Czech Pension Reform and Experience with Private Pensions

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Content

Basic Information (1)

1st pillar

(mandatory, state budget, PAYG, uniform for all EA, DB, Old-age + I + Surv., state administration)

- Contribution Rate	28%
– Compliance	98 -100%
– Number of pensioners	2.75 mil. (2008)
– Replacement Ratio	40.6% (2007)
– Expenditures	8.2% of GDP (2007)

- Flat rate (1/5) + Earnings related (4/5)
- 30 years assessment base indexed by average wage
- Benefits adjusted according to prices + partly wages

Basic Information (2)

Private pensions

(voluntary, FF, DC plans only, state contribution + tax incentives, state supervision)

- Number of pension funds	10 (31 Dec. 2008)
– Number of participants	4.14 mil (3Q 2008)
– Average contribution	436 CZK(3Q 2008)
– Pension fund assets	4.7 % of GDP (2007)
– Average real rate of return	< 1 % (1995-2007)

II. History of Czech PR

Pension Reform Scenario 1990

	Objective	Achieved
1.	Universal coverage	+
2.	Uniformity	+
3.	Separation from SB	-
4.	Combination of Bismarck + Beveridge	+
5.	Adjustment to economic development	+
6.	Adjustment to demographic development	partly
7.	Democratic governance	-
8.	Supplementary occupational provisions	partly
9.	More individual responsibility	partly
10.	EU compliance	+

Development of the Czech PR

1990-1992	Aboliton of preferences, adjustments in the process of price liberalisation, reintroduction of payroll contributions
1993-1995	**Act 42/94, Act 155/95**
2003	**Further retirement ages increase)**
2004	Political expert committee
2008	Pension reform reserve account, adoption of the 1st stage of the pension reform

Specific Factors Influencing the Czech PR

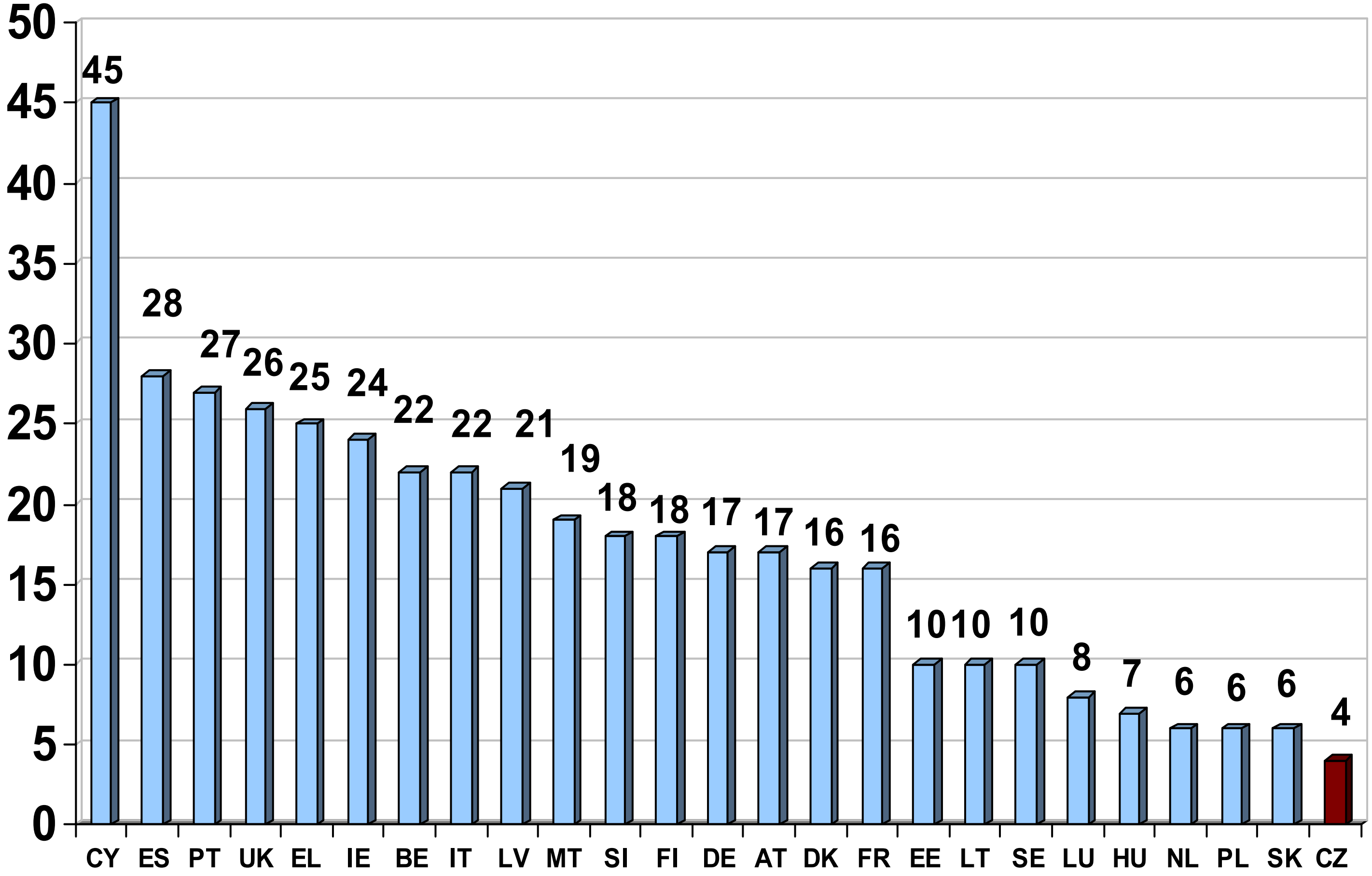
- Tradition and relatively high level of the social security administration
- Decisive role of local experts, esp. MLSA
- The low debt of the country and limited influence of international financial institutions
- The failures of almost all segments of financial markets
- Quick privatisation and its problems
- Unclear position of political parties and the fact that pension reform has not become political priority
- The development of democracy

