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Economic Watch

Pensions

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Econimic Analysis

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Pension funds and infrastructure in Mexico

- **Gradually, the investment regimen of the Specialized Retirement Funds (Siefore) has become more flexible** and currently allows for greater portfolio diversification and the possibility of channeling resources to infrastructure projects by way of structured instruments.

- **The growing participation of pension funds in domestic infrastructure projects will strengthen** the intermediation of financial resources in the long-term and in the domestic currency.

- **Of the structured instruments, Capital Development Certificates (CKDs), offer pension funds diversification and potentially attractive performance,** and at the same time, represent an interesting opportunity for those companies requiring long-term financing.

- **In turn, there are other elements that could boost infrastructure investment,** such as the bill on Public-Private Associations (APPs).

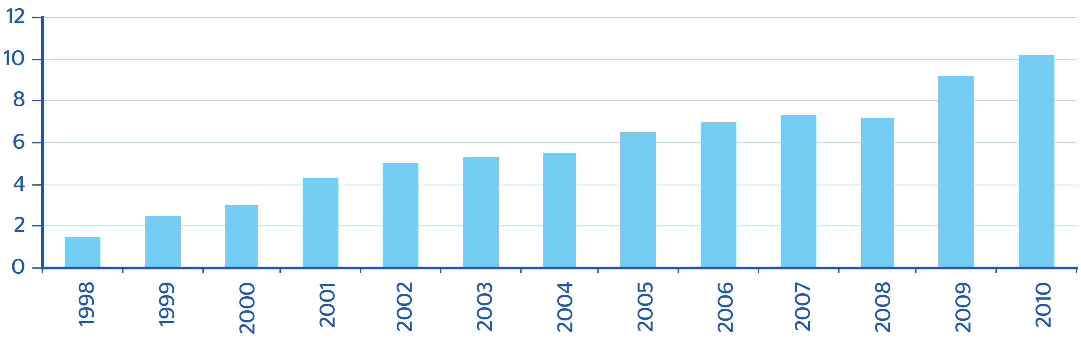
- **Despite the advances made, the need to continue working to obtain a favorable institutional framework is clear;** this framework would have to evolve according to the objectives of pension fund savers, infrastructure development and the growth of the country as a whole.

- **The goal established of placing Mexico among the top thirty countries in infrastructure** will be attainable to the extent that the required changes are made to the regulatory framework.

- **Resources from pension funds represent a potentially significant source of long-term financing for infrastructure project investment in Mexico.**

According to CONSAR data[1], at the close of February 2011, funds managed by the Retirement Fund Administrators (Afores) totaled[2] USD $114,240 million, and the managed accounts surpassed 41.3 million. As a percentage of GDP, pension funds in Mexico have risen from 1.4% at the end of 1998 to 10.2% at the close of 2010 (see chart). These accumulated funds are managed in portfolios with a diversification criterion depending on the age range of the pension savers. Potentially speaking, a percentage of them could be invested in domestic infrastructure projects with benefits for both the pension saver and for the national economy.

Chart 1
Resources Invested by SIEFORES (% GDP)



Source:CONSAR and Banxico (data from Dec. of each year)

On the one hand, investment opportunities for the pension funds in infrastructure assets are beneficial for those funds because it allows them to increase the diversification of the investment portfolio and reduce the risk, as they present a low correlation with other instruments, such as stocks and bonds. Furthermore, they provide a long-term investment horizon adjusted to the objective of offering a savings mechanism for retirement with the possibility of providing optimum performance for the pension savers.

On the other hand, due to their long-term nature, pension funds may play an important role in the financing of investment projects in infrastructure in Mexico. In general, this type of project is characterized by very long-term financing requirements; an elevated volume of funds related to the size of the market and a high and growing financing in the local currency. In contrast, the domestic capital markets in countries like Mexico are generally characterized by a scarce depth and low liquidity of long-term financing, not to mention a reduced capacity to absorb placements for the considerable sums usually required in projects of this nature.

