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PERFORMANCE AUDIT REPORT

MEXICO

**CONTRACTUAL SAVINGS DEVELOPMENT PROGRAM (CSDP I)
(LOAN 4123-ME)**

**CONTRACTUAL SAVINGS DEVELOPMENT PROGRAM II (CSDP II)
(LOAN 4343-ME)**

October 23, 2000

Operations Evaluation Department

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Currency Equivalents

Currency Unit		Peso
US\$1.00	=	7.6 (1996)
	=	7.9 (1997)
	=	9.1 (1998)
	=	9.6 (1999)

Acronyms

AFORE	Administradora de Fondos para el Retiro
CNBV	Comision Nacional Bancaria y de Valores
CONSAR	Comision Nacional del Sistema de Ahorro para el Retiro
CSDP	Contractual Savings Development Program
FTAL	Financial Sector Technical Assistance Loan
ICR	Implementation Completion Report
IDB	Inter-American Development Bank
IMSS	Instituto Mexicano del Seguro Social
INFONAVIT	Instituto del Fondo Nacional de la Vivienda de los Trabajadores
ISSSTE	Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado
PEMEX	Petroleos Mexicanos
PROCESAR	Pension System Operator
SAR92	Sistema de Ahorro para el Retiro initiated in 1992
SHCP	Secretaria de Hacienda y Credito Publico (Ministry of Finance)
SIEFORE	Sociedades de Inversion Especializadas de Fondos para el Retiro

Fiscal Year

Government: January 1 – December 31

Director-General, Operations	:	Mr. Robert Picciotto
Director, Operations Evaluation Department	:	Mr. Gregory K. Ingram
Manager, Country Evaluation & Regional Relation	:	Mr. Ruben Lamdany
Task Manager	:	Ms. Laurie Effron

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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

October 23, 2000

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

**SUBJECT: Performance Audit Report on Mexico: Contractual Savings
Development Program (CSDP-I) (Loan 4123-ME) and Contractual Savings
Development Program II (CSDP-II) (Loan 4343-ME)**

This is the Performance Audit Report on these two loans, each for an amount of US\$400 million. The Contractual Savings and Development Program, CSDP I, was approved in December 1996, fully disbursed, and closed six months behind schedule in December 1997. The second Contractual Savings and Development Program, CSDP II, was approved in June 1998, fully disbursed, and closed as planned in June 1999. Both loans were single-tranche adjustment loans.

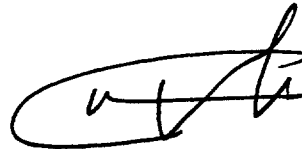
The main objectives of both CSDP I and CSDP II were to establish and supervise a new private pension system. CSDP I focused on introducing the legal and regulatory framework; designing an investment management regime for pension fund administrators; assessing the fiscal costs of transition; improving the performance of INFONAVIT, a pension fund making low cost housing loans to contributors; individualizing the accounts and strengthening capacity to manage the new system; and encouraging public confidence in the new system. CSDP II took the reforms to the next stage and focused on fine-tuning the reformed pension system for private sector workers; updating the fiscal costs of transition; deepening reforms of INFONAVIT; starting the process of reform of the public pension system; sustaining public confidence in the new system; and making progress in complementary financial sector reforms such as banking, mutual funds, and development of new instruments.

CSDP I was highly satisfactory: except for the reforms to INFONAVIT, all of the objectives were met. Of particular note are: (a) the development of the legal and regulatory framework of the pension reform, which provide generally appropriate rules for both investment guidelines and supervisory oversight and enforcement; the regulatory agency CONSAR has been able to carry out its functions efficiently and forcefully; and (b) the success of what is mundane but essential to pension reform, the individualization of accounts and strengthening the capacity of the local agency, IMSS, to manage the new system. An earlier attempt at pension reform failed in part because of the inability to reconcile worker contributions with their individual accounts. Taking into account the considerable progress on the regulatory and supervisory aspects and the negligible progress on reforming INFONAVIT, institutional development is considered, on average, modest. Sustainability is uncertain for reasons discussed below. Bank performance is rated as highly satisfactory.

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CSDP II, which built on the successes of CSDP I, but tackled more difficult reforms, was less satisfactory. The regulatory framework, supervision, and enforcement all continued to be strengthened and the individualization of accounts made further progress, including the transfer of balances left from the earlier attempt at pension reform. No further progress was made on reforming INFONAVIT, however, and this in turn has implications for the fiscal costs of reform: if required contributions to INFONAVIT have low returns, the government's guarantee of minimum levels of pension income may be called. Little progress was made on preparing the way for reform of the public pension system (studies were carried out, but not made publicly available). On complementary financial sector reforms, progress has been mixed: in the banking sector, significant reforms have been undertaken, while in other areas that involve developing new financial instruments, products, and services, such as annuities, life insurance, mutual funds, and mortgages, there has been much less progress. Pension fund managers were limited in their investment options, which in turn reduced their ability to optimize the risk-return portfolios of investments. CSDP II is considered to have a marginally satisfactory outcome, with modest institutional development, for reasons explained above. Because of the failure to reform INFONAVIT and the lack of progress on some important complementary financial sector reforms, overall sustainability of the pension reform program is considered uncertain and this applies to both CSDP I and CSDP II. Bank performance under CSDP II is considered satisfactory.

Lessons include the usefulness of a series of single tranche adjustment operations, which can be used to tailor the pace of supporting reforms to the ability of the country to undertake them and to adjust the reform measures to address constraints as they emerge, rather than trying to predict what will become the most binding constraints. Second, an important objective of pension reform should be to expand coverage, particularly to government workers and to workers in the informal sector and this requires specific efforts for each group. Third, pension reform in particular is a complex process and requires complementary financial sector reforms if it is to be fully successful. Finally, Mexico, like many countries, is subject to a substantial country risk premium, which results in high real interest rates on domestic debt. Pension fund managers are likely to concentrate their investments in government bonds, which limits their experience with portfolio management and results in a more roundabout and probably expensive way of financing the government's debt.



Robert Picciotto

Contents

Preface	i
Ratings and Responsibilities	ii
1. Introduction/Background	1
2. Objectives	1
3. Design	3
4. Implementation	5
5. Outcomes	7
6. Institutional Development	13
7. Sustainability	14
8. Bank Performance	15
9. Borrower Performance	15
10. Findings and Lessons	16
 Annexes	
Annex 1: Basic Data Sheet	18
Annex 2: Comments Received from the Region	23
Annex 3: Comments Received from the Borrower	25

Laurie Effron (OEDCR) was the Task Manager for this report, which was substantially researched and written by Robert Vogel, consultant. Roziah Baba provided administrative assistance.

Preface

This is a Performance Audit Report (PAR) on the Contractual Savings Development Program I and II (Loans 4123 and 4343), each in the amount of US\$400 million. CSDP I was approved on December 17, 1996 and closed on December 31, 1997. CSDP II was approved on June 11, 1998 and closed on June 30, 1999.

The PAR is based on the Implementation Completion Reports (ICRs) on the two projects prepared by the LAC Regional Office and issued in May 1998 and December 1999, the President's Reports, the legal documents, project files, related economic and sector work, discussions with Bank staff, Government and Central Bank documents, and background papers.

An OED mission visited Mexico to discuss project performance with Government officials, members of the banking and business communities, University economists, and World Bank Department staff. Their generous cooperation and assistance in the preparation of this report is gratefully acknowledged.

The draft PAR was sent to the Government and the co-financier for comment; the comments received are reflected in the document where appropriate and attached in the original in Annex 3 to the report. In addition, comments received from the Region are attached as Annex 2.

RATINGS AND RESPONSIBILITIES

	CSDP I		CSDP II*	
	ES	Audit	ICR**	Audit
Outcome	HS	HS	S	MS
Institutional Development	Substantial	Modest	Partial	Modest
Sustainability	Likely	Uncertain	Uncertain	Uncertain
Bank Performance	HS	HS	HS	S
Borrower performance	HS	HS	HS	S

* The Region and the Government have commented on these ratings; see Annexes 2 and 3, respectively.

** ES not available at time of PAR

Key Staff Responsible

Contractual Savings Development Program (CSDP-I) (Ln 4123-ME)			
	Task Manager	Division Chief/ Sector Manager	Department/Country Director
Appraisal Completion	Gloria Grandolini	Sri-Ram Aiyer	Olivier Lafourcade
	Gloria Grandolini	Sri-Ram Aiyer	Olivier Lafourcade
Contractual Savings Development Program (CSDP-II) (Ln 4343-ME)			
	Task manager	Division Chief/ Sector Manager	Department/Country Director
Appraisal Completion	Gloria Grandolini	Krishna Challa	Olivier Lafourcade
	P.S. Srinivas	Danny M. Leipziger	Olivier Lafourcade

1. Introduction/Background

1.1 Pension reform was initiated in Mexico in the mid-1990s at a time of crisis in the Mexican economy in general and in the financial sector in particular. The dramatic fall in the exchange rate that began in December 1994 led to major losses for those with dollar liabilities unhedged by dollar assets and to much higher interest rates on peso instruments, in nominal and in real terms. This, in turn, impacted the solvency of banks, not only directly but also indirectly through the impact on the ability to pay of important borrowers. Moreover, these problems revealed severe structural weaknesses in the banking system, and throughout the financial sector, and serious shortcomings in the capacity of the existing regulatory regime. At the end of 1995, either in spite of these major difficulties or because the crisis provided the economic necessity and the political possibility, the Mexican Government, supported by the Bank, initiated thorough-going pension reform.