III. Evaluation of I. pillar

Achievements of the I. Pillar Scheme

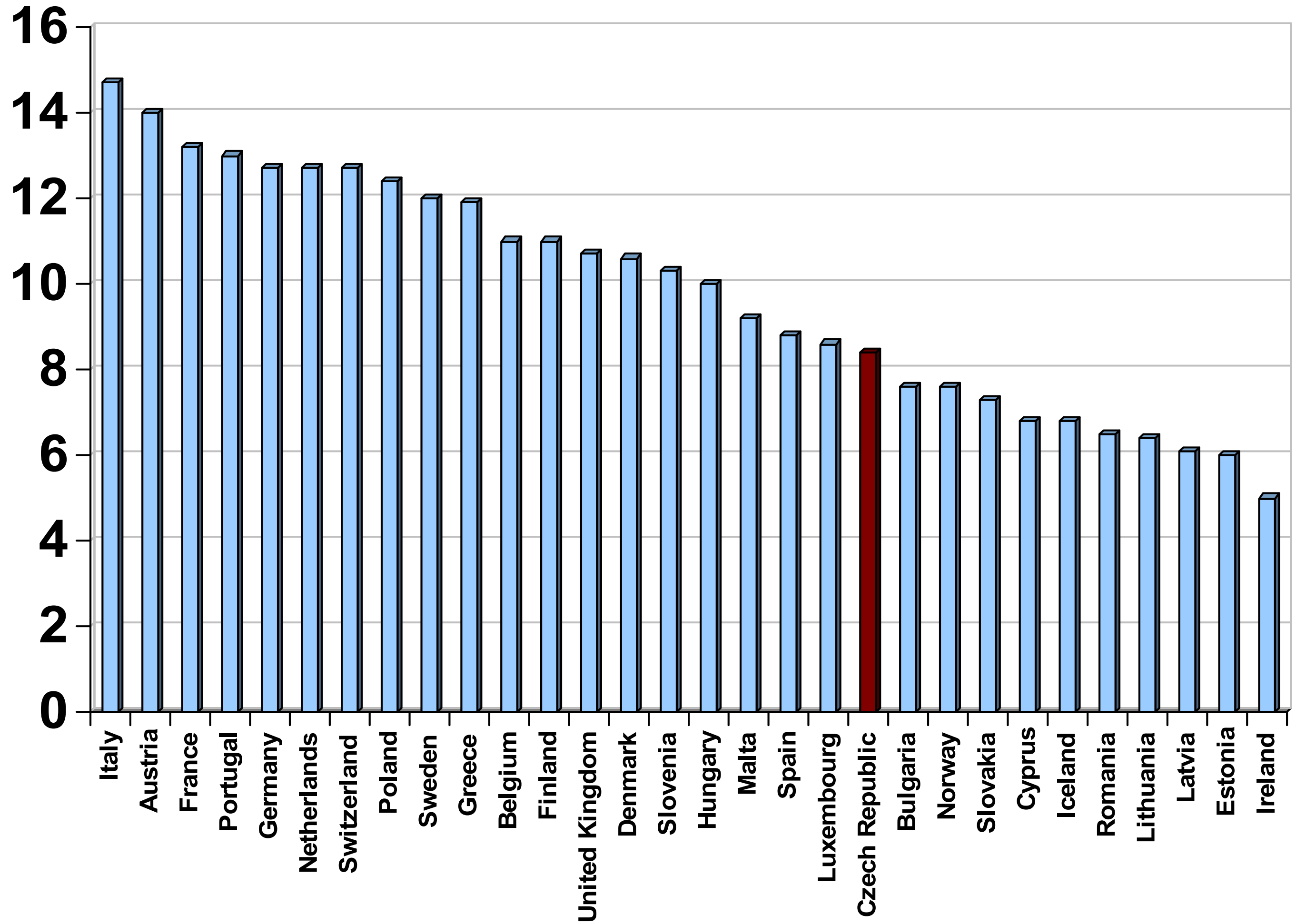
- Very low poverty rate among pensioners
- High coverage
- High compliance
- Good administration
- Acceptable cost