Thus, the participation of pension funds in domestic infrastructure projects will strengthen the intermediation of long-term financial resources in the national currency. In addition to contributing to the potential development and growth of the economy, the above has several other advantages on the financial side. They include the mitigation of the so-called mismatches risk between the local and foreign currency, as the effects of the exchange rate, as well as the spreads in maturities between the short and long terms are significantly reduced.

Likewise, the participation of institutional investment in infrastructure projects reduces the pressure on public funds as it frees funds that could be allocated to other sectors, such as health, education and pensions themselves. Furthermore, as public investment in infrastructure is one of the most greatly affected areas during the stabilization programs, as shown in the recent financial crisis, a greater participation of pension funds in this sector would enable greater stability of investment allocated to that area and its positive effects on the economy. Resources from pension funds potentially represent a strong source of long-term financing for investment in infrastructure projects in Mexico.

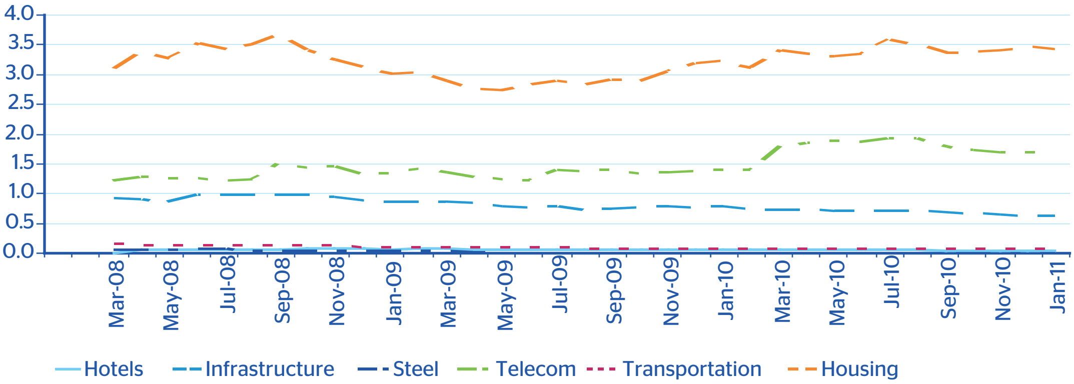
1: http://www.consar.gob.mx/
2: Totals calculated with the share prices for the SIEFORES registered on the Mexican Securities Market as of 28 February 2011, at the peso-dollar exchange rate to resolve obligations in foreign currencies (FIX).

The role of pension funds in infrastructure investment

Also, regarding the pension funds, and as part of the measures announced by the Federal Government for promoting infrastructure investments, actions have been taken to expand the investment regimen of the Siefores. This way, they could invest in an increasingly broad range of instruments which, in turn, would promote investment in priority sectors.

Chart 2

Investments by National Private Debt Instrument, in the Total Siefores Portfolio (%)



Source:CONSAR

In theory, the investment regimen of the Siefores allows for the indirect investment of SAR funds in infrastructure projects through debt instruments, private bonds for the productive sector. As a percentage of the total portfolio, the investment in those funds in national private debt rose from 16% in March 2008 to 17.8% in February 2011. By type of instrument, the investment fell from 0.9% to 0.6% in the same period. However, upon considering other areas such as hotels, the iron and steel industry, transport, telecommunications and homes, the participation in those instruments increased from 5.5% to 5.8% (see chart).

It was only after March 2008, with the reform of the investment regimen[3], that direct investment in infrastructure was allowed through trusts as well as financial instruments related to infrastructure projects. Specifically, Siefores were permitted to invest in so-called structured instruments through which direct financing is provided to new companies, specific projects, sectors or industries in Mexico. These instruments include Capital Development Certificates (CKDs)[4] designed for institutional investors; securities representing capital subject to Initial Public Offering (IPO); individual shares in companies listed on the Mexican Stock Market (BMV) that are not listed on authorized indices[5]; and Infrastructure and Real Estate Investment Trusts (REITs)[6].