1.2 Even though pension reform might have strained the technical capacity of the Mexican Government, and even of the Bank given the need for specialized pension skills together with some knowledge of the Mexican financial sector, a decision was made to move forward as quickly as possible. Demographics of the Mexican population and its participation in the formal and informal labor markets provided an opportunity for pension reform in the short run that was not offset by the potential impact of reform on a fiscal deficit already strained by dealing with the banking crisis. Pension reform also offered an opportunity for the Bank to collaborate with the IMF and the IDB (Inter-American Development Bank) on a major reform program that could substantially enhance the external financing available to Mexico in the very short run to deal with the financial crisis. Moreover, the earlier unsuccessful pension reform program initiated in 1992 provided useful lessons on how to do things better.

2. Objectives

2.1 The Mexican Government has given high priority to pension reform as a continuing activity during the 1990s and beyond, with the two projects under review here, CSDP-I and II, supporting the first major steps in the process. Pension reform has also been closely related to other high priority objectives of the Mexican Government in overall financial sector reform, and this relationship is two way in that successful pension reform can greatly enhance the overall performance of the financial sector, while the objectives of pension reform will be difficult to achieve without success in complementary financial sector reforms. Taken together, these reforms were seen as measures that could increase domestic savings, promote private sector development, especially in the modernization of social services, and, more narrowly, develop second-tier mortgage lending institutions and a market for mortgaged-backed securities. Coming

at a time of financial turmoil in Mexico, these loans, especially CSDP-I, also complemented other quick disbursing loans in support of the financial sector.¹

2.2 The overall objectives of pension reform, to be supported by a series of Bank operations including CSDP-I and II, were to: (1) increase the equity, efficiency and sustainability of the old age security system and gradually expand effective coverage; (2) establish a financially viable pension system; (3) limit the fiscal impact of the current pension system and ensure transparency of the fiscal costs of transition; (4) enhance the development of capital markets by stimulating greater private financial intermediation and increase the array of financial instruments and contracts available; and (5) raise the level of institutional savings and improve the allocative efficiency of domestic savings.

2.3 The specific objectives to be accomplished under CSDP-I, approved at the end of 1996, were:

- (1) introduction of the legal and regulatory framework needed to establish the new pension system and to regulate and supervise private pension fund administrators;
- (2) design and issuance of an investment management regime;
- (3) assessment of the fiscal costs of the transition;
- (4) initiation of improvements in the performance of the Instituto del Fondo Nacional de la Vivienda de los Trabajadores (INFONAVIT);
- (5) individualization of accounts and strengthening the capacity of the Instituto Mexicano del Seguro Social (IMSS) to manage the new pension system; and
- (6) encouragement of public confidence in the new system through education and promotion.

2.4 The specific objectives to be accomplished under CSDP-II, approved in mid 1998, were:

- (1) implementing, consolidating and fine-tuning the reformed pension system for private sector workers;
- (2) updating estimates of the fiscal costs of transition;
- (3) deepening reforms to INFONAVIT to ensure adequate returns on the housing sub-account;
- (4) advancing in the technical preparatory work for the reform of the public pension systems;
- (5) sustaining public confidence through education and information; and
- (6) advancing in the implementation of complementary financial market initiatives, specifically in the banking sector, mutual funds, occupational and voluntary pension plans, and development of new instruments.

2.5 The first objective was further sub-divided into:

¹ These loans, especially CSDP-I, not only had synergies with other Bank loans but also with the activities of IFC, IMF, and the IDB (IDB cofinanced CSDP-I).

- (1) ensuring a flexible and responsive regulatory framework;
- (2) initiating operation of the reformed system and increasing its efficiency;
- (3) transferring SAR92 balances (the result of the earlier attempt at pension reform) from the Central Bank to individual Administradora de Fondos para el Retiro (AFORE) accounts;
- (4) fine-tuning investment policies and improving risk management;
- (5) strengthening supervision and enforcement; and
- (6) initiating payment of disability and survivors benefits by private insurers.

2.6 As noted above, complementary activities in the financial sector are important for the success of pension reform, specifically: (1) continued restructuring of commercial banks; (2) modernization of regulatory and supervisory structures for mutual funds and voluntary pension plans; (3) deepening of the insurance market for the provision of life and disability coverage and annuities; and (4) development of long-term instruments and financial services (including government debt, corporate debt, and housing mortgages) together with infrastructure such as rating agencies and custodial services. It is interesting to note that insurance reform is mentioned under CSDP-I, but not under CSDP-II, while longer term instruments are mentioned under CSDP-II, but not CSDP-I. The lack of immediate progress in the area of insurance and annuities may be the reason that it was later excluded² while the addition of longer term instruments may have come from a realization that their absence was a problem for providing appropriate investment vehicles for pension funds.

2.7 The objective of pension reform has become an increasingly important element in overall financial sector reform. Both CSDP-I and II contain lists of specific, detailed objectives, and these have proven essential for the overall success of pension reform. Moreover, as indicated by the inclusion of a wide and changing array of important complementary activities, successful pension reform requires numerous supporting reforms in the overall financial sector, many of which are not yet in place. Recognition of the importance of attention to detail and of new barriers that are encountered elsewhere in the financial sector as pension reform proceeds may be among the most important lessons from the Bank's experience with pension reform in Mexico. There is no question of the relevance of CSDP-I and II, not only for pension reform itself but also for the overall development of the Mexican financial sector.

3. Design

3.1 CSDP-I and II were both designed as single tranche operations, with all conditions to be met prior to loan signing. This was at the time a relatively new type of operation for the Bank, so that the experience with these operations may provide particularly useful lessons for the Bank. Documentation and discussions with Bank staff showed strong support for this type of operation. In this case, the single tranche operations increased the leverage for the Bank, especially important for policy-based

² CONSAR has commented that growth has been strong in the insurance industry and that there are now 14 specialized insurance companies with over 61,800 accounts, with a value of over 21.9 billion pesos (about US\$2.3 billion).

loans, and helped to avoid a situation where subsequent tranches of a multi-tranche loan came due and compliance with conditions was mixed. Another advantage is that, by definition, single tranche loans are quick disbursing — an important consideration for CSDP-I in particular when external financing was a critical component in resolving Mexico's financial crisis. A third advantage of single tranche operations is that they can be more readily adapted to address emerging constraints: various aspects of pension reform that were not covered in adequate detail under CSDP-I required more detailed "fine-tuning" under CSDP-II, and the sequential single tranche operations provided an excellent design framework to introduce such refinements. Nevertheless, maintaining momentum for reform over the longer term (and sometimes maintaining compliance with conditions) may require more than one single tranche operation, as has been the case with pension reform in Mexico. In addition, there is a temptation to include conditions that are easiest to agree on in the first operation, rather than those that are essential for ultimate success, just as the easiest conditions are often included in the initial tranche of a multi-tranche operation.³

3.2 The most important design issue here is thus priorities — whether the most important or just the easiest steps were taken with CSDP-I relative to II. In general terms, the answer appears to be positive: CSDP-I addressed basic issues of the legal and regulatory framework, the investment management regime, administration of accounts, the major problem of reforming INFONAVIT, development of public support for the reforms and, of course, the fiscal costs of transition, while the main role of CSDP II was, logically, to deepen these initial reforms. Nevertheless, INFONAVIT has continued to be a major problem, pension reform for public sector workers did not become a specific objective until CSDP-II, despite its major implications for the fiscal costs of transition, and expanding pension coverage to workers outside the formal system was not a specific objective of either CSDP-I or II, even though expansion of coverage is part of the first overall objective of the Mexican pension reform program.

3.3 Another design element that might be considered potentially weak is the government's guarantee of minimum levels of pension income both for workers formerly under the old system and for new workers. The cost to the government of this guarantee is presently unknown, so that the fiscal costs of transition and of the new pension system cannot be calculated.⁴ Moreover, as discussed in detail later in this report, there are substantial risks that certain costs could be very high — due to the performance of INFONAVIT, in particular. Nonetheless, including such a government guarantee in pension reform design is both appropriate and transparent: no matter what the performance of the new defined contribution pension systems, the Mexican Government would not be able to escape from the political requirement to provide minimum levels of pension income. The risk that needs to be dealt with is the performance of INFONAVIT.

³ As suggested above, a crisis situation may provide the political opportunity (in addition to the economic necessity) for major fundamental reforms that may be lost once the crisis has passed.

⁴ CONSAR has commented that SHCP does have a model which they use to calculate such costs.

4. Implementation

4.1 “Implementation” was in essence accomplished prior to the effectiveness of CSDP-I and II in that all conditions had already been met for the disbursement of each of the two single tranche loans, some prior to Board presentation and others prior to loan effectiveness. The required laws were passed, the circulars were issued to implement these laws along with other required regulations, and other actions were taken by the government agencies involved.⁵ Nevertheless, not all conditions continued to be adhered to fully, and this might have been dealt with by systematic monitoring of continuing adherence to loan conditions, although the development of the second operation undoubtedly provided important informal monitoring. This underlines the importance of using single tranche loans in a series, whereby the development of subsequent operations can serve to monitor and to provide incentives to continue to adhere to existing conditionalities.