At-risk-of poverty rate, people aged 65+, 2006



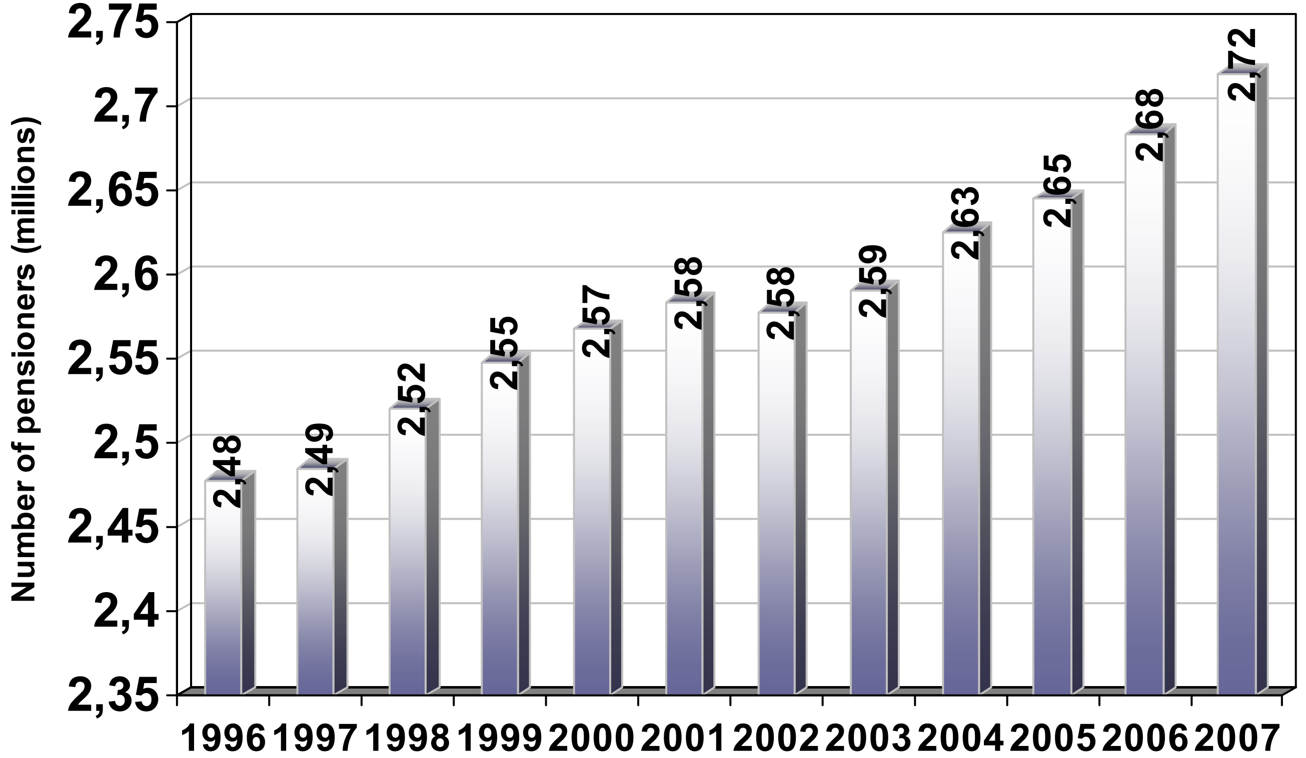
Source: Eurostat

Expenditure on Pensions (% of GDP, 2006)