To date, the regulatory advances for the direct investment of pension funds through structured instruments has evolved such that currently, the investment regimen of the Siefores permits up to 15% of the portfolio in those instruments for the three most diversified Basic Siefores (BS) (see table). For further information on the current investment limits, please see CONSAR Circular 15-27 of the Official Bulletin of the Federation dated March 10, 2011[7].

3: For more details, please see CONSAR Circular 15-20.
4: CKDs are senior bonds issued by a trust. A company is transferred assets that generate a variable performance. They are designed to finance medium and large-scale, long-term projects.
5: Those that are not on any stock index due to their low capitalization, as is the case of small and medium enterprises.
6: The FIBRAS are an investment vehicle designed for the construction and acquisition of real estate in Mexico for lease and potential sale in the future.
7: www.consar.gob.mx/.../pdf/.../circulares/Circular_CONSAR_15-27.pdf

Table 1
Investment regimen of the Siefores

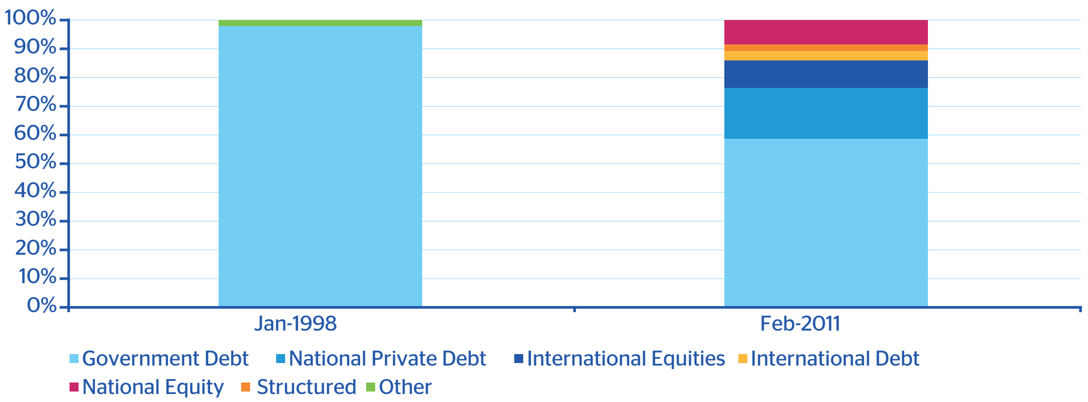
	Limits per Type of Basic Siefore				
Type of instrument	**1**	**2**	**3**	**4**	**5**
Treasury Inflation-Protected Securities (TIPS)	Min 51%				
Government Debt Instruments	100%	100%	100%	100%	100%
Equtiy	0%	20%	25%	35%	35%
Foreign Instruments	20%	20%	20%	20%	20%
Asset-backed Securities	10%	15%	20%	30%	40%
Structured Instrumens	0%	10%	15%	15%	15%

Note: The limits of the investment regimen are expressed in percentages of net assets for the Siefores.
Source: Circular 15-27 of the Official Bulletin of the Federation

In addition, prudential limits on diversification per instrument are established in the investment regimen. In the case of structured instruments, the diversification criteria establishes that up to 35% of the capitalization value of the assets of a company per Afore may be invested. If the investment is over 50% but below 85% of the authorized limit, it must be diversified into two or more structured instruments. Finally, if the investment is over 85% of the authorized limit, it must be diversified into three or more structured instruments.

Unlike in 1998, when practically all of the funds were invested in government debt, at the close of February 2011, the portfolio of the AFORES presented a significant degree of diversification: 58.8% invested in sovereign debt; followed by 17.8% in private local debt; 9.5% and 8.6% in foreign and domestic equity, respectively, 3.3% in foreign debt and the remaining 2.4% in the so-called structured instruments. Given the total net assets of the Siefores at that date of USD $114,240 million and the investment limits established for the structured instruments, the potential funds that the Afores could allocate to these funds was more than USD $13,800 million. Thus, with a holding of 2.4%, equivalent to USD $2,700 million of the net assets of the Siefores, the remaining investment capacity in those instruments is estimated at USD $11,200 million.