4.2 The reform of INFONAVIT provides an example of the kind of implementation problems that can arise in a single tranche operation: the conditions designed to improve INFONAVIT’s performance were not effectively enforced, and the failure to deal with the INFONAVIT problems now endangers the overall success of pension reform because of the major impact that INFONAVIT’s investment returns can have on retirement incomes of contributors.⁶ Specifically, CSDP-I had two conditions that apply to INFONAVIT: (1) the Commission Nacional Bancaria y de Valores (CNBV) will supervise INFONAVIT as it does other financial institutions; and (2) the Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR) was to publish at least twice a year the performance of INFONAVIT.⁷ Neither of these conditions was implemented. As CNBV was in the midst of the banking crisis, it had inadequate resources to deal seriously with INFONAVIT. More important, as CNBV has pointed out (see Annex 3 for CNBV’s comments on this), its powers are limited by law to approving INFONAVIT’s accounting system and internal audit function and reporting irregularities to the SHCP. As to the publication of INFONAVIT’s investment performance, the experience surrounding KPMG’s audit of INFONAVIT and the results of conditions placed on INFONAVIT under CSDP-II (see below) suggest that figures produced by INFONAVIT about its performance are meaningless.⁸

5 Loan 4123-ME (CSDP-I) was approved on December 17, 1996, and made effective on August 18, 1997, after an extension of the original closing date of June 30, 1997. Loan 4343-ME (CSDP-II) was approved on June 11, 1998, and made effective on December 14, 1998, with no extension required.

6 As the ensuing discussion of INFONAVIT will suggest, subsequent problems can be attributed to design as well as to implementation, but it seems easier to understand the various shortcomings if the discussion of INFONAVIT is concentrated in a single place.

7 These modest conditions were based on the Bank’s view that fundamental changes in the law governing INFONAVIT, (such as the law requiring that a large proportion of workers’ pension contributions, 30-40% according to Bank estimates, go to INFONAVIT) were not politically possible at the time. However, in 1997, changes were made in the INFONAVIT law with respect to cofinancing arrangements for mortgages.

8 CONSAR has commented that it considers that the condition has been met: workers receive financial statements of INFONAVIT on a regular basis. See Annex 3.

4.3 Improvements in the performance of INFONAVIT under CSDP-I were predicated on the assumption that greater transparency would create pressures for improvements in performance (i.e., contributors would demand higher returns). Transparency is undoubtedly a key element in improving the performance of financial institutions, including those in the public sector, but transparency alone may not be enough. Even if contributors became keenly aware of INFONAVIT's poor performance, they have a government guarantee of a minimum level of pension income regardless of investment performance, so they would be unlikely to be greatly alarmed. Even if they were to become seriously alarmed at INFONAVIT's low returns, they do not have an option of investing that portion of their pension contributions elsewhere. Rather than taking individual independent actions to resolve this problem, these contributors would have to be sufficiently dissatisfied with INFONAVIT's performance to take action in the political arena in order to change the law governing the operation of INFONAVIT. Thus the notion that transparency alone would provide all the incentives necessary to improve INFONAVIT's performance is flawed on several counts.

4.4 The specific conditions on INFONAVIT under CSDP-II were based primarily on a "Convenio" approved by INFONAVIT's Board early in 1998 that included acceptance of various new accounting standards (e.g., for mortgage loans, for accruing and provisioning of interest, and for provisioning of non-performing loans), more appropriate external financial controls, limits on loan amounts, and a review of rules for granting loans.⁹ As the number and detail of the conditions in CSDP-II (and less transparently in the Convenio) suggest, INFONAVIT reform required major changes in all aspects of INFONAVIT's lending. The detailed conditionality suggests that the Bank approached the issue as a technical one, but the reasons given in Bank documents for not pressing more aggressively to treat the INFONAVIT problem under CSDP-I were basically political (e.g., the impossibility of changing the law). The Bank was aware of the difficulty of trying to use a technical approach to reforming INFONAVIT, because KPMG had attempted an audit of INFONAVIT as CSDP-I was coming to an end and CSDP II was being prepared: the audit could not be carried out, either because INFONAVIT could not or would not provide the necessary information, but the Bank thought that it might have greater success. In any case, key conditions that appeared to be met at the time of loan effectiveness were later reversed or complied with in ways that avoided the intent of the conditions. The basic reason given in Bank documents for this reversal was that INFONAVIT's Board, dominated by labor unions and the construction industry, vetoed whatever changes would have effectively curtailed their benefits.¹⁰

9 It was agreed not to make public the exact terms of the Convenio secret for a considerable period of time because of their "political sensitivity". SHCP notes, however, that the document was shown to Bank staff and the drafting of the Convenio was carefully examined during the discussions of the conditions of the Loan. After approval by the commission and general assembly of INFONAVIT, the document became practically public (see Annex 3).

10 INFONAVIT's Board is dominated by groups that have direct interests in the allocation of INFONAVIT's investments and also have direct links to the political party that dominated the Mexican Government. The strength of political opposition to reforming INFONAVIT may not even have been fully appreciated by high-level government officials, as one leader of the pension reform process transferred from SHCP to a high-level position within INFONAVIT to help implement reforms, but soon transferred

4.5 To understand the “rules of the game” for institutions such as INFONAVIT, it is not necessary to know anything in detail about the Mexican political system or even about INFONAVIT itself. Similar institutions exist in many other countries. It is clear from other experiences that the attractiveness, and hence durability, of institutions like INFONAVIT is not that they offer a transparent monetary return to contributors, but that contributions function as lottery tickets for subsidized housing loans that eventually may not even need to be repaid. Even if the lottery is believed to be an unfair one, it provides some chance of reward for paying what most contributors probably see as just another tax. Indeed, in most other countries, a substantial share of INFONAVIT-type loans are not for low-income worker housing, as politically advertised, but rather for larger loans to well-connected individuals such as military officers, congressmen, party officials, etc. and their friends and relatives. The limited information available about the allocation and loan size of INFONAVIT’s portfolio is consistent with experience elsewhere, and changing this has correctly been the focus of much the Bank’s conditionality directed toward INFONAVIT’s reform.

4.6 The link between housing finance and pension funds can be seen, in a sense, as logical in that these represent, respectively, the largest users and suppliers of long term finance in most countries. However, problems tend to arise when this supply and demand are negotiated within a single institution without the intervention of an “arms-length” market relationship. Whether Bank interventions can solve such problems is unclear, either in general or in the case of INFONAVIT, but what is clear is that the solution probably lies in the liquidation of such institutions, or at least in cutting off their assured supply of funding. The latter was initially considered among the first steps in Mexico’s pension reform process, but was deemed at the time difficult politically. In any case, INFONAVIT’s reform is clearly not a technical issue, but a political one that will require commitment at the very highest levels of the Mexican Government.

5. Outcomes

5.1 To assess the outcomes of CSDP-I and II, it is first necessary to evaluate the extent to which the six specific objectives of each loan have been achieved. Then, the extent to which these achievements have contributed to achieving the longer-term, overall objectives of pension reform is evaluated, which also involves consideration of the achievement of certain complementary reforms in the financial sector and their importance for the success of pension reform. As a summary to this section, the discussion is put in terms of the issues of relevance and efficacy.

5.2 The clearest accomplishment of the pension reform program, especially CSDP-I, has been the development of the legal and regulatory framework (Objective (1) under CSDP-I) and the ability of CONSAR to carry out its regulatory and supervisory functions (objective (5) under CSDP-II). Most of the major conditions of CSDP-I involved passing

back to SHCP without accomplishing any substantial reforms. SHCP has pointed out, however, that they continued to push hard for reforms, well beyond loan closing, and these efforts have resulted in agreement by the Board of INFONAVIT to changes in credit practices (although the changes have not yet been implemented). SHCP therefore thinks that the process of reform of INFONAVIT continues (see Annex 3).

laws and instituting the associated regulatory and supervisory rules, and this was all accomplished before signing and release of that loan's single tranche. While these rules appear to be appropriate in strictly limiting the concentration of investments by the Sociedades de Inversion Especializadas de Fondos para el Retiro (SIEFOREs, specialized retirement funds), especially in securities of "related parties" (although the exact percentages may need to be adjusted), specific limitations on investments in private Mexican debt and the exclusion of foreign investments and equity investments may be more problematic. Although the rating systems for private securities are not yet adequately developed in Mexico, limiting investments in these securities does not provide incentives to encourage the development of such rating systems.¹¹ Moreover, specific percentage limits on investments in private debt in general and bank debt in particular, once taken, may be difficult to reverse.¹² The exclusion of foreign investments is probably based on political concerns, not economic considerations. On the other hand, the ability of CONSAR to impose fines on the AFOREs (pension fund administrators), including the largest ones, suggests that the regulatory and supervisory regime exists in fact and not just in name.