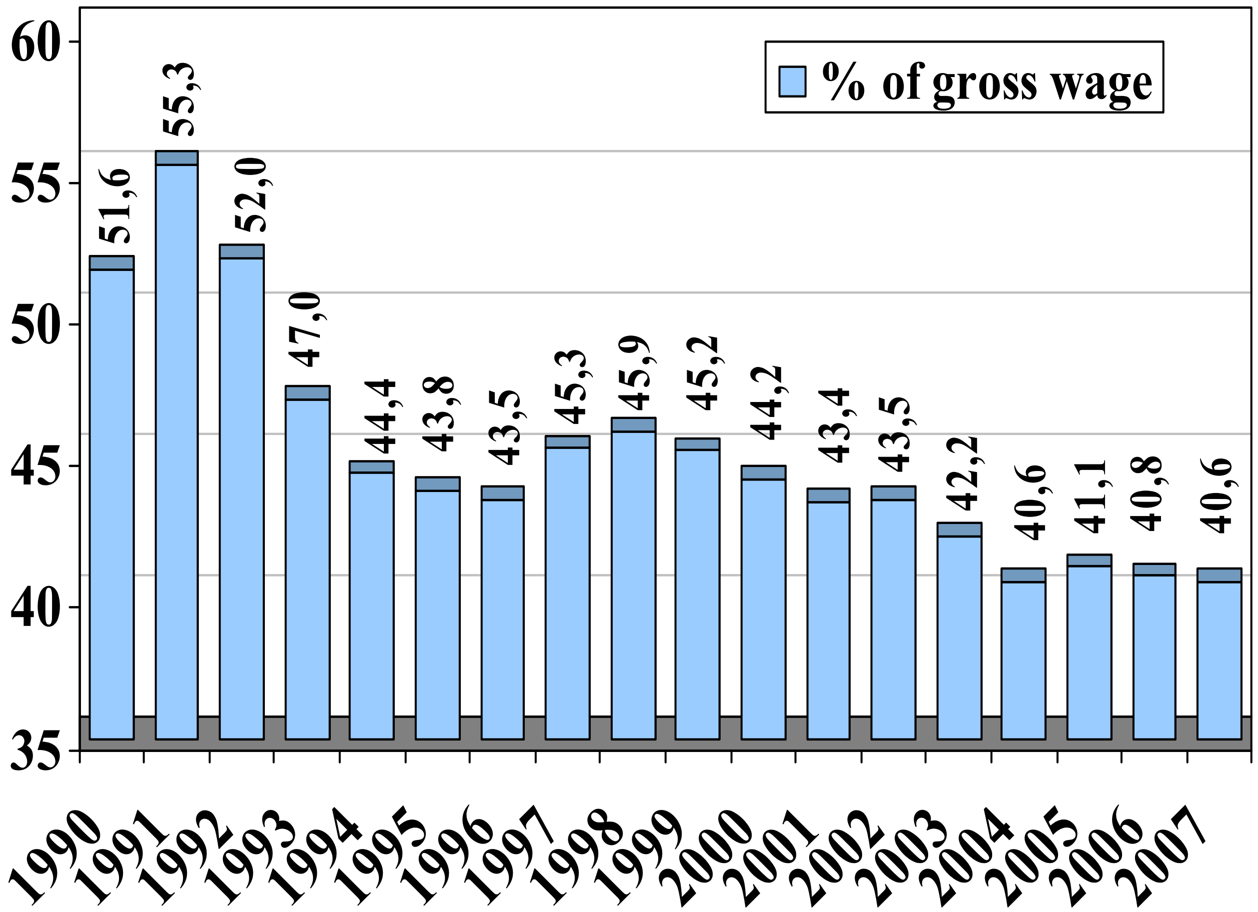
Source: Eurostat

Number of pensioners



Source: Ministry of Labour and Social Affairs

Total Replacement Ratio

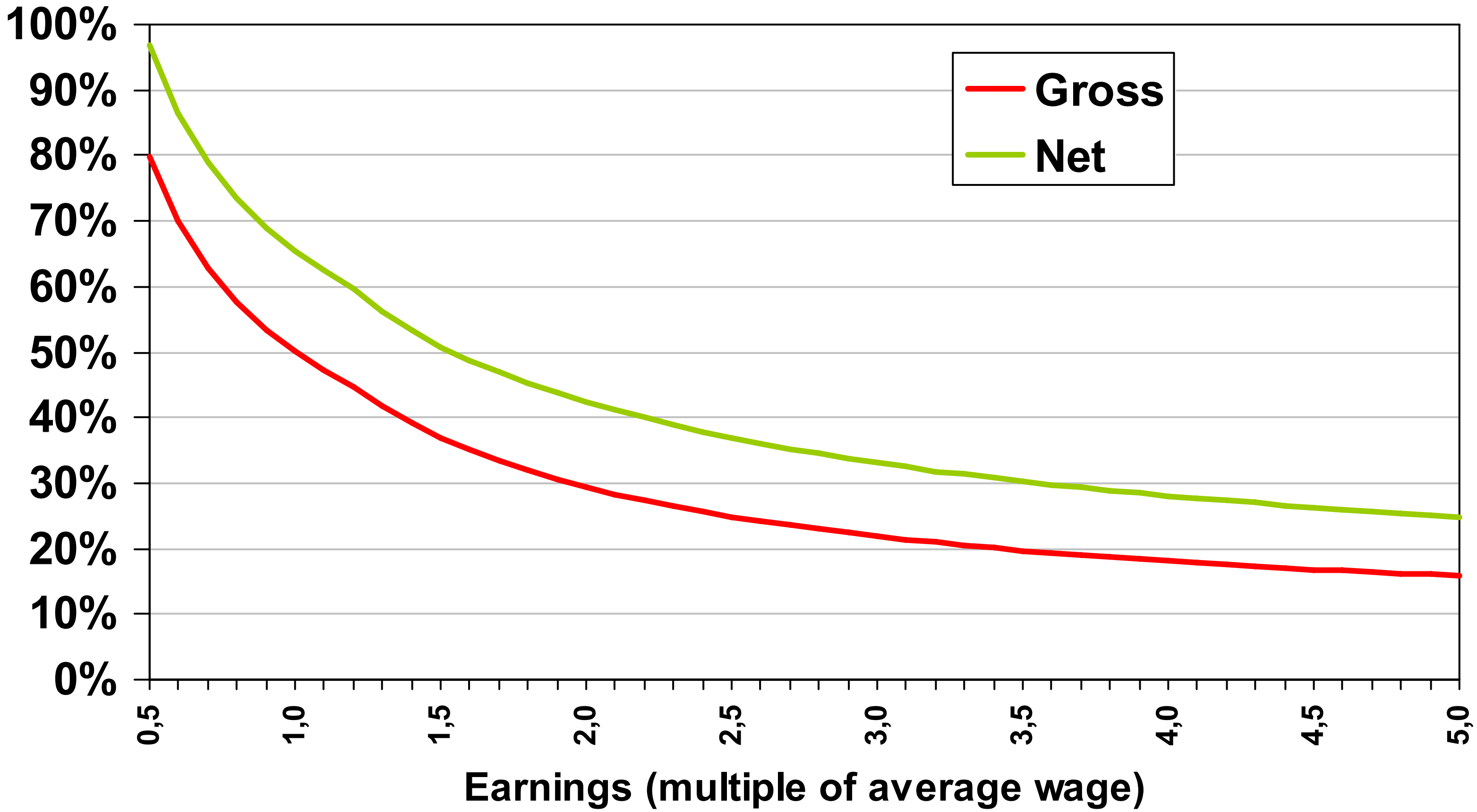


Source: Ministry of Labour and Social Affairs

Weaknesses of the 1st Pillar Scheme

- Low differenciation (low equivalence).
- Large extent of non-contributory periods.
- Only one source financing (only contributions).
- Self-employed.
- Increase in dependency ratio due to aging.

