

Reform of the Retirement Savings System

Mercer's point of view

On December 9, 2020, the Congress approved the reform proposal submitted on September 25th by the President of Mexico, Andrés Manuel López Obrador, regarding the Social Security Law and the Retirement Savings System.

This reform will become effective as of January 1, 2021, but considers a transition period of 8 years, in which some conditions of the main changes will be modified year after year until reaching a Law that, as of 2030, will have contribution levels, calculation of guaranteed pensions and eligibility, aimed to improve the financial well-being of employees at retirement.

The main changes proposed to the Pension System in Mexico are:



Increase the percentage of contributions in early retirement and old age branch from 6.5% to 15%.



Increase the amount of the Minimum Guaranteed Pension (MGP).



Reduction to the required number of contribution weeks to be eligible to retire and receive the Minimum Guaranteed Pension.



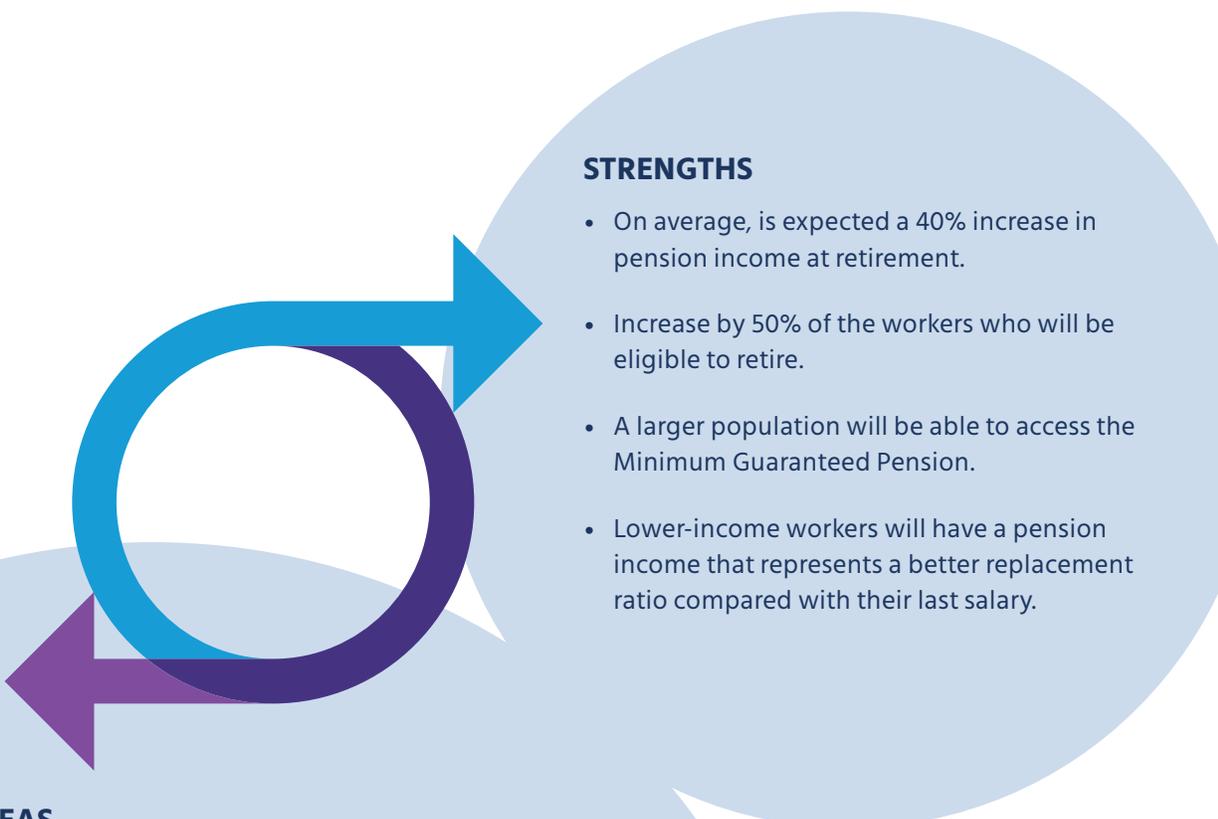
Decrease in commissions charged by the Afores.

This document presents Mercer's point of view, as consultants in pension plans, of the proposed changes to the Social Security Law, as well as the effective dates.



Our point of view

The approval of the Reform represents a step towards strengthening the Mexican pension system. The approved changes aim to increase the retirement benefit benefit of workers who retire under the 1997 Law, raise the total level of contributions generated among the Government, the business sector and employees, to a more competitive level compared with the rest of the OECD countries.



STRENGTHS

- On average, is expected a 40% increase in pension income at retirement.
- Increase by 50% of the workers who will be eligible to retire.
- A larger population will be able to access the Minimum Guaranteed Pension.
- Lower-income workers will have a pension income that represents a better replacement ratio compared with their last salary.

OPPORTUNITY AREAS

- The reform aims to benefit 14 million employees affiliated to Social Security who began to contribute after July 1, 1997 and will retire with their AFORE savings. However, these employees only represent 26% of the country's Economically Active Population (EAP), in other words, only one in four Mexicans at working age will enjoy the benefits of this reform.
- What was left out:
 - Establish a criteria that independent workers could save in the Social Security system;
 - Integrate gender equity in various aspects, including maternity period, that should be considered within the minimum contribution weeks to be able to have a MGP;
 - Voluntary contributions of all employees in the “opt-out” mode, by salary level;
 - 100% deduction of contributions to private pension funds;
 - An integrated system that includes the other public sector pension systems.