5.3 CSDP-I and II were successful in: design and issuance of an investment management regime (objective 2 under CSDP-I), initiating operation of the reformed system and increasing its efficiency, fine-tuning investment policies, and improving risk management (objectives 2 and 4 under CSDP-II). Initially, 17 pension fund administrators, AFOREs, were authorized and began operations, and these have now merged down to 14 with no apparent problems. Further consolidation is anticipated, and limits on the maximum market share of any single AFORE are being increased. At this point, overall fees are low compared to other Latin American countries, and differing fee structures among AFOREs also suggest competition, but the larger size of the Mexican system and limitations on switching to once per year to control costs, especially marketing costs, seem to be the main reasons for the apparently greater efficiency. At the same time, affiliation with AFOREs under the new system has progressed to the point that over 90% of workers from the old system are now affiliated. Nonetheless, it will be important to continue to monitor interactions among consolidation, competition and efficiency, and especially the resulting impact on fees.

5.4 Issues of investment policies and risk management were complicated under both CSDP-I and II. When CSDP-I was prepared, the Mexican banking system was suffering severe problems, so that a major aspect of the regulation of AFORE investments was to limit purchases of financial instruments issued by banks. Moreover, the potential problems were greater because most of the AFOREs were owned partly or totally by

11 Under CSDP-II, regulatory adjustments have focused primarily on more and better information to enhance transparency of the pension fund administrators and the funds themselves, rather than transparency of the instruments in which they might invest.

12 As discussed later, they are also not the most efficient way to optimize risk-return trade-offs of investment portfolios. CONSAR has noted that restrictions on investments were initially established to allow time for the development of the system. However, this year the first changes to the investment regime have already been made, within a gradual strategy that permits flexibility while achieving higher yields. (Annex 3).

banks, international as well as Mexican. Thus, there was clear potential for insider abuse, especially since Mexican banks with solvency and/or liquidity problems could find it tempting to finance themselves with the funds flowing to their AFORE affiliates. Aware of these risks, the Bank encouraged the Mexican authorities to limit such investments, and the result was that only 10 percent of the assets of a SIEFORE (pension fund) can be in bank instruments and only 5 percent in an affiliate. In addition, the assets of a SIEFORE are limited to 35 percent in private debt instruments in total and 15 percent in the debt of members of the same group. There are also limits placed on percentages that a SIEFORE can hold of a single issuer and a single issue, but the most important other restrictions are that SIEFORES can hold no equities or foreign instruments of any kind.

5.5 Presumably, the reason for these restrictions is to limit risk, but, as modern portfolio theory shows, portfolio risk is not directly a function of the riskiness of any individual security but rather of the portfolio as a whole. Thus, there are better ways to limit portfolio risk. However, the main factor presently limiting investments by Mexico's AFORES is related to high real rates of interest in Mexico, even for Mexican dollars instruments. This is due to country risk, which in turn comes from continuing problems (in spite of recent reforms: see below, para. 5.12) in the banking system. Mexican Government debt instrument are highly attractive, especially those denominated in dollars or indexed to inflation or to the exchange rate. Moreover, high quality private sector borrowers can borrow more cheaply in the U.S., especially exporters with direct access to foreign exchange and so are unlikely to issue high interest debt instruments on the domestic market.

5.6 The AFORES invest therefore almost exclusively in Mexican Government debt instruments, so that pension reform has led at least in the short run, to a more roundabout (and likely more expensive) way to finance the fiscal deficit. Lifting the restrictions against investments in foreign securities and equities, as well as liberalizing other limits, will be a necessary but not sufficient condition for dealing with investment policies and risk management. Although recent reforms in the banking system have helped to reduce country risk, it will also be necessary to give AFORES time to acquire the expertise to manage a wider array of investment alternatives efficiently. As of now, SIEFORES can earn high rates of return with little apparent risk and thereby allow AFORE managers to indulge in the kind of "herd behavior" that is often attractive for fund managers.

5.7 Two other objectives were also met: individualization of accounts and strengthening the capacity of social security institute (IMSS) to manage the new pension system (objective 5 under CSDP-I), and transferring SAR92 balances (the result of an earlier attempt at pension reform) from the Central Bank to individual AFORE accounts (objective 3 under CSDP-II). IMSS appointed a private operator, PROCESAR, to handle all processing of account information, and this has been highly successful; more than 95% of worker contributions have been reconciled with their individual accounts. Such reconciliations presented serious problems for the 1992 attempt at pension reform, as indicated by the fact that transferring SAR92 balances to individual AFORE accounts has remained a specific objective under CSDP-II and is not yet fully accomplished, though good efforts and good progress are being made. In addition, the fully automated system now provides the status of all accounts to CONSAR on a daily basis and thus allows

CONSAR to carry out its supervisory functions quickly and efficiently. A major lesson of the Mexican experience has in fact been the crucial importance of such “mundane” infrastructure for successful pension reform.

5.8 The objectives of assessing the fiscal costs of the transition (under CSDP-I), and updating the estimates (under CSDP-II) have been partially met: the fiscal costs of transition have been analyzed through a complex actuarial model that includes a large number of demographic and economic projections.¹³ Based on most likely scenarios, the fiscal costs have been estimated at about 1 percent of GDP each year over the next fifty years, and estimated costs actually decreased slightly from CSDP-I estimates to CSDP-II. The elements of fiscal costs most directly relevant to the reform program are the returns earned by the SIEFOREs and by INFONAVIT because, if such earnings are inadequate, the government will have to honor its guarantee of minimum pension levels. To this point, SIEFORE performance has not presented a potential problem, but, as emphasized throughout this report, lack of progress in INFONAVIT reforms presents a major threat.

5.9 As noted above, the objectives of improving the performance of INFONAVIT (under CSDP-I), and deepening reforms to INFONAVIT to ensure adequate returns on the housing sub-account (under CSDP-II) have been the least successful aspects. Failure to implement INFONAVIT reforms, with resulting low returns on required contributions to INFONAVIT, can have dire consequences for the fiscal costs of pension reform and, in fact, for the overall success of the reform program.

5.10 Encouragement of public confidence in the new system through education and promotion, an objective under CSDP-I, and sustaining public confidence through education and information, under CSDP-II, have been mixed: CONSAR has been in charge of education and promotion, and has apparently done an excellent job in design of materials, but dissemination has been limited by the high cost of television advertising in Mexico. CONSAR has focused on dissemination through larger employers, job centers, and a phone-in service. The results can only be judged over the longer term by the extent of movement of workers from the very large Mexican informal sector where they do not participate in the reformed pension system to the formal one. By all accounts, it will be a formidable task to convince these workers through information, education, and promotion that the benefits to be received will outweigh the contributions (taxes) to be paid.¹⁴

5.11 Advancing in the technical preparatory work for the reform of the public pension systems was an objective under CSDP-II. To this point progress has been marginal at best for two reasons: (1) studies, which have not been made publicly available, have indicated that various public pension systems are in serious deficit actuarially, those for

13 The actuarial model might have been used to carry out sensitivity analysis on variations in different parameters to identify which ones had the greatest potential impact on fiscal costs and, subsequently, to monitor these parameters with particular care. Instead, however, focus has been on estimates of fiscal costs using best case, worst case and most likely case scenarios, which is not as useful for monitoring.

14 AFOREs have not targeted informal workers in their promotional activities. At the same time, CONSAR has been praised for monitoring advertising by AFOREs to insure its integrity, and as it has resulted in most of the fines levied on AFOREs, it indicates CONSAR's enforcement capabilities.

state government employees in particular, and the Mexican Government does not appear ready to increase its fiscal debt by assuming these liabilities, as would likely be part of any serious reform package; and (2) most public sector employees likely believe that they have benefit packages that are more attractive, relative to the contributions made, than those being offered to private sector workers under the reform (notwithstanding the educational efforts described above). Including public sector workers in the initial reform package might have served to make it more broadly based, although the Bank thought it was more practical to involve public sector workers at a later stage.¹⁵

5.12 Initiating payment of disability and survivors benefits by private insurers and making progress on complementary financial market initiatives, specifically in the banking sector, mutual funds, occupational and voluntary pension plans, and development of new instruments, were CSDP-II objectives. Significant reforms have been undertaken recently in the banking sector. These include interventions in two of the six largest banks; the partial sale of a large domestic bank to a foreign bank; the introduction of more stringent capital requirements, stricter prudential regulations, new accounting standards and increased transparency; the establishment of new deposit insurance institute and the phased introduction of unlimited deposit insurance. In addition, new laws on secured lending and bankruptcy are expected to have some impact on the capital market and thus indirectly on the scope for AFOREs investments. In other areas, however, there has been little or no progress. Although the banking reforms have been significant and have resulted in an upgrading of the rating on country risk, realizing the full benefits of pension reform awaits significant progress in these other complementary areas. On one hand, workers will be unable to manage their retirements and related insurable risks efficiently if the complementary pension and insurance products listed above are not attractively provided by the private sector. On the other hand, the private system of AFOREs and SIEFOREs will be unable to offer the most efficient combinations of risk and return for pension contributors so long as the range of instruments available remains limited.