Replacement Rate



Note: Full career, 45 years of insurance, retires in 2008

IV. Evaluation of Private Pension Scheme

The History of the Czech Private Scheme

1994 - Introduction of the voluntary Supplementary Pension Insurance Scheme With a State Contribution

1999 - Introduction of tax incentives

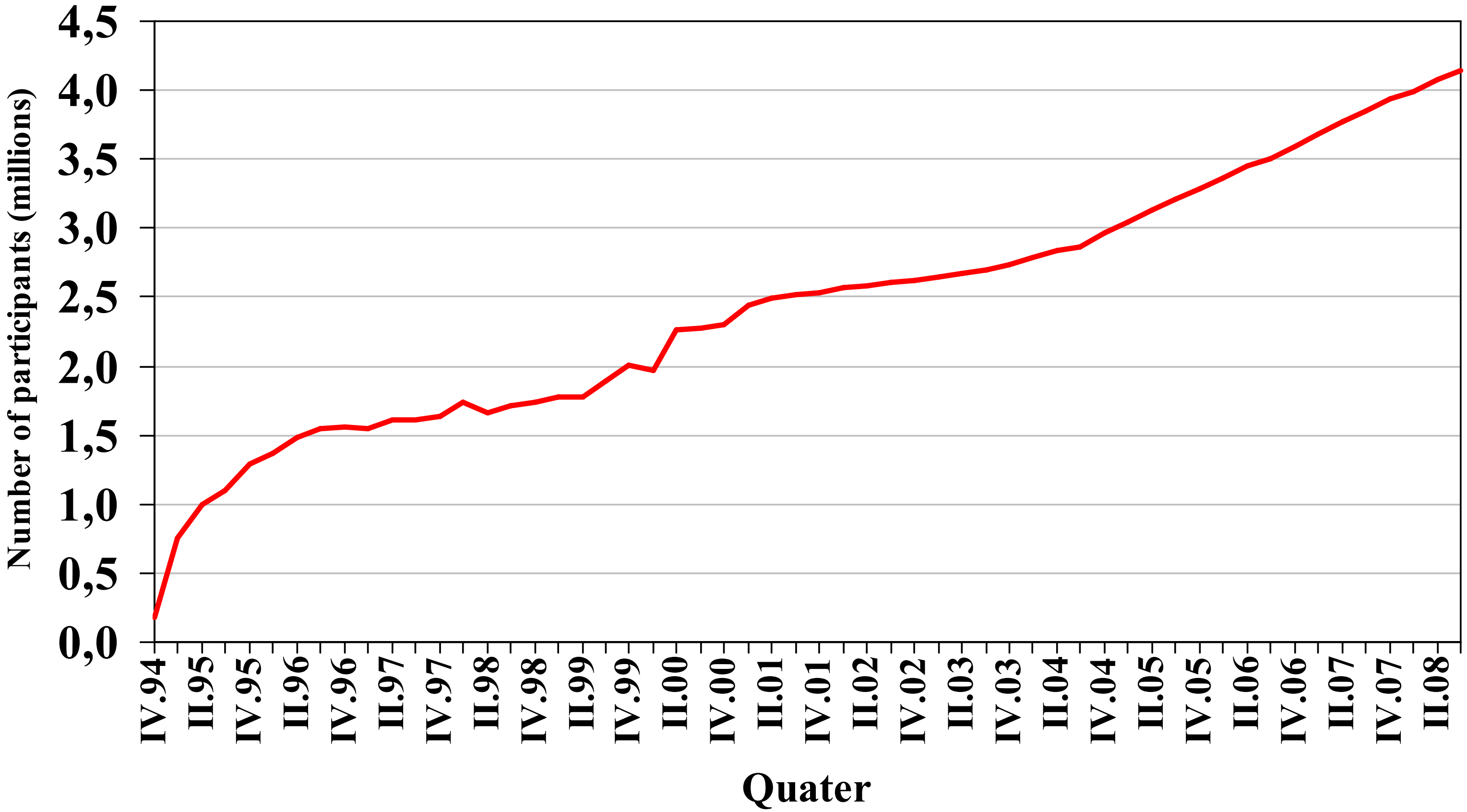
2000 - Tax incentives for old-age types of life insurance products

