RETIREMENT PLANS IN MEXICO DEVELOPMENT AND OPPORTUNITIES BY ACT. JUAN JOSE SOLORZANO AND ACT. MARCELA FLORES

I PREFACE

The actual pension plans in Mexico have been considered in general not a real benefit for the companies, but an option to replace old employees, when they reach a retiring age, that ranges between 55 to 65 years old.

The Mexican Federal Labor Law stipulates that any company that desires to dismiss an employee, must compensate him by giving him three months of his salary plus 20 days per year of service of the same salary. This salary includes proportional part of christmas and holidays bonus.

This payment is known as Legal Indemnity.

Even though retirement by age is not a real cause to dismiss an employee, most of the companies in Mexico consider the above mentioned items as the Legal Indemnity stipulated by law to retire an employee.

It is necessary for Mexican companies to give to their employees their respective indemnity, when retiring by age, in view that payments for pension concepts that the Mexican Social Security grants to these employees is so low that, they do not want to retire voluntary without receiving it.

The Mexican Social Security uses in the calculation of pensions, the salary gotten during the last five years of service in the company, for the retirement payments.. but even though it may seem attractive, due to the high inflation rates suffered in Mexico for the past ten years, these payments from the Social Security has been beated up and had reached levels of 30% average of the last salary for a person that had quoted(1) during 30 years.

On the other hand, the Mexican Social Security for pension concepts establishes a limit in the salary quotation(2) of 10 times the general minimum wage in force, so persons with superior salaries get approximately the 8% of their last salaries from the Social Security.

So, the Mexican companies have adopted the following:

a) Informal Plan.- Not to set up a specific pension plan and wait until the retiring date comes and proceed to give the legal indemnity in a compensation way.

* Reviewer Notes: (1) quoted = contributed
(2) salary quotation = covered salary
(3) quotes = contributions

b) Formal Plan.- Set up a pension plan for retirement concepts in order to yield periodic payments, which actuarial value at retirement age will be the total legal indemnity. In practice the employee receives the actuarial value in a lump sum.

These plans are based upon .6% by seniority and the average salary during last year.

The actuarial value of a pension with the above features, for life and at a 6.0% interest rate in the annuity calculation, will always be inferior to the three months salary plus 20 days per year as legal indemnity, and then the pension plan sets up that the actuarial value will not be lower to such amount.

With this kind of pension plan , some companies add additional pensions to those employees with wages over 10 times the minimum salary, in order to compensate them for the low pension payment from the Social Security.

So this item of the retirement plans is what the employees with superior salaries consider a good fringe benefit.

Other existing problem is that in general the employee who gets his retirement payment in a lump sum, it is usually not managed adequately and shortly he runs out of it counting, only with the Social Security resource.

It is common that the companies with informal pension plans or with out specific definition for the future of such payments, have not created any kind of fund or reserve, so when a person reaches the retirement age, the financial results of that accountant year are drastically affected.