5.13 It is too soon to evaluate whether the basic objectives of the Mexican pension reform program have been fully accomplished, but this is not surprising given the limited amount of time since the initiation of reform under CSDP-I and II. The expected **increases in the equity and efficiency of the old age security system** are difficult to measure, and no specific monitoring indicators have been proposed. The **expansion of effective coverage** has occurred, but been limited to the conversion of about 90% of private sector workers under the old system to the new system; public sector workers and workers from the informal sector have not yet been incorporated. Whether **a financially viable pension system has been established** will not be known until enough time has passed for the performance of the AFOREs and SIEFOREs to be evaluated, while the performance of INFONAVIT has clearly contributed nothing to its financial viability. The extent of success in **limiting the fiscal impact of the current pension system and ensuring transparency of the fiscal costs of transition** will likewise not be known until

15 Government worker pension programs include the very large Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (ISSSTE), as well as important groups like military personnel and Petroleos Mexicanos (PEMEX) workers, other parastatals, and state government workers.

the reform of INFONAVIT and the returns earned by the SIEFOREs can be evaluated, so that the costs to the Mexican Government of providing guaranteed levels of retirement income will also continue to be unknown for some time. Any significant contribution of pension reform to **developing capital markets by stimulating greater private financial intermediation and increasing the array of financial instruments and contracts available** cannot be achieved until the AFORE-SIEFORE system is given greater latitude to invest in private sector securities. Likewise, **improving the allocative efficiency of domestic savings** awaits greater flexibility in CONSAR's rules about investing in private securities, while **raising the level of institutional savings** awaits the incorporation of new workers into the system.

5.14 In summary, the relevance of pension reform, and of the role of CSDP-I and II in that process, was clearly high. Reforming financial markets and increasing the role of the private sector have been priorities of the Government, and the advent of the crisis in 1994 gave urgency and impetus to the rehabilitation of Mexico's financial sector. While pensions and pension reform are both by nature long-term undertakings, the crisis provided an opportunity to move ahead quickly. In addition, promoting savings and mobilizing them in a long-term form are high on the list of specific financial reform objectives in Mexico and are also at the heart of pension reform.

5.15 The efficacy of CSDP-I and II has been mixed. While considerable progress has been made in accomplishing many specific objectives, there have also been some failures, especially in the reform of INFONAVIT and in some of the complementary developments in financial markets that are necessary to allow more latitude for the investment of pension contributions. At this point it is also unclear how much progress has been made with respect to more basic, longer-term objectives of pension reform. Nevertheless, CSDP-I made considerable progress on the regulatory and supervisory aspects of pension reform and was highly successful in its support for the technical management of the new pension system; its outcome is rated as highly satisfactory. Under CSDP-II, progress continued on the regulatory and supervisory aspects, but the operation tackled more difficult reforms and made less progress: little progress was made in reforming INFONAVIT, the public pension system, or in complementary financial sector reforms other than recent ones in the banking system and capital market. The overall outcome of CSDP II is therefore considered marginally satisfactory.

5.16 Both the Region and the Borrower think that this PAR gives too much weight to the reforms relating to INFONAVIT. The Borrower also has commented that the audit gives too little weight to the establishment of the new pension system, deepening and consolidation of regulations and supervision of the new administration of private pension funds, and measures taken to disseminate information to workers on the new scheme for retirement savings. The Government also highlighted the complexity of the reforms relating to INFONAVIT, which will continue to take time. Finally, the Government pointed out that it has continued to strengthen the pension system even after the Bank's loans closed (see Annex 2 for the Region's comments and Annex 3 for the Government's comments on this rating).

6. Institutional Development

6.1 Institutional development has, with one important exception (discussed in 6.4), been a strong point of both CSDP-I and II. CONSAR, the main counterpart agency, has developed a highly effective capacity to design, refine and implement the required regulatory and supervisory infrastructure for the new pension system. It has also been a key participant in the development of the information system that allows the new pension system to operate and CONSAR to verify the assignment by each AFORE of contributions to the correct individual accounts and to monitor publicity disseminated by the AFOREs. In addition, CONSAR appears to have the power in reality, and not just in theory, to require the AFOREs to make corrections as needed and to impose significant fines on even the largest and most important ones when they are not in compliance. The only cloud on the horizon has been CONSAR's loss of some key high-level staff because of its inability to pay competitive salaries and the fact that the exciting and challenging phase of pension reform start up is now past.

6.2 Developing the institutions to implement the more mundane aspects of pension reform has also been impressive, especially when compared to the problematic experience with SAR92 reform effort, the aftereffects of which are still not fully resolved. Specifically, IMSS has assigned to PROCESAR, a private entity, the function of processing all pension account information, and PROCESAR has been able to reconcile contributions with individual accounts in close to 100% of cases (in 1998 it was 98.6%; in 99, 98.8%; and in 00, it is 99.9% of cases). PROCESAR has also been able to provide this information to CONSAR on a daily basis, which has been instrumental in CONSAR's speed and efficiency in that aspect of supervision of the AFOREs and SIEFOREs.

6.3 It is too soon to draw definitive conclusions about the institutional development of the AFOREs and their associated SIEFOREs. Measured by their ability to attract contributors, the AFOREs have varied widely, but this is mainly due to their connections with banks and, through banks, to major employers served by these banks, rather than to any significant differences in performance or in the ability to attract new participants to the reformed pension system. There has already been some consolidation in the industry, but it is too soon to tell how many and which ones will finally survive competitive pressures, and what the effect will be on the level and structure of fees. Nonetheless, the overall level of fees compares favorably with other Latin American countries, although this may be due mainly to economies of scale and the substantially larger size of the Mexican system. Current CONSAR rules on investments severely limit the options available to the SIEFOREs so that most funds have gone into Mexican Government securities. Moreover, because of country risk, as noted above, real rates of interest have been high so that performance as measured by returns has been good. However, this does not mean that the AFOREs have developed the ability to manage portfolios efficiently, with high returns for a given level of risk, and it will continue to be difficult to evaluate performance of the SIEFOREs — and a serious constraint to the development of the pension system — so long as country risk remains high and changes are not made in the restrictive rules on investments, especially those prohibiting equities and foreign securities.

6.4 INFONAVIT, which remains a key element in determining whether pension reform will ultimately meet its fiscal goals, has shown no institutional development under CSDP-I and II. Moreover, institutional development of INFONAVIT is unlikely to occur until INFONAVIT ceases to have assured funding through required employee contributions and is thus subject to market forces. Institutional development impact thus ranges from high to negligible depending on the institution being evaluated: overall, the rating of both operations is thus considered to be modest.

7. Sustainability

7.1 Sustainability can be seen narrowly in terms of maintaining what has been achieved under CSDP-I and II or, more broadly, in terms of the overall objectives of the pension reform program. Viewed narrowly, it will depend, most importantly, on containing the fiscal costs of pension reform. This, in turn, depends on three key outcomes that cannot be known at this time: (1) Will the SIEFOREs earn adequate rates of return so that retirees will not choose the government guaranteed retirement option? (2) Will there be an effective reform of INFONAVIT so that its earnings will make an adequate contribution to worker retirement incomes (or alternatively, will participating workers be allowed to opt out of contributing to INFONAVIT)? (3) Are the projections of the actuarial model sufficiently robust so that unexpected variations in life expectancies, economic growth rates, wages rates, labor force participation, etc. do not result in substantial additional fiscal costs?

7.2 The failure of INFONAVIT reforms under CSDP-I and II affects potential sustainability adversely in two ways: directly, as low INFONAVIT returns can invoke the government's guarantee of minimum retirement incomes; and indirectly, because poor performance by INFONAVIT implies that SIEFORE returns must be that much higher for a worker to benefit from the pension offered by the reformed system relative to the government guarantee. This in turn creates incentives for AFOREs to offer SIEFOREs with higher expected returns and hence higher risks. The Government (e.g., CONSAR) could attempt to limit risk-taking by maintaining the rule against an AFORE offering more than one SIEFORE or by maintaining (or tightening) the rules limiting investment options, but such policies reduce the potential efficiency of the reformed pension system. Sustainability is further compromised by country risk because, with the resulting high real interest rates, AFOREs have little pressure to develop serious expertise in portfolio management. If, as hoped, Mexico reduces country risk by dealing effectively with its troubled banking system, among other issues, lower real interest rates will require that SIEFOREs have a wider range of investment options available and are able to make effective use of them. This in turn will require considerable agility on the part of government regulators (e.g., CONSAR) and the AFOREs themselves.

7.3 The sustainability of pension reform taken more broadly requires implementation of complementary reforms. These include restructuring the banking system, on which the Government has recently made notable progress as described above, as well as others on which much less progress has occurred, such as introducing or modernizing complementary financial products and services (e.g., annuities, life and disability

insurance), introducing new instruments or strengthening existing ones (e.g., mutual funds, mortgages, longer-term corporate and government debt), and providing additional infrastructure (e.g., rating agencies, custodial services). Sustainability of the achievements of CSDP-I and II, as well as the broader aspects of pension reform, is thus uncertain.

