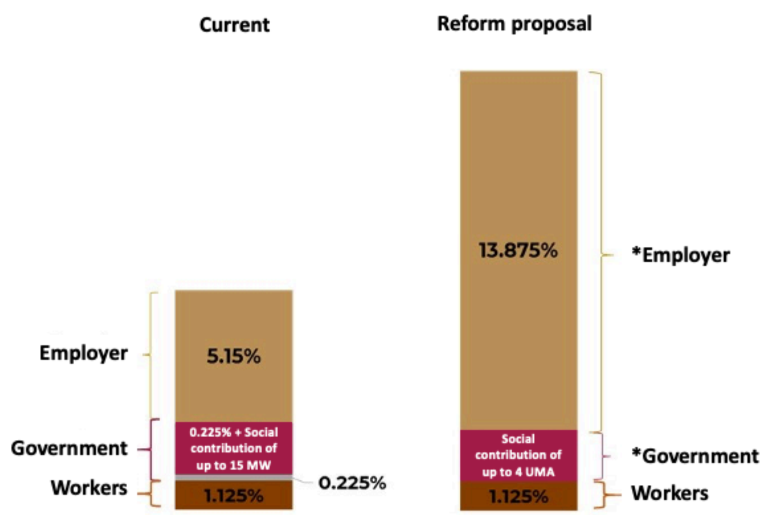
Important announcement on pension reform that will increase investor confidence in highly challenging times. Today, during the morning press conference of president Andrés Manuel López-Obrador, the Executive announced that they will submit to Congress a reform initiative to the National Social Security (IMSS) Law. The event was attended by the Finance Minister, Arturo Herrera, the president of the Lower House, Mario Delgado, the president of the Senate, Ricardo Monreal, the Director of IMSS, Zoé Robledo, the president of Mexico's business chamber CCE, Carlos Salazar, and the senator Carlos Aceves del Olmo, who is the Secretary of the Confederation of Mexico's Workers (CTM). In our view, a reform of this magnitude is very relevant considering the country's complex backdrop, as it is navigating through a global pandemic that has caused one of the worst economic crises in the last 100 years.

The four most relevant aspects of the initiative. Moreover, this proposal complements the reform to Article 4 of the Constitution, carried out at the beginning of the year. Broadly speaking, we highlight four key elements in today's initiative: (1) It implies an agreement with the private sector, reflecting a renewed commitment of Mexican businesses with social justice; (2) The reform will benefit workers; (3) The project is progressive and in line with best international practices; and (4) The proposal will increase confidence among both local and foreign investors and is contrary to some ideas floated by individual legislators, offering greater certainty about the macroeconomic and institutional backdrop.

Strategies to improve workers pensions affiliated to IMSS. The proposal has three main actions that aim to improve pensions currently offered by the retirement system (*Sistema de Ahorro para el Retiro,* or SAR in Spanish) to workers affiliated to IMSS. These three guidelines include:

(1) *Increase in pension contributions*. The total contribution will increase gradually during the next 8 years, to 15% from 6.5% of wages. This will be primarily through employers' contributions, which will be increased from the current level of 5.15% to 13.875%. The government's contribution of 0.225% of wages plus a "social fee" will increase in the second component up to 4 times the *Unit of Measurement and Update* (*Unidad de Medida y Actualización* or UMA, in Spanish). For details, see chart below. Therefore, workers in the low end of the wage distribution will be able to obtain a higher replacement rate. On the other hand, it is important to stress that workers' contributions will not be modified.

Pension contributions
% of monthly income unless otherwise stated



*Depending on each worker's income.
In the case of the employer, it can go from 5.151% for workers earning 1 MW up to 13.875% for workers earning 25 UMA. For the government, the proposed social amount goes from 8.724% for workers earning 1MW to 1.798 earning 4 UMA
Source: MoF

(2) *A reduction in the number of necessary weeks worked to access pension benefits.* The proposal implies to lower the requirement to obtain a guaranteed pension, from 1,250 weeks worked currently (about 25 years) to 750 (around 15 years). Going forward, this will be increased gradually during a span of 10 years, to end at 1,000 weeks (20 years). On their statement published today regarding the proposal, the Federal Government "*…the reform will allow to more than double the percentage of workers that will be able to reach this benefit…"*. It should be mentioned that this does not mean that by working less, people can retire and receive a pension, it does mean however that a lot of them that worked for many years and unfortunately did not fulfill the minimum number of weeks worked, can now access an adequate pension.