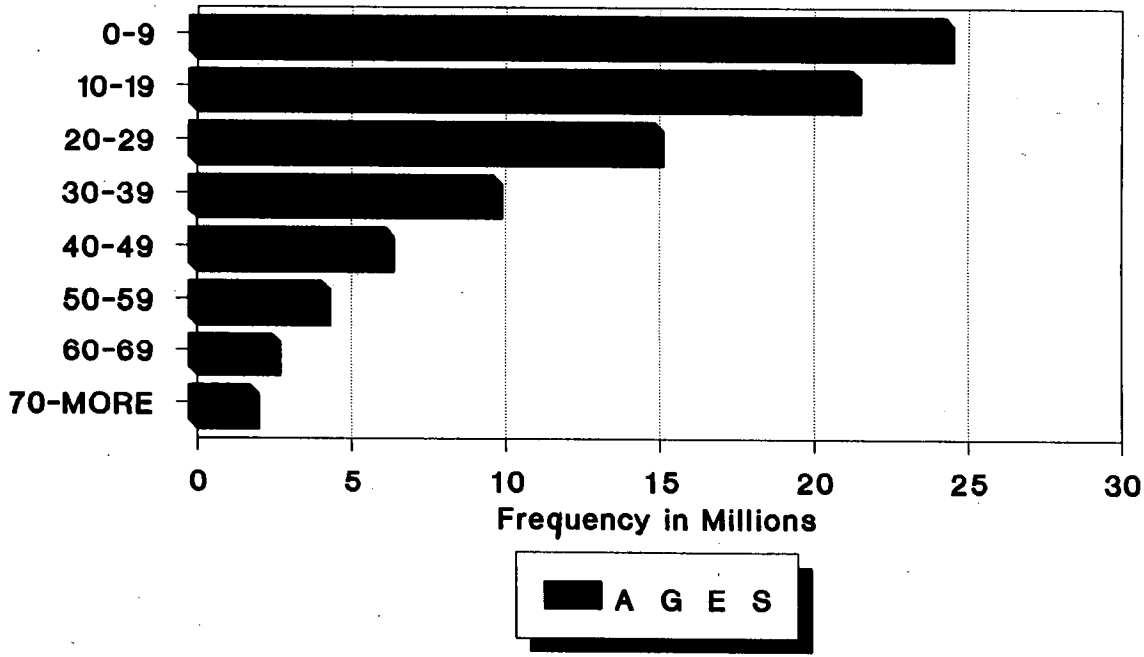
Only those companies with defined retirement plans, create funds, and/or trusts getting fiscal benefits for the contributions as for the interest generated from such funds, which are considered as not aggregate income for tax purposes.

Companies with informal pension plans do not get any fiscal benefit until the payment is realized, so they can not record this liability when it is generated, but until it is required.

One of the reasons why Mexican companies and their employees are not aware of retirement plans, is due that the number of retirement cases is pretty low, mainly because the country has a distribution of ages, according with the following figures in table one.

MEXICO

Age Distribution (Decimal Groups)



Due to the above, workers affiliated to Mexican unions and employees prefer other kind of fringe benefit instead of the retirement plans, because they think it is a long term fringe benefit. Also in our country there is no culture in retirement matters and, with experience, the person who retires and was used to work his whole life, gets the feeling of becoming useless, and his life will change drastically.

II. FISCAL BENEFITS

II.1 For the companies.

Contributions invested in an external fund for financing the liabilities, are income tax deductable and the interest generated from these funds is considered not aggregated income for tax purposes.

II.2 For the employee.

The compensation from an informal pension plan or the legal indemnity for an employee with 65 years old and 30 years of service, has a tax exemption of 36 million Mexican pesos ($ 11,650 dollars approx.).

Under a retirement plan, pensions paid during periodically terms are subject of tax deductions for the equivalent amount of 9 minimum salaries, I.E. $ 3.6 million by month ($ 1,165 dollars approx.).

If the amount granted to an employee is paid through a retirement plan in one lump sum, the tax deduction is for $ 430 million pesos ($ 140,000 dollars approx.), for a 65 years old employee with 30 years of service.

So as it was shown above, tax exempt benefits are superior for those companies with established retirement plans.

III. MODIFICATIONS FOR 1992

III.1 Retirement matters.

As of February 24, 1992 the Mexican Government improved the Social Security Law, adding to it a "Retirement Insurance", consisting in the following:

Employers are obliged to pay quotes (3) of the 2% of the employees' salaries, through bank institutions, to be deposited into individual accounts through a saving and retirement system under each employee name.

The salary quotation (2) to be considered for this insurance will have a maximum limit of 25 minimum wage in force ($ 3,235 dollars approx.).

Quotes[3] received in the banks from the Social Security, must be deposited into an individual account in the Bank of Mexico, and it will invest them in credits in charge of the Federal government.

These credits will be adjusted month by month according with inflation level officially published by the Bank of Mexico and will generate interest rates no lower than 2% annuity monthly payable and reinvested in the same accounts.

The quotes[3] will generate interest from the 4Th laborable day received from the banks, which represents a minor effective interest rate for the employee.

The employee could Withdraw the money from his account, when reaching the retirement age, I.E. at 65 years old or before at 60 years old or in case of a 50% disability, or total disability.

a) For buying a life annuity with tax exemption of 9 minimum wages in force ($ 1,165 dollars approx.), and paying taxes just for the exceeding amount.

b) The actuarial value of the pensions in a lump sum.