8. Bank Performance

8.1 Bank staff moved quickly during the development of the pension reform program under CSDP-I to provide Mexican policymakers with a thorough review of other pension reform experiences, especially in Latin America, and to bring together expertise with the wide range of skills necessary to help Mexican officials work through the key issues of pension reform. In addition, significant support for CONSAR was financed under an Financial Sector Technical Assistance Loan (FTAL), and the Bank selected an innovative type of operation (single tranche) to facilitate agreement on a medium-term reform strategy during a politically sensitive period. Consideration of more sensitive issues such as the reform of INFONAVIT and limitations on SIEFORE investments was deferred to the preparation and appraisal of CSDP-II. At the same time, the fact that a series of single tranche operations was contemplated allowed on-going monitoring of adherence to CSDP-I conditions. Bank performance under CSDP-I is therefore considered highly satisfactory.

8.2 Fine-tuning of the pension reform program under CSDP-II, especially in strengthening CONSAR's excellent handling of regulatory aspects and enhancing key elements of pension infrastructure, was again greatly facilitated by the Bank's provision of the expertise necessary to assist Mexican officials in carrying on the reform process. On the other hand, the Bank agreed not to work directly with INFONAVIT on its reform program, but rather to work through high-level Mexican technical staff (mainly at SHCP and CONSAR), and also agreed to a Convenio, the terms of which were not made public for some time (see footnote 9). This approach to INFONAVIT reform was unsuccessful, and the possibility of another CSDP operation was not sufficient incentive for INFONAVIT to adhere to the agreed conditions of tranche release. Could the Bank have done better, or was crucial momentum lost at the time of CSDP-I when the Bank did not use the financial crisis to push harder for essential INFONAVIT reforms? The lack of significant progress in expanding pension coverage or dealing effectively with complementary reforms other than the recent ones in the banking system are further reasons to rate Bank performance as (only) satisfactory under CSDP-II. The Government thinks that the reforms that were agreed to went as far as was politically possible at that time (see Annex 2 for the Region's comments and Annex 3 for Government's comments on this rating).

9. Borrower Performance

9.1 Officials of SHCP worked diligently and effectively to develop the overall pension reform program for Mexico and to assist in designing and implementing the

conditionalities under CSDP-I. Special efforts were made in reviewing pension reform programs in other countries and assuring that Mexican policymakers and others with important roles in shaping public opinion were made fully aware of the benefits of pension reform through workshops and seminars and visits to other countries. In addition, SHCP brought together a multi-disciplinary, inter-institutional team, for which SHCP played the leading role in developing the model that provided estimates of the fiscal costs of the transition and in demonstrating the Government's commitment to the pension reform process. CONSAR, the government agency responsible for the regulatory regime, also played a leading role in assuring effective implementation of much of the infrastructure required for successful pension reform. On a number of counts, Borrower's performance under CSDP-I is rated highly satisfactory.

9.2 Both SHCP and CONSAR continued to be diligent and highly effective in their various technical roles under CSDP-II. Within the constraints embodied in existing law and political conditions, CONSAR also moved to liberalize somewhat the limits governing SIEFORE investments and to fine-tune effectively the overall regulatory regime. Both SHCP and CONSAR were far less successful, however, when their efforts turned to negotiating a reform program for INFONAVIT, including the Convenio and other conditionality.. Even their clear understanding of the technical issues was not sufficient to effect change given the political realities. With the notable exception of the considerable progress in reforms in the banking sector and other legal reforms that will have an impact on the capital markets, they were also unable to move very far in complementary financial sector reforms or in extending coverage of the reformed pension system to government workers or the informal sector. Borrower performance thus slipped from highly satisfactory under CSDP-I to satisfactory under CSDP-II. The Government has commented on this rating that it considers that great efforts were undertaken by its technical team which are being underestimated in this report. (See Annex 2 for the Region's comments and Annex 3 for Government's comments on this rating.)

10. Findings and Lessons

10.1 The main finding is that, with respect to all but a few (important) elements, the Mexican pension reform program has been successful and should consequently be given high marks. However, among those few problematic elements have been the failure to achieve certain critical objectives (i.e., lack of progress in fundamental INFONAVIT reforms and inability to loosen restrictions on SIEFORE investments) which can endanger the whole reform process. Other shortcomings, especially in the inability to expand coverage significantly and to implement some of the important complementary reforms elsewhere in the financial sector, continue to impede realization of many of the benefits of pension reform.

10.2 One lesson of this experience is that single tranche operations can be more effective, efficient, and realistic instruments for providing timely balance of payments support than multi-tranche operations. A series of single tranche operations allows the

reform process to proceed at the pace determined by the client country, rather than by the tight time-frame required for multi-tranche adjustment loans.

10.3 The newness and far-reaching complexity of pension reform made it particularly attractive to use a series of single tranche operations for technical reasons: as pension reform unfolded, important details of certain technical issues that were not originally obvious became clearer over time. The need under CSDP-II for fine-tuning the regulatory infrastructure and for paying more attention to certain complementary developments in the financial sector (e.g., improved provision of annuities and insurance services, development of new financial instruments, expanded infrastructure such as rating agencies and custodial services, etc.) are clear examples of this. However, single tranche operations can also increase the temptation to postpone essential reforms that face political barriers from the first operation to later ones. At the time CSDP-I was undertaken, it was possible to overcome seemingly major political obstacles and initiate the pension reform process in Mexico with a considerable degree of success.¹⁶ By the time of CSDP-II, with the worst of the financial crisis past, the momentum to overcome such political obstacles may have been lost. Nevertheless, on balance, the advantages of single tranche operations outweigh their disadvantages.

10.4 The other lesson on pension reform is its far-reaching complexity and the need for major complementary financial sector reforms in order for the benefits of pension reform to achieve their full potential. As emphasized above, great progress has been made in the Mexican case in the design and implementation of the regulatory regime and in providing crucial infrastructure that allows pension contributions to flow quickly and accurately to the proper individual account and for this information to be immediately available to the regulatory body, CONSAR. As witnessed by the earlier Mexican experience with pension reform under SAR92, failure to provide this seemingly mundane infrastructure can undermine the entire activity and cause on-going problems that can take years to resolve.

10.5 With respect to complementary reforms in the financial sector, the Mexican experience suggests four lessons:

- (1) pension reform benefits will be incomplete unless individuals in the pension system have access to attractive complementary annuity and insurance products;
- (2) the array of instruments available to pension fund managers must be expanded to include those that are long term, but have reasonable liquidity and risk profiles, something not quick and easy to achieve when there was no market for such instruments before pension reform;

¹⁶ It is also important to note that, at the same time the pension reform process was able to move ahead, the operation to resolve the banking crisis met with great difficulties. Thus, even with a multi-tranche operation, the political obstacles to pension reform might not have been overcome.

- (3) the array of risk and return options available to individuals will not be on the efficient frontier unless the regulatory regime focuses on portfolio risk rather than on the risks of individual securities; and
- (4) pension reform benefits will be greatly reduced if the government directs the investment of pension funds to specific institutions or sectors (e.g., INFONAVIT) and/or prohibits investments that are essential for constructing portfolios with optimal risk-return profiles (e.g., prohibition of investments in foreign securities).

10.6 Two final lessons come out of the Mexican experience that may also be generalizable to pension reform elsewhere:

- (1) An important objective of pension reform is to expand coverage, particularly to government workers and workers in the informal sector. It may be more difficult to incorporate government workers later in the process as their benefits may need to be adjusted downward or those of private sector workers upwards to reach equality at a later date (with major fiscal costs that are more difficult to deal with when they come as later “surprises”). In addition, concerted efforts would be required to bring informal sector workers into a pension system, by both the government in carrying out a public awareness campaign of the long-term benefits of pensions, and by private pension providers to actively seek out these workers as clients.
- (2) Mexico and many other developing and transitional countries are subject to substantial country risk premiums. This results in high real interest rates which mean that domestic debt instruments offer more attractive returns than foreign ones. At the same time, many “grade A” borrowers have access to funds in foreign financial markets on attractive terms, and thus are unlikely to issue higher real interest rate instruments in domestic markets. This makes reforms to reduce country risk very important for pension reform. Otherwise, pension fund investment managers are likely, regardless of the regulatory regime, to see government debt instruments as the only logical choice, so that they fail to gain much portfolio management experience. Under such circumstances, moreover, pension reform becomes a more roundabout, and likely expensive, way of financing the government’s debt.