2003 - Compliance with EU

Achievements

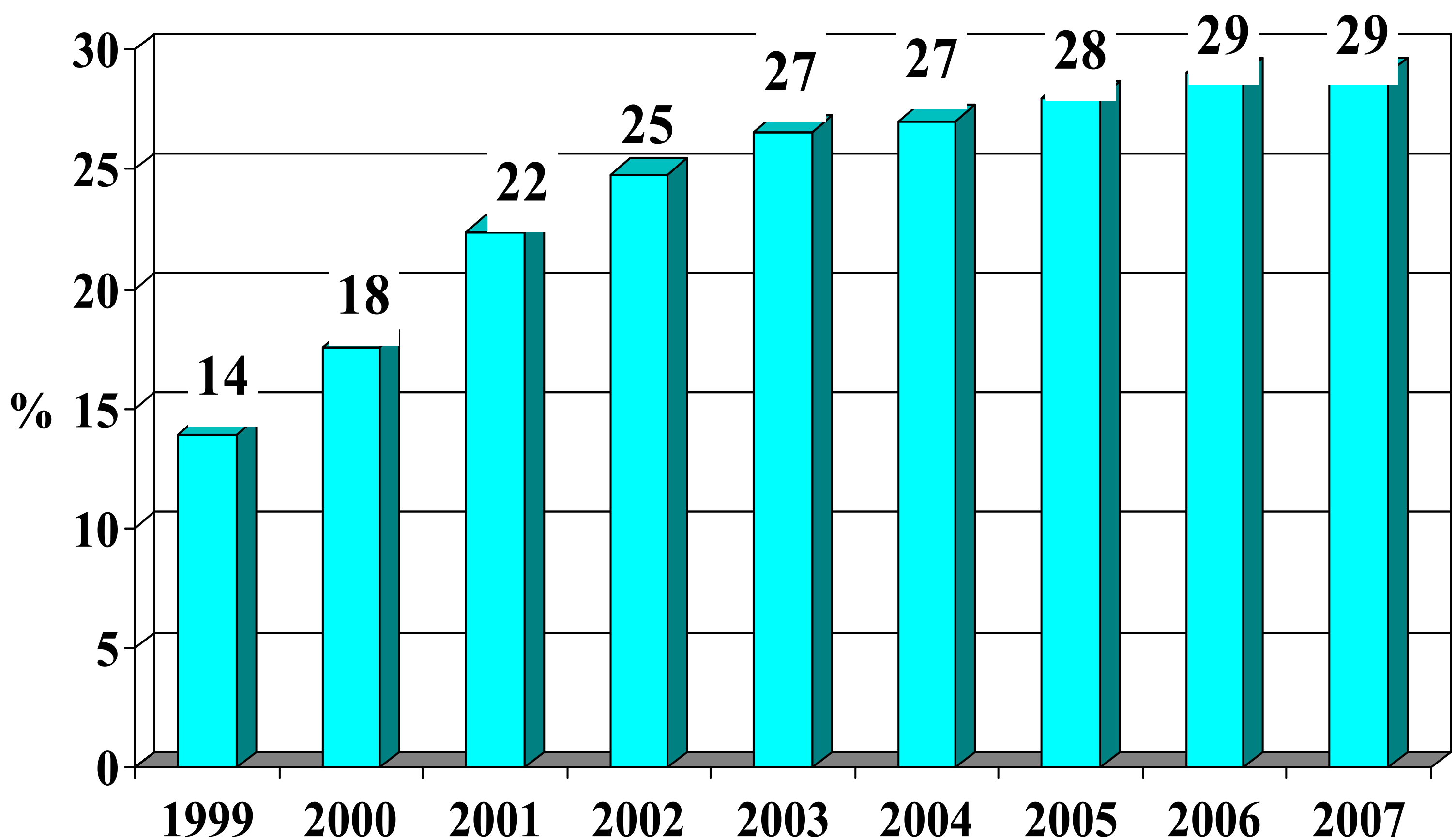
- High participation
- Increasing number of employers contribution
- Integration of PF
- High safety of the scheme