Chart 3
Evolution of the Siefores' Portfolio Composition (%)



Source:CONSAR

Since the CKDs are designed to finance medium and large-scale, long-term projects, they provide an interesting opportunity for those companies requiring said type of funding. Likewise, they are an opportunity for institutional investors who need to place their money in projects with competitive performance levels and an acceptable risk. Furthermore, the CKDs could be a possible solution to the dilemma regarding the long-term projects; however we must also keep in mind that there are some disadvantages. For example, they permit the support of medium and long-term projects with acceptable risk while providing the opportunity to obtain attractive yields for thousands of savers and Afore regimen savers. On the other hand, some problems that exist with these instruments include the difficulty of valuation, the associated risk of non-compliance with the guarantees and the fact that the expected yields are not guaranteed.

CONSAR data from December 9, 2010 indicated that, on that date, USD $2,340 million were placed in CKDs (see table), the holding of the SIEFORES in CKDs supported productive projects valued at USD $2,110 million and they were in the process of placing and analyzing nearly 20 new projects. Of the CKDs related to infrastructure acquired by the SIEFORES, some that stand out include Macquarie with the participation of the AFORES, FONADIN and Macquarie itself; and Red de Carreteras de Occidente (RCO, Western Roads Network), a subsidiary of Ingenieros Civiles Asociados (ICA, Associated Civil Engineers), the largest construction company in Mexico and Latin America.

Table 2
CKD's acquired by the SIEFORES

Issuer	Shareholding (%)	Total placed (million USD)
Agropecuaria Santa Genoveva	100	168.9
Red de Carreteras de Occidente – Western Roads Network	97	620.1
WAMEX Capital	80	62.5
Macquarie	100	280.4
Atlas Discovery México	89	97.5
Nexxus Capital	96%	211.5
Promecap	94%	202.8
AMB	81%	254.7
PLA Inmuebles Industrias	80%	250.7
Artha Operadora	60%	196.8

Source: CONSAR (Figures from 9 December 2010)

Macquarie is the leading mutual fund for infrastructure of the Macquarie bank in Australia launched in Latin America. The fund gathering activities are carried out through the issue of CKDs placed among the Siefores. Their objective is to invest in infrastructure assets, such as roads and railways, airports and ports, water and water treatment and waste, energy and public services, as well as social infrastructure and telecommunications. The equity of the trust comprises infrastructure investments in the form of debt, capital or other capital-like investments such as infrastructure assets. The allocations depend on the cash received by the trust derived from a divestment or the payments of principal, interests, dividends and other income from the infrastructure investments.

Furthermore, RCO was the first project to issue CKDs (October 2009) through a trust for capital gains held jointly by ICA and Goldman Sachs Global Infrastructure Partners. Its assets are primarily made up of a security contract without transfer of possession on series B shares of capital stock in the variable of RCO[8]. Specifically, RCO is responsible for a package made up of four toll highways (highways in use), that were bailed out in 1997, whose grant is for 30 years: 1) Maravatío-Zaplotanejo Highway (309.7 km); 2) Guadalajara – Zaplotanejo Highway (26 km); 3) Zapotlanejo – Lagos de Moreno Highway (118.5 km); and 4) León – Aguascalientes Highway (103.9 km)[9]. It was announced recently that 1,100 million pesos (approximately USD $92 million) would be invested this year for extension and maintenance projects[10].

8: Does not have a credit rating for the issue granted by an authorized rater.
9: See Víctor Cardoso, "Entregará la SCT dos carreteras rescatadas a ICA y Goldman Sachs", La Jornada, 4 October 2007.
10: See "Red de Carreteras de Occidente invertirá mil 100 mdp en obras", informador.com.mx, 29 March 2011.