Basic Data Sheet

CONTRACTUAL SAVINGS DEVELOPMENT PROGRAM (CSDP-I) (LOAN 4123-ME)

Key Project Data (amounts in US\$ million)

Item	Appraisal Estimate	Actual	Actual as% of Appraisal
Bank	400.0	400.0	100
IDB	300.0	150.0	50
Cancellation	NA	0	0
Date Physical components completed	NA	NA	NA
Economic Rate of Return	NA	NA	NA

Cumulative Estimated and Actual Disbursements (in US\$ million)

	FY97	FY98
Appraisal Estimate	400.0	400.0
Actual	0	400.0
Actual as % Estimate	0	100

Project Dates

	Planned	Actual
Identification	9/95	10/95
Preparation	10/95-4/96	11/95-4/96
Appraisal	5/96	5/96
Negotiation	10/96	10/96
Letter of Development Policy	11/96	11/96
Board Presentation	12/96	12/96
Signing	2/97	5/97
Effectiveness	2/97	8/97
First Tranche Release	2/97	8/97
Project Completion	6/97	8/97
Loan Closing	6/97	12/97

Staff Inputs (staff weeks)

Stage of Project Cycle	Planned		Actual	
	Weeks	US\$	Weeks	US\$
Preparation of Appraisal	13	63.8	4.6	37.4
Appraisal through Board Approval	11	96.7	16.3	95.2
Supervision	15	49.8	20.9	53.5
Completion	12	18.2	0.4	9.1
Total	40	228.5	42.2	195.2

Mission Data

Stage of Project Cycle	Month/ Year	Number of Persons	Days in Field	Staff Specialities	Performance Rating
Through Appraisal Identification	9/95	10	4	A,b,f,g,h	
	9/95	4	4	A,b,g,h	
	10/95	4	11	A,b,f,g,h	
Preparation	12/95	2	4	F,i	
	12/95	5	5	A,b,d,h	
	4/96	4	3	F,i	
	5/96	3	3	A,b	
Appraisal Through Board Approval	9/96	5		A,b,g,h	
Supervision	Throughout Preparation	Various	Various	A,c	
Completion	9/97	6	5	A,b,c,d,e,f	HS

Staff Speciality:

A: Senior Financial Economist/Task Manager

B: Principal Operation Officer

C: Financial Sector Specialist

D: Housing Finance Specialist

E: Pension Fund Investment Specialist

F: Consultants: Pensions, Insurance and Annuities, Deposit Insurance, Actuarial Analysis,
Financial Regulation

G: Legal Counsel

H: Financial Regulatory Expert

I: Country Economist

Other Project Data**Related Operations**

Loan/Credit Title	Year of Approval	Status
<u>Preceding Operations</u>		
1. Financial Sector Technical Assistance Loan and Supplemental	1995	
2. Financial Loan Sector Restructuring Loan	1995	Closed
<u>Following Operations</u>		
1. Contractual Savings Development Program II	1993	Closed

Basic Data Sheet

CONTRACTUAL SAVINGS DEVELOPMENT PROGRAM (CSDP-II) (LOAN 4343-ME)

Key Project Data (amounts in US\$ million)

Item	Appraisal Estimate	Actual	Actual as% of Appraisal
Bank	400.0	400.0	100
Cancellation	NA	0	0
Date Physical components completed	NA	NA	NA
Economic Rate of Return	NA	NA	NA

Cumulative Estimated and Actual Disbursements (in US\$ million)

	FY99
Appraisal Estimate	400.0
Actual	400.0
Actual as % Estimate	100

Project Dates

	Planned	Actual
Identification	9/97	10/97
Preparation	12/97	10/97-4/98
Appraisal	1/98	5/98
Negotiation	2/98	5/98
Letter of Development Policy	4/98	5/98
Board Presentation	4/98	6/98
Signing	9/98	9/98
Effectiveness	12/98	12/98
First Tranche Release	12/98	12/98
Project Completion		
Loan Closing	6/99	6/99

Staff Inputs (staff weeks)

Stage of Project Cycle	Planned		Actual	
	Weeks	US\$	Weeks	US\$
Preparation of Appraisal	85	228.4	108.7	226.1
Appraisal through Board Approval	21	50.4	6.9	17.0
Supervision	33	85.8	15.2	28.2
Completion	0	0	NA	NA
Total	139	364.6	130.8	271.3

Mission Data

Stage of Project Cycle	Month/ Year	Number of Persons	Days in Field	Staff Specialities	Performance Rating
Through Appraisal Identification	9/97	8	7	A,b,c,d,e,f	
Preparation	12/97	7	7	A,b,c,d,e,f	
	1/98	3	6	A,d,f	
	3/98	6	11	A,b,d,e,f	
Appraisal Through Board Approval	9/96	5	2	A,b,g,h	
Supervision	Throughout Preparation	Various	Various		
Completion	4/99	1	7	c	S

Staff Speciality:

- A: Senior Financial Economist/Task Manager
 B: Principal Operation Officer
 C: Financial Sector Specialist
 D: Housing Finance Specialist
 E: Financial Economist
 F: Consultants: Pensions, Financial Institutions
 G: Capital Markets Specialist

Other Project Data**Related Operations**

Loan/Credit Title	Year of Approval	Status
Related Operations		
1. Financial Sector Technical Assistance Loan	1995	Ongoing
2. Financial Loan Sector Restructuring Loan	1995	Closed
3. Contractual Savings Development Program I	1996	Closed

Regional comments on ratings under CSDP II¹

1. We believe that the ratings for Bank and Borrower performance in CSDP II should be changed to Highly Satisfactory (as in CSDP I). In our view, the rationale provided for changing the ICR's ratings for CSDP II do not take into account some key issues.

2. Starting with **Borrower performance**, it is difficult to conceive of what additionally the Borrower - which is the Government of Mexico (through BANOBRAS) - could have done to make the process more successful. One major reason given in the PAR is the limited reforms to INFONAVIT. As has been recognized and stated clearly in almost all documents relating to the project, INFONAVIT has an institutional structure that makes it extremely difficult for the Government alone to ensure that reforms are implemented. The difficulty of reforming this institution was obvious from the start and we believe that the Government did the best that it could, given the constraints. The only real alternative to limited success with INFONAVIT reforms was not tackling the INFONAVIT issue at all, and that would have been a less preferred course of action. The Borrower, with the Bank's support, succeeded in highlighting and publicizing the problems facing INFONAVIT and the likely adverse impact that it could have on both pension reforms, the broader financial sector, and, potentially, on the government fiscal position. It is important to keep in mind that the very process of highlighting the problems with INFONAVIT and making INFONAVIT reform an important policy issue was a success of the project. As the ICR has explicitly indicated, the fact that implementation was weak is not something that either the Borrower or the Bank is happy with, but this should not be construed as being due to the poor performance of the Borrower. Progress has also been made on the other reasons mentioned in the PAR. Actuarial studies of state level (government worker) pension systems has been initiated and there is an increased level of awareness - both among the public and policy makers - that these pension systems need to be reformed as soon as possible. There has been substantial progress of complementary financial sector reforms - the banking sector crisis of 1994/95 at last seems to have a resolution mechanism in sight with the establishment of IPAB, sale of banks, and opening up of the banking sector to foreign investments. These reforms were supported by the Bank through a separate loan in December 1999. Progress in legislation in important areas such as bankruptcy and secured transactions has been made. Specifically, the legislation creating IPAB was approved in December 1998 and IPAB started operations in May 1999. The bankruptcy and secured transactions legislation was passed in April 2000. Based on all of this, the Borrower performance should be upgraded to Highly Satisfactory.

3. **Bank performance** should also be upgraded for some of the same reasons as mentioned above. The main reason given in the Evaluation summary for the change in rating is "the inclusion in the program design of reforms to INFONAVIT that were easily undermined after tranche release". The alternative facing the Bank was not to tackle the INFONAVIT issue at all - and this would have been a poor choice. In addition, while it is true that the reforms were undermined after tranche release, this was not by design. The CSDP II MOP and the ICR state that the Bank was aware of the risk that the reforms would not be implemented to the full degree but it felt that, on balance, it was better to tackle the issue rather than not do so at all (see para 3.63 of the MOP). Explicitly including INFONAVIT in the reform process, undertaking substantial policy dialog with the government and making progress (albeit incremental) on INFONAVIT were extremely difficult for the Bank. But it did so keeping the larger

¹ The Government has written that it is in complete agreement with the comments in this Annex with respect to Borrower performance. See Annex 3 for details of Government's comments on this.

developmental implications in view and with full awareness of the risks. Reform of INFONAVIT is a long term process, and with its work in CSDP II, the Bank has made a beginning.

4. The **overall performance** of the project as "Marginally Satisfactory" is justified on the basis of the failure of significant reform of INFONAVIT. We believe that the rating should be upgraded to "Satisfactory". First, the Bank went into the project fully aware of the risks regarding implementation of reforms to INFONAVIT (see para 3.63 of the MOP). The approval of the loan by the Bank indicates explicitly its willingness to live with the downside scenarios were the risks identified in the MOP to materialize. In such a case, the PAR rating should take into account (and give appropriate credit to) the frankness of the Bank team in owning up to the second best nature of the public policy choice for INFONAVIT both to Bank management and the Board. It demonstrated a conscious design decision that weighed technical factors along with a pragmatic understanding of political constraints and the opportunities for tackling INFONAVIT down the road when the necessary constituency for radical reform or closing it may be constructed. Second, both the CSDPs were part of an overall program of pension reform. In this case, it is hard to see why they have two different ratings.

G.M.1

Comments received from the Borrower

DIRECCION GENERAL DE CREDITO PUBLICO
DIRECCION DE ORGANISMOS FINANCIEROS
INTERNACIONALES

306.-VI-4.-204

México, D.F., a 23 de agosto de 2000

SR. RICHARD CLIFFORD
Gerente del Sector Infraestructura
Banco Mundial
Insurgentes Sur N° 1806 Piso 24
Caj. San Jose Insurgentes Sur
Presente.