Number of Participants



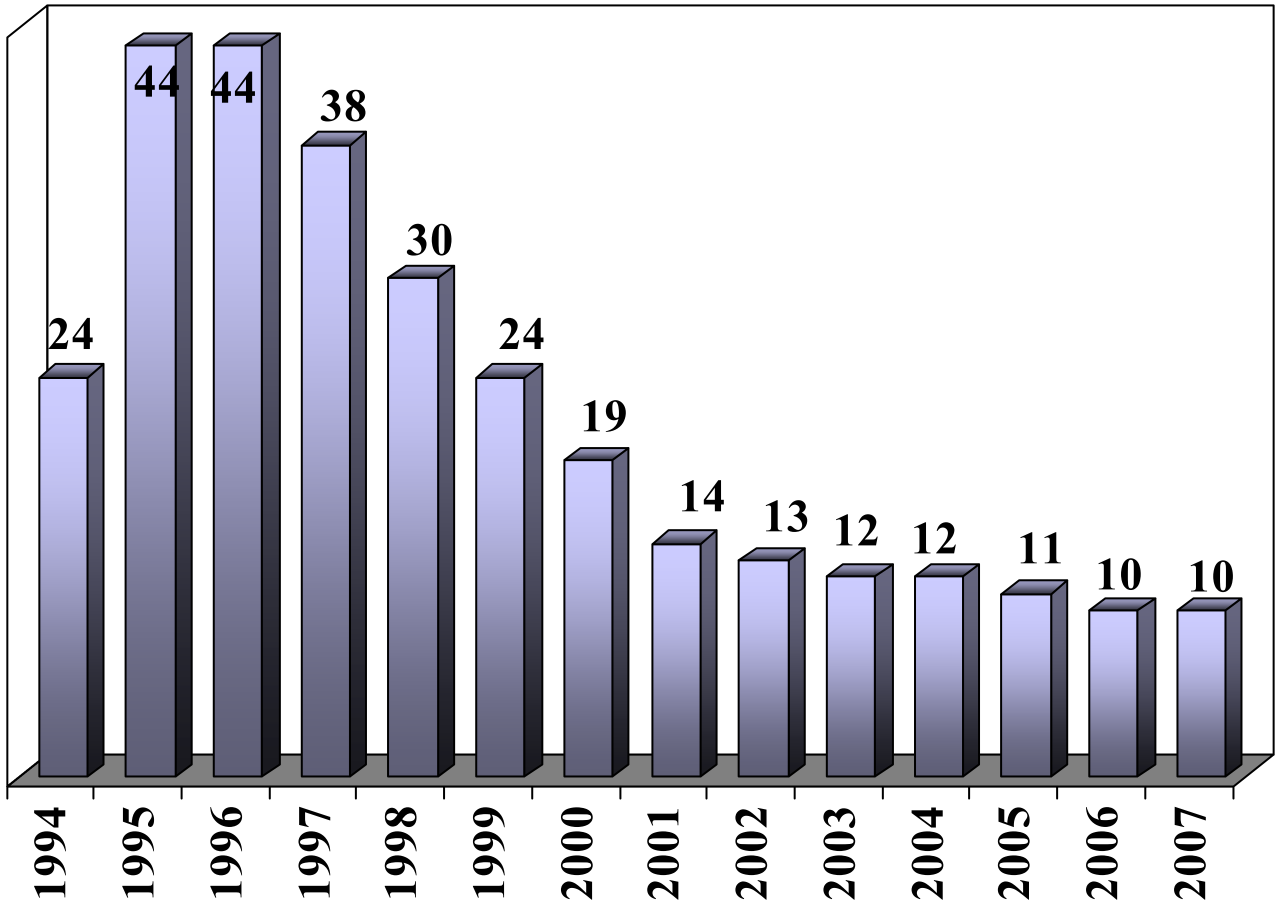
Source: Ministry of Finance

Participants with Employers´ Contributions
in % of total number of participants