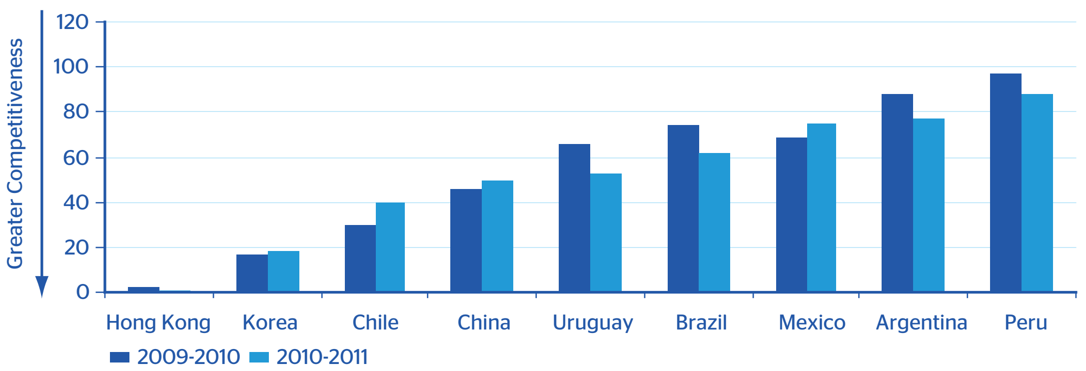
One point to highlight is that, depending on its shareholding, AFORES are given a representative seat in the Holders Assemblies of countries under the CKDs' trust. The above significantly fortifies the protection of investors' rights. However, there are possible risks associated with this scheme. There is no guaranteed yield and there is a certain liquidity risk as the companies are not listed on the securities market. Finally, without other infrastructure funds in which to invest, this market is still quite incipient and has zero competition.

Reforms needed for greater infrastructure investment in Mexico and the participation of the Afores

Infrastructure is a key factor in the economic growth, competitiveness and social development of countries. Due to its multiplicative effects on the domestic economy, in terms of domestic demand and job creation, promoting the infrastructure of a country has proven to be one of the best strategies for boosting long-term economic growth and competitiveness, and thus, potential growth.

However, Mexico currently holds the 75th place for competitiveness of its infrastructure and is 79th in quality of infrastructure of a sample of 139 countries in all regions of the world, according to figures from the 2010-2011 Global Competitiveness Report of the World Economic Forum (WEF). With respect to the previous year's report, which included 133 countries, Mexico lost competitiveness in that sector as it formerly held the 67th place. The above indicates a significant lag in comparison with other peer economies, such as Chile, Uruguay and Brazil, holding 40th, 53rd and 62nd, respectively; and with other emerging countries, such as the case of the Asian Tigers Hong Kong and Korea, holding 1st and 18th, respectively; and China (50th), in addition to severe consequences in terms of growth and reduction of poverty (see chart).

Chart 4
Competitiveness Ranking in Infrastructure from the WEF



Source: World Economic Forum 2009& 2011

Although an adverse economic environment negatively affects the competitiveness in this sector, we must keep in mind that an unfavorable and restrictive institutional framework for investment in long-term projects has direct negative consequences. Historically, one factor that has worked against a larger and more active participation of the private sector in infrastructure projects has been a rigid and inefficient institutional framework, overloaded with excessive administrative paperwork and an ambivalent, uncertain legal framework. Furthermore, the lack of viable studies for the projects or their low quality, as well as delays in environmental authorizations, road rights and permits continue to be major factors.

Therefore, the Mexican government has established a set of initiatives with the objective of boosting infrastructure in the country by promoting greater participation of private investment which comprises: 1) the National Infrastructure Program 2007-2012; 2) National Infrastructure Fund (FONADIN); 3) Public-Private Association Law initiative to Congress (APPs); and 4) Adjustments to the Siefores Investment Regimen[11].