In case of death the balance of the retirement individual account, will be delivered to the beneficiaries.

EXAMPLE :

For an employee with $ 1,000,000 Mexican pesos ($ 324 dollars approx.) of monthly salary, considering a 2.0% of interest rate in his individual saving and retirement account. The amount that he could expect to have in his account over **N** years of savings, in months of salary will be as the following figure,

TABLE 2

N SAVING YEARS	FUND IN MONTHS OF SALARY
5	1.26
15	4.20
30	9.86
40	14.70

If we compare the above figures with the legal indemnity:

TABLE 3

N SENIORITY	LEGAL INDEMNITY IN MONTHS OF SALARY
5	6.33
20	13.00
30	23.00
40	29.67

As we show in the figures at retirement age the average that the individual accounts are going to pay represents less than 50% of the legal indemnity.

The 2% fund analized in a periodical pension way at a same rate of the 2.0% anually payable by month, for a person with 30 years of savings will give a pension in salary percentage, as follows:

INTEREST RATE	60 YEARS OLD	65 YEARS OLD
2	5.2%	9.0%
4	6.1%	10.2%

This percentage added to the Social Security one, per normal retirement or retirement in advance concepts, will reach pensions in average between 40% to 50% of the last salary, for employees with salaries lesser than 10 times the minimum salary.

So, since the social security does not guarantee increases, the pensions will lose buying power.

Due to this, it will be necessary for the companies to continue dismissing or paying indemnities.

III.2 In Accouunting Matter.

Actually, the obligation to register the contingent liabilities per seniority premium, pensions for retirement and compensations for dismissal concepts, exists through the D3 Bulletin since 1970, but neither the external auditors nor the accountants of the companies, follow it in a strict way.

The transnational companies with branches in Mexico have the obligation to apply the FASB 87 bulletin to register the contingent liabilities. So, because of this reason and because year by year there are more retirements through legal indemnity that affect just one fiscal year in the accountant of the companies, the Accountant Institute made a new bulletin, D03, in order that the companies have a strict obligation to register the contingent liabilities.

Actually this bulletin is in process of approval by the members of the Institute.

The purpose of this bulletin is to set up the appropriate features to register such liabilities already established, or for informal retirement plans.

Through the application of this bulletin the companies will reflect in their financial statements the total cost of employment per employees.

IV. OPPORTUNITIES

Due to the above mentioned items, from this year on, the companies will have to do the following:

a) To register the contingent liabilities for retirement concepts in their books, even if they count or not with formal or informal pension plans.

b) To pay an additional 2% over salaries, which will be reflected in their costs.

In view of the two above mentioned issues, it is convenient for the companies to do the following:

1. For those companies with no specific pension plans:

To establish a retirement pension plan to cover at least the equivalent legal indemnity, paid formerly through an informal plan, which will be considered as complement of the benefit granted by the Social Security, retirement insurance.

The above will be in order to get the following benefit:

a) The cost of the 2% payroll established for the retirement insurance do not be considered as additional cost, but as complementary payment for retirement concept. In this way the companies could reduce the cost of the 2% of salaries established in the Social Security Law.

b) In view that they must reflect in their books the cost of the contingent liabilities and if the reserve is constituted only in books, it will not be tax deductable it will be an advantage to create a fund in a bank or in an insurance company or in a stock house, and have the fiscal benefits over tax reductions.

c) Grant to their employees higher benefits like a lump sum of a pension plan instead of the legal indemnity because of the higher exemption in taxes.

2. For the companies with established retirement plans:

   a) The cost of the 2% payroll for the retirement insurance do not be considered as additional cost, but complementary payment for retirement concept.

      The cost is going to be just for the withdrawal, because they are changing part of the defined benefit plan by a defined contribution plan.

   b) Not to affect the cash flow of the company using the resources already established in the funds of the pension plans and transfer the corresponding amount to each individual account.

   c) To improve the benefits with tendency to pay pensions periodically and giving real benefits to their employees.