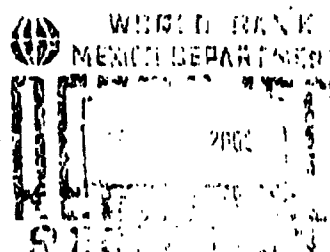
Me refiero a los préstamos para financiar los Programas de Ahorro Contractual (PAC I) Préstamo 4123-ME y Ahorro Contractual II (PAC II) Préstamo 4343-ME contratados con el Banco Mundial, y en particular al Borrador del Informe de Evaluación de Auditoría de los proyectos referidos.

En términos generales el Informe presentado, es un documento crítico y bien estructurado de los resultados obtenidos en ambas operaciones. Sin embargo es importante destacar algunos comentarios de carácter general y sobre las conclusiones presentadas.

El Informe califica el desempeño del PAC II como marginalmente satisfactorio. Al respecto consideramos que esta calificación resulta de asignar en ponderación excesiva a las medidas relacionadas con el INFONAVIT mientras que subestima los resultados alcanzados en relación a: I) el establecimiento del nuevo sistema de pensiones, II) la profundización y consolidación de las reformas realizadas en materia de regulación y supervisión de los nuevos administradores privados de fondos de pensiones, y III) las acciones emprendidas para difundir e informar a los trabajadores del sector privado sobre el nuevo esquema de ahorro para el retiro. En este sentido debe destacarse la complejidad de las reformas al INFONAVIT que se incluyeron como parte del programa, con lo cual se sientan las bases de un proceso que podrá consolidarse en los próximos años.

Por otra parte, la evaluación de este tipo de programas debe tomar en cuenta la complejidad de las reformas propuestas así como el período de tiempo necesario para consolidarlas. En este sentido, cabe mencionar que el Gobierno de México ha continuado trabajando en el fortalecimiento del nuevo sistema de pensiones, no obstante que el proyecto con el Banco Mundial ha concluido.

Particularmente encontramos impreciso el señalamiento de que el líder del proyecto por parte del Gobierno de México regresó del INFONAVIT a la SHCP sin lograr medidas significativas. Este señalamiento desconoce los avances alcanzados para llevar a cabo cambios sustanciales en las prácticas crediticias del INFONAVIT que son un elemento sustancial para la reforma de dicha institución y, por lo tanto, del sector.





Adicionalmente, anexo encontrará comentarios y observaciones específicas emitidas por los agentes ejecutores Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR), Comisión Nacional Bancaria y de Valores (CNBV) así como de esta Secretaría de Hacienda y Crédito Público (SHCP).

Agradeceré a usted que tanto los comentarios generales como los específicos sean incluidos en el Informe de Evaluación de Auditoría a fin de darle mayor exactitud al documento. Una vez completado dicho Informe le solicito atentamente nos envíe el documento final.

Sin otro particular por el momento reitero a usted la seguridad de mi más atenta distinguida consideración.

SUFRAGIO EFECTIVO. NO REELECCION.

El Director de Organismos Financieros Internacionales,



Ricardo Ochoa

**SECRETARIA DE HACIENDA Y CREDITO PUBLICO
(SHCP)**

**Comentarios al Reporte de Auditoría del Banco Mundial
Programa de Ahorro Contractual I y II**

Párrafo 8.2

Aunque el convenio se llevó a cabo en forma confidencial durante su preparación, su contenido no fue guardado para siempre en secreto, como lo sugiere el reporte. Una vez que fue aprobado por la comisión y por la Asamblea General del INFONAVIT, el documento se hizo prácticamente público. En cierta etapa de las negociaciones, el documento fue mostrado a los funcionarios involucrados del Banco Mundial y la redacción del convenio fue examinada cuidadosamente en las discusiones de las condiciones del préstamo.

El párrafo sugiere que una posterior reforma del INFONAVIT pudo haber sido presionada en las negociaciones del Programa de Ahorro Contractual I, las cuales se llevaron a cabo a mediados de la crisis financiera. El gobierno está convencido de que las reformas de 1997 fueron tan lejos como fue posible políticamente en ese tiempo.

Anexo 2

El gobierno está completamente de acuerdo con los puntos de vista expresados por la región en el anexo 2, en relación a la calificación del desempeño del prestatario como menos que Altamente Satisfactorio debido al limitado progreso en las reformas del INFONAVIT. Al respecto consideramos que se subestiman los grandes esfuerzos del equipo técnico del gobierno, así como el esfuerzo político que se ha hecho por los altos funcionarios en esta materia, y que se asigna una ponderación desproporcionada a las acciones del INFONAVIT, sin reconocer adecuadamente las importantes medidas que se desarrollaron en el sistema de pensiones y en materia de regulación y supervisión.

Pie de página 8 en la página 6

El informe menciona que el líder del proceso de reforma del sistema de pensiones fue transferido al INFONAVIT para intentar de implementar las reformas y regresó al poco tiempo sin haber alcanzado logros significativos. Al respecto, se debería puntualizar que desde el regreso del Dr. Noriega a Hacienda, la Secretaría tomó el mando con una iniciativa de gobierno muy agresiva para impulsar la reforma. Este esfuerzo no terminó con el convenio, sino que continuó durante los siguientes dos años, lo cual resultó en una aprobación formal por parte del Consejo de INFONAVIT a las substanciales reformas de prácticas de crédito, la mayoría de las cuales aún no han sido puestas en práctica.

Párrafo 8.16

En la penúltima línea, señale CSPD I y se trata del CSPD II.

COMISION NACIONAL DEL SISTEMA DE AHORRO PARA EL RETIRO (CON SAR)

Observaciones al documento del Banco Mundial (Reporte de Auditoría. Programa de Ahorro Contractual I y II)

- En la sección 2.6, último párrafo, se menciona que existe muy poco progreso en el área de aseguradoras y anualidades. Al respecto debe considerarse que el crecimiento de este tema en los tres años de vida del sistema ha sido bueno, existiendo en la actualidad 14 empresas aseguradoras especializadas en rentas vitalicias, las cuales llevaban al 15 de mayo del año en curso 61,861 casos atendidos con 21 mil 900 millones de pesos en montos constitutivos.
- En la sección 3.3, segundo párrafo, mencionan que el costo para el Gobierno Federal de la garantía de pensión mínima es aún desconocido. Al respecto se tiene conocimiento que la Secretaría de Hacienda y Crédito Público, como entidad competente para su determinación, tiene como modelo para estimar ese costo, con el cual ya ha hecho el cálculo.
- En la sección 4.2 hablan de los problemas para implementar cambios en el INFONAVIT, así como de la falta de cumplimiento de la condición de CON SAR de publicar dos veces al año los resultados del Instituto. A este respecto, es conveniente señalar que en los estados de cuenta que le llegan al trabajador, se informa el rendimiento que dicha Institución otorgó para los recursos que maneja provenientes del sistema, lo cual se considera de cumplimiento conceptual al compromiso adquirido.
- En la sección 5.2 se critican las limitaciones que existen en el régimen de inversión de las SIEFORES. Al respecto puede comentarse que dicho régimen fue restringido originalmente como parte de las medidas prudenciales necesarias al arranque del sistema. No obstante, durante el año en curso ya se ha realizado las primeras modificaciones a ese régimen, dentro de una estrategia gradual que permita su flexibilización y la obtención de mayores rendimientos.
- En la sección 5.6 comentan que México no cuenta con la infraestructura financiera suficiente y lo ejemplifican con empresas calificadoras de valores. Es de mencionarse que desde 1991 operan en México varias calificadoras de valores de nivel internacional, las cuales realizan sus actividades de manera eficiente, y en los próximos meses otras dos empresas (Moody's y Bankwatch) iniciarán operaciones.

(CONSAR)

- En la sección 5.15 parece que al final confunden CSDP II con CSDP I.
- En la sección 6.2, segundo párrafo, mencionan que PROCESAR lleva una conciliación de los recursos de los trabajadores del 95%. A este respecto se informa que la conciliación de los recursos fue del 98.6% en 1998, del 99.8% en 1999 y del 99.9% para lo que va del año 2000.

**Secretaría de Hacienda y Crédito Público
COMISIÓN NACIONAL BANCARIA Y DE VALORES
(CNBV)**

**Observaciones al documento del Banco Mundial
(Reporte de Auditoría. Programa de Ahorro Contractual I y II)**

Al cuarto inciso, en lo que se refiere al ámbito de competencia de la CNBV:

- **Es necesario precisar que la CNBV no ha realizado una supervisión al Infonavit similar a la que efectúa al sistema bancario ya que carece de las mismas facultades de supervisión. En el caso del Infonavit las facultades de la CNBV están muy acotadas de acuerdo a lo especificado en la fracción II del artículo 66 de la Ley de dicha Institución, misma que señala que: "La Comisión Nacional Bancaria y de Seguros, aprobará los sistemas de organización de la contabilidad y de auditoría interna del Instituto y tendrá acceso a dicha contabilidad, pudiendo verificar los asientos y operaciones contables correspondientes. La propia Comisión vigilará que las operaciones del Instituto se ajusten a las normas establecidas y a las sanas prácticas, informando al Instituto y a la Secretaría de Hacienda y Crédito Público de las irregularidades que pudiera encontrar, para que se corrijan".**
- **Adicionalmente se considera conveniente la eliminación del pie de página número 6, que indica que el personal de la CNBV no cree que este organismo tenga el poder político de manejar efectivamente dicha relación de supervisión con el Infonavit.**