11: The Specialist Pension Funds Investment Companies (Siefores) are the instrument through which the Afore invests the funds from each individual worker

Specifically, the National Infrastructure Program (NIP 2007-2012 of the Federal Government establishes a set of objectives, goals and actions for increasing the coverage, quality and competitiveness of the country's infrastructure, as well as for increasing the creation of permanent employment, etc. In effect, the goal of this program is to place Mexico among the top thirty countries in infrastructure in the world, based on the 2010 evaluation by the WEF. In fact, concrete objectives are laid down in this program regarding the investment required and the goals per sector including the highway, airport, telecommunications sectors, etc.

However, to date, this responsibility has fallen predominantly on the public sector, ruling out any possible advantages of allowing a joint participation of the private sector in infrastructure investment. According to SHCP figures, 82% of infrastructure investment recorded in the 2007-2009 period comes from public funds, which total USD $77.2 billion. Specifically, 76% (USD $71.2 billion) comes from the Federal Expenditures Budget; followed by 4% (USD $3.5 billion) from the National Infrastructure Fund (FONADIN)[12] and the remaining 3% (USD $2.5 billion) in credits granted by Banobras. The participation of the private sector is limited to only the remaining 18% (USD $17 billion).

As a supplementary part of the NIP, FONADIN's objectives include supporting the programs' projects with public-private participation. Likewise, by assuming the risks the market is not willing to take and facilitating the mobilization of private capital, efforts are made to achieve a balance with those projects with social profitability but low financial yield.

Likewise, given the need to create the legal context to promote private investment in that sector, some of the actions needed to speed up the infrastructure agenda include the Federal Government's planned modernization of the corresponding legal framework. To this end, the Chamber of Deputies has been sent a decree bill which would issue the Public-Private Associations Act (APPs). The purpose of this proposal is to regulate the long-term contractual relations between the private and public sector authorities, for the rendering of services to the public sector or end user and in which infrastructure provided partially or totally by the private sector is used. In turn, this act establishes restrictions to prevent private initiative from participating in the construction of infrastructure in strategic sectors, such as the petrochemical industry. Unfortunately, despite the State's efforts to promote new public-private participation schemes, especially since the 1995 crisis, these changes have been too slow in regard to the current need.

Although the modifications made to date in the Siefores investment regimen promote investment in local infrastructure projects, there are still significant limitations to optimizing the financing of private projects in that sector. Structural factors like low liquidity of the associated instruments, the difficulty of valuating those assets and the little or null background countries normally have and, therefore, the difficulty of assigning them a credit rating, hinders the participation of private investors.

However, not participating in the financing of this sector would involve a high opportunity cost for institutional investors like pension funds. Given the direct relationship between the greater flexibility of the investment regimen and a higher degree of diversification in the Siefores investment portfolios, it would be desirable that the authorities continue to promote greater participation of private investment in the infrastructure sector. Therefore, providing the proper conditions for pension funds to participate in the financing of infrastructure in a more committed fashion is essential. This requires an ad hoc evolution in the context of the investment regimen to be able to evolve properly and in line with the objectives.

Likewise, it is important to more quickly and constantly reduce the many legal restrictions so that the private sector in general could increase its holding in various economic sectors. Thus, it would be helpful to broaden the opportunities that the legal and institutional framework offers pension funds and other private investors to invest in this sector by creating a mutually beneficial situation.

12: This fund was created to be the primary vehicle for the Federal Government to boost private investment in infrastructure.

Finally, the capacity to assess and select infrastructure investment projects needs to be developed given the high level of specialization required. The highway bailout experience in 1997 in which the Federal Government bailed out 23 of the 52 highways in concession demonstrated the serious problems and consequences of a deficient valuation and estimation in this type of project. Likewise, institutional investors like the Afores must seek support from specialized consulting firms or develop their own capacity to select the projects in which to invest. Therefore, it would be highly recommendable to increase the quality of the technical assessments and to achieve a collaboration between the public and private sector where institutions like BANOBRAS (the National Bank for Public Services and Works) have years of experience in the matter.

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