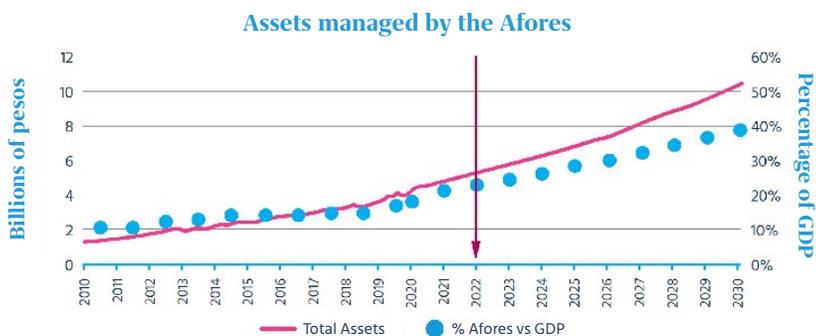
Article 37 of the Social Security Law is modified, which refers to a reduction in the commissions charged by the AFORES, establishing a maximum equivalent to the arithmetic average of commissions of the defined contribution systems in the United States of America, Colombia and Chile. The CONSAR* Board approved that the commissions AFORES will charge during 2021, will be 0.807%, representing a decrease of 11.5 bps compared to the 2020 average, which was 0.922%.

This modification may generate a financial impact to the AFORES as their income would decrease and generate financial pressure. In the medium term, there will be a challenge for the regulatory institutions of the AFORES to maintain the level of service to employees, regardless of whether their revenues decline.



Source: SHCP. December 2020.

On the other hand, the increase in employer contributions (from 5.150% to 13.875%) would significantly increase the amount invested in AFORES, Mercer estimates that by 2030, managed assets could reach levels close to 38.6% of GDP. Although it is true that the level of assets will increase, this won't happen immediately, there will be an 8-year transition, which suggests that a strategy of gradual reduction in commissions would have been more appropriate.



Source: Mercer. September 2020

Finally, for companies, the termination indemnity liability will continue to be an obligation that companies must provision. Similarly, the minimum benefit of traditional retirement plans will not be modified. Regarding retirement plans with a Defined Contribution scheme, the contributions from employees and companies will continue to be relevant to increase the replacement ratio between the Social Security pension at retirement and the employee's salary. Therefore, companies, among with specialists, can define multiple strategies to contain additional costs.

* CONSAR (Comisión Nacional del Sistema de Ahorro para el Retiro) - Mexican government institution designed to control and regulate the AFORES.

How can we help?

The increase in employer contributions will have a financial impact to companies up to 3 times the current cost, depending on the salary structure.

Mercer can help to **measure the impact and perform financial projections** in the short and medium term to determine the level of financial impact this reform will bring to the company considering that employer fees are 100% tax deductible.

Once knowing the impact, Mercer can analyze together with the company, the composition of the compensation to determine **strategies of containment and cost optimization**, and analyze the increase in Financial Wellness for employees and their future income through retirement plans.



Summary of changes

Detail of the proposed changes to the Social Security Law, as well as the effective dates of these changes:

1. Increase the percentage of contributions in early retirement and old age branch from 6.5% to 15%.

The main element of the reform is to increase the contributions to Social Security for the branch of early retirement and old age, the employer will absorb most of this increase. The government redistributes its spending for workers with Base Contribution Salary (BCS) up to 4 Adjustment and Measurement Unit (UMA for its acronym in Spanish). The employee contribution remains unchanged.

1.1 Employer

Starting in 2023, the employer contribution will increase in the branch of early retirement and old age (REO). This increase will occur progressively over 8 years.

The employer contribution in the retirement branch has no change and remains at 2.00% of the BCS.

1.2 Federal Government

The percentage of government contributions of 0.225% disappears to use those resources in the social quota. In this way, government spending does not increase, it is only redistributed.

1.3 Employees

Employees do not change their contribution, it remains at 1.125% of the BCS.



2. Increase to the amount of the Minimum Guaranteed Pension (MGP)*.

According to the current Social Security Law, the employee have the possibility to obtain a MGP whose value in 2020 is \$165 USD per month, which will be updated every year in February according to the NCPI (National Consumer Price Index).

The reform considers that the value of the MGP will be variable and will be determined based on the Base Contribution Salary, the worker's age and the weeks of contribution. The eligibility of the variables of age and weeks of contributions would start at 60 years and 1,000 weeks of contributions after the transition period.

The MGP will be between \$130 - \$410 USD by 2021, with an average increase of 32% when compared to the current MGP value. The increase that the new MGP will have in the future will be in accordance with the NCPI or annual inflation.

* Exchange rate: \$1 USD = \$20.55 Mexican pesos.

3. Reduction to the required number of contribution weeks to be eligible to retire and receive the Minimum Guaranteed Pension.

As of January 1, 2021, the minimum number of contribution weeks to qualify for a MGP is reduced from 1,250 to 750 weeks, equivalent to approximately 24 and 15 years of Social Security contributions. However, a transition period is established, in which year after year, these contribution weeks increase by 25 weeks until reaching a new minimum of 1,000 contribution weeks starting in 2031.



4. Decrease in commissions charged by the Afores.

Article 37 of the Social Security Law is modified, which refers to a decrease in the commissions charged by the AFORES. These commissions will be subject to a maximum that will be defined as the arithmetic average of the commissions that the defined contribution systems have in the United States of America, Colombia and Chile, which in 2020 was 0.54%, compared to the 0.92% average commission charged by the AFORES.

Additionally, simplify the process of receiving retirement benefits

Article 190 of the Social Security Law is modified, seeking to simplify the process of receiving retirement benefits, which instead of receiving a pension (or single payment from an AFORE and on the other hand receiving the benefit at retirement from a private plan through a financial entity (other than the AFORE), then the retiree may request the AFORE to transfer the resources to the private plan financial entity in order to receive a unified monthly pension payment or single payment.

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