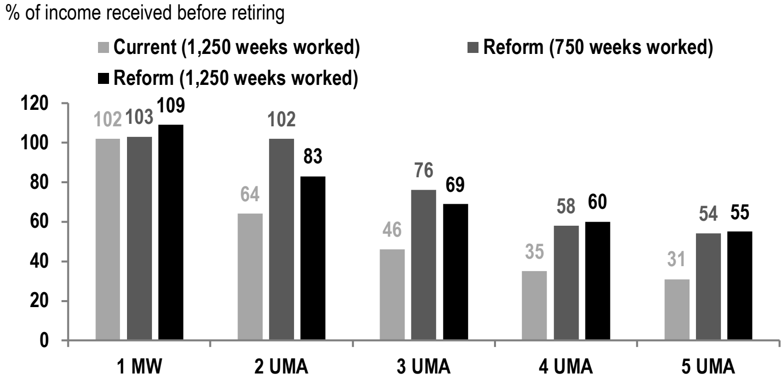
(3) *A higher guaranteed pension amount.* The aim is that the monthly amount of the guaranteed goes from $3,289 (80% of the minimum wage; US$146.8) to an average of $4,345 (US$194.0). The pension will be determined by the age, weeks worked and the wage. "*With these actions, the replacement rate, which represents the pension relative to the last wage earned by the worker before retiring, will increase on average by 40% relative to its current level*".

The reform proposal also includes other aspects that aim to improve workers' conditions when they retire. These include the possibility of combining retirement annuities with scheduled withdrawals, the ability to access voluntary savings without delay –currently at 6 months–, and the elimination of rights' expiration. In addition, it considers a further reduction in AFORES commissions to achieve a fast convergence towards international standards at around 0.7% of AUM, along the modification in their investment regimes.

Need to reform the current system. In our view, a reform to the current pension system is highly necessary to improve worker's conditions in Mexico when compared to international standards (see section below) while also tackling welfare issues. In this sense, the Minister of Finance warned of two big challenges to the current system.

First, workers' savings and contributions were not enough to attain a minimum pension and a replacement rate that could offer them appropriate conditions for their retirement. In this context, it is important to mention that all comparisons already include the amount of the *Welfare Pension for the Elderly*, which was granted as part of the changes to Article 4 of the Constitution on May 8th. This consists of a bi-monthly payment of $2,550 (US$113.8) to all adults aged 68 or above across the country, and those aged 65 and higher in indigenous populations. According to the calculations of the Federal Government and to exemplify the benefits of the reform, the chart below shows current replacement rates and those estimated after the reform, for workers earning between one minimum wage and five times the UMA, under two scenarios: (1) Retirement after 750 weeks worked; and (2) retirement after 1,250 weeks, in line with the current system. Specifically, for a worker earning 5 UMA (equivalent to a daily wage of $434.4 or US$19.4), the current replacement rate stands at 31%, while in the most favorable scenario –with 1,250 weeks worked–, the rate would increase to 55% (+24%-pts).

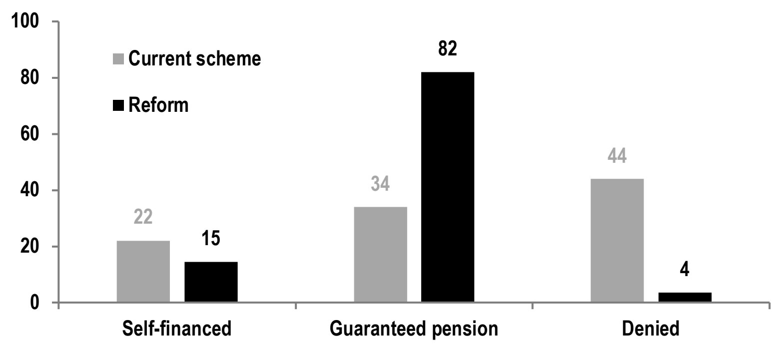
Replacement rates
% of income received before retiring



MW = Minimum wage; UMA = Unit of Measurement and Update
Source: MoF

The second challenge, given the high degree of informality in Mexico, is that a lot of people do not fulfill the minimum requirement of 25 years worked to access the Guaranteed Pension, leading to the need of a fairer and more equitable system. Similar to the current situation, the Guaranteed Pension will be given to people aged 60 and older. However, there are two changes: (1) Reduce the number of weeks worked to 750 (close to 15 years) from 1,250 (25 years); and (2) the amount will be determined considering the recipients' age, wage and weeks worked, oscillating between 0.7x and 2.2x the minimum wage, instead of a flat amount of 0.8x across the board. According to the Federal Government, these changes would increase the percentage of total workers with the right to a pension to 97% from 56%, getting close to the goal of being universal. In addition, and as shown in the chart below, the coverage of the Guaranteed Pension would increase to 82% of workers from 34% currently, boosted by the addition of informal sector workers, while the 44% that do not qualify for a pension would fall to only 4%.

Workers with a pension
%



Source: MoF

Positive reform to improve workers' pensions. It is important to mention that replacement rates under this proposal will remain below those in the 1973 IMSS' Law. That is a "defined benefit" plan, in which, at retirement, the worker receives the average wage perceived in the previous five years until passing away. In this sense, the replacement rate was close to 100%. Nevertheless, this meant that the government takes the risk of workers' contributions falling short from adequately funding pension-related liabilities. The latter implied a very important risk to the health and sustainability of government finances in the medium- and long-term.

As a result, in 1997 the law was changed to the AFORES regime, which is a "defined contribution" system. In this, the amount received at retirement depends only on contributions made –therefore, workers' savings– and net investment returns. The main problem is that savings rates have been very low. As a result, this translates into very low replacement rates (close to 30% currently) at retirement. In this context, we consider that the proposal is positive, as its main goal is to substantially increase contributions –with said increase mainly financed by employers– as well as improving efficiency in costs to achieve higher net returns. In this respect, replacement rates and workers' pensions would go up.

Improvement under international standards. The estimated increase in the replacement rate is very important, as it would improve the position of Mexican workers relative to other countries. According to OECD estimates in their document *Pensions at a Glance 2019*, Mexico's replacement rate at the end of 2019 stood at 29% –very close to the MoF's figure of 30%–. Assuming the 40% estimated increase, the rate would come close to 42%. Out of the total 36 countries in the organization, Mexico would climb from the 35th place (just above the UK) to 30th, with similar levels to New Zealand and South Korea and even higher than countries such as Australia and Japan.

An important step in the right direction. Despite important advances that have been made in the pension system in Mexico, our country was lagging behind in certain aspects, as it has been analyzed throughout this research note. In our view, today's reform proposal is a relevant step in the right direction to improve workers' retirement conditions, especially during a complex backdrop for the Mexican economy. In addition, this initiative has positive implications in terms of welfare for a significant number of Mexican households. We have identified four important aspects amid this reform initiative: (1) It has embedded an agreement with the private sector, conveying a strong commitment from the business community to enhance policies and strategies with a significant social dimension; (2) the reform will be beneficial for workers; (3) it is a progressive project aligned with best international standards; and (4) the proposal will boost confidence among local and foreign investors as it will be perceived as market friendly, in contrast with previous comments from some legislators with a more radical view, providing a more certain landscape about Mexico's macroeconomic and institutional framework. On the other hand, we stress out the need to acknowledge some risks to ensure a well-suited implementation. This strategy could result in higher costs associated to formal employment, although the perks for workers could completely offset the potential costs. In this sense, and in a similar way, we are convinced that reforming efforts should continue to lower the fiscal burden coming from the current pensions system, starting with a comprehensive and progressive fiscal reform, which should be able to trigger the appropriate incentives to increase investment, innovation and formality.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Tania Abdul Massih Jacobo, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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