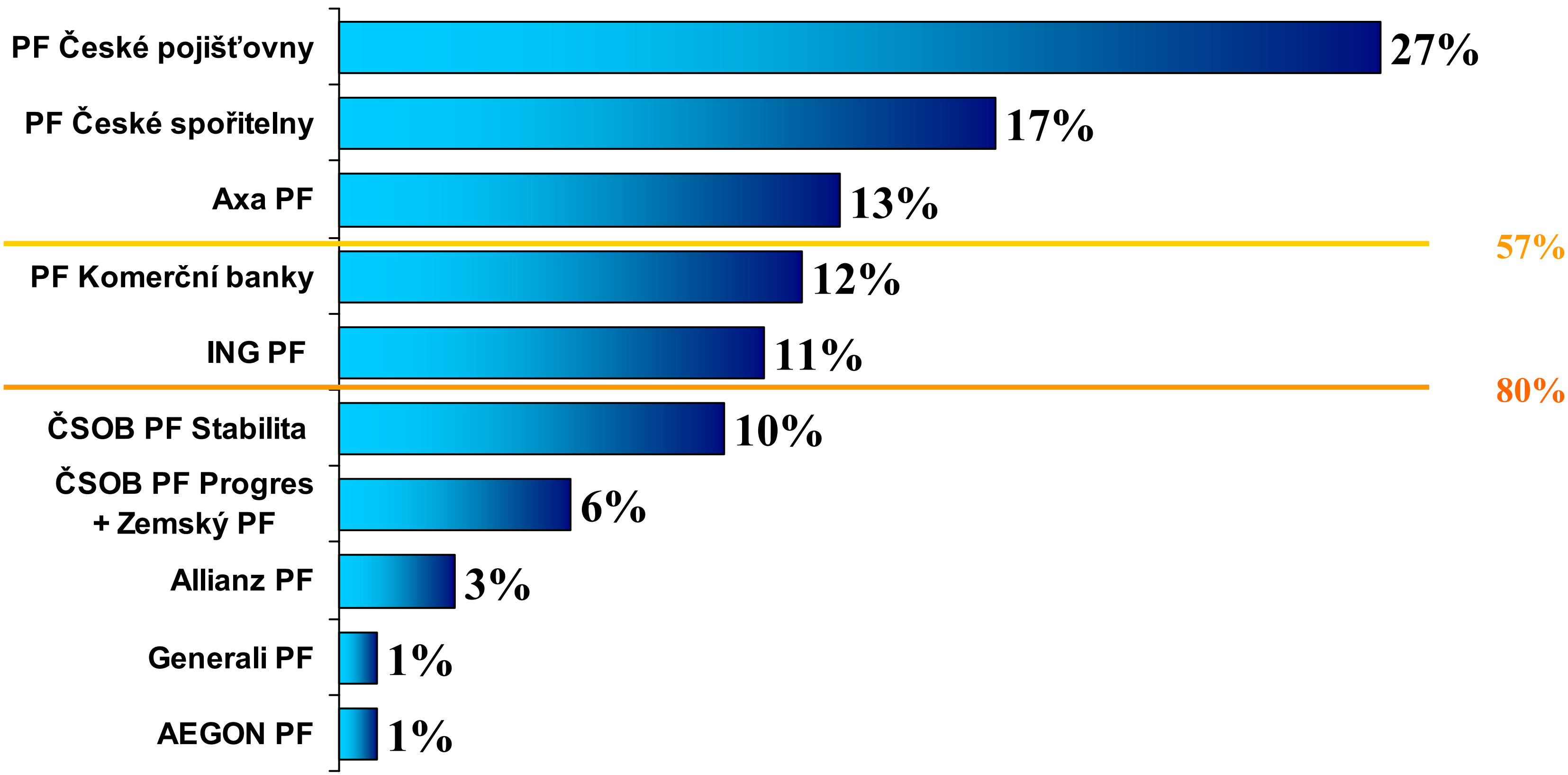


Source: Ministry of Finance

Number of Pension Funds

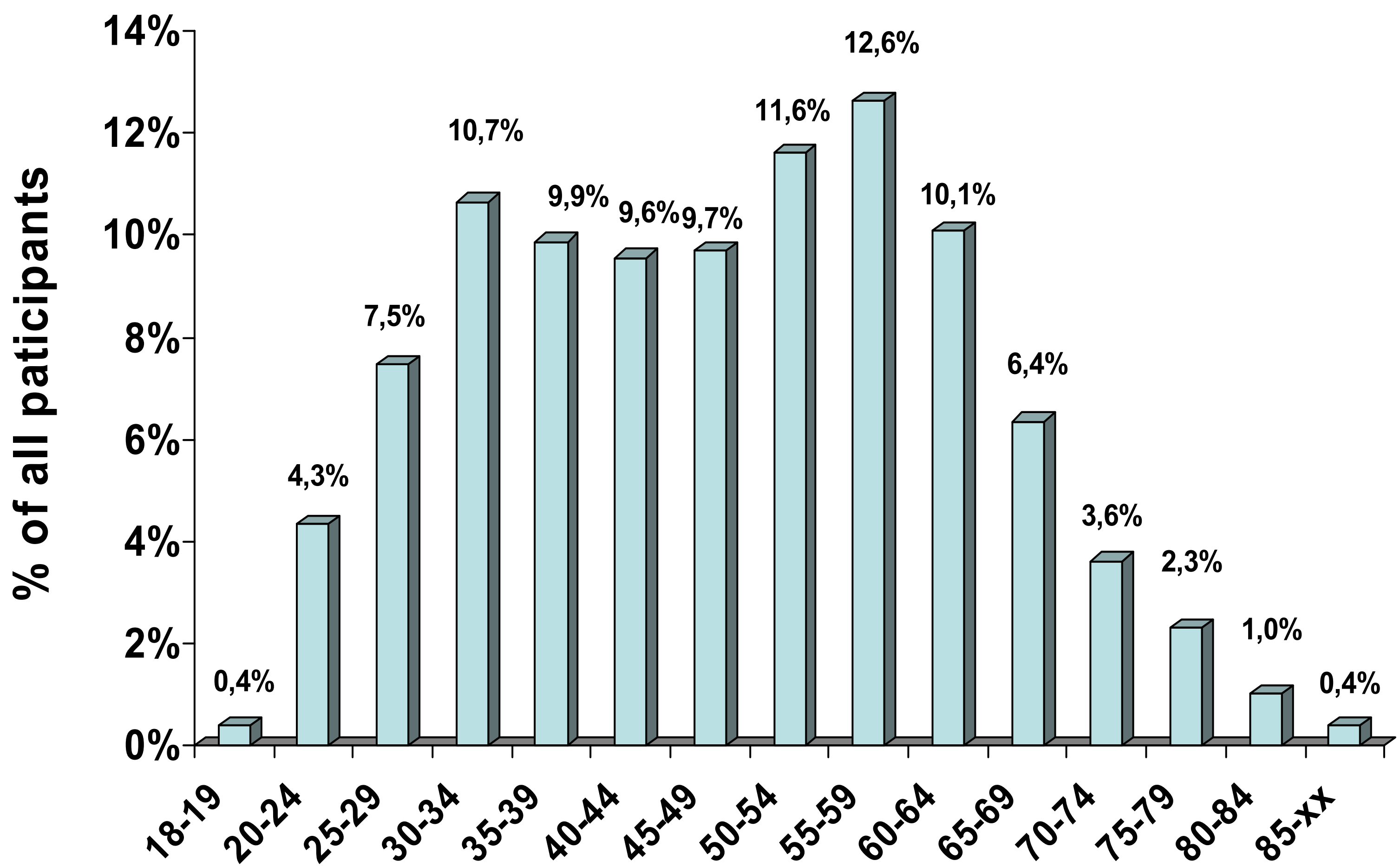


Number of Participants by Pension Fund (3. Q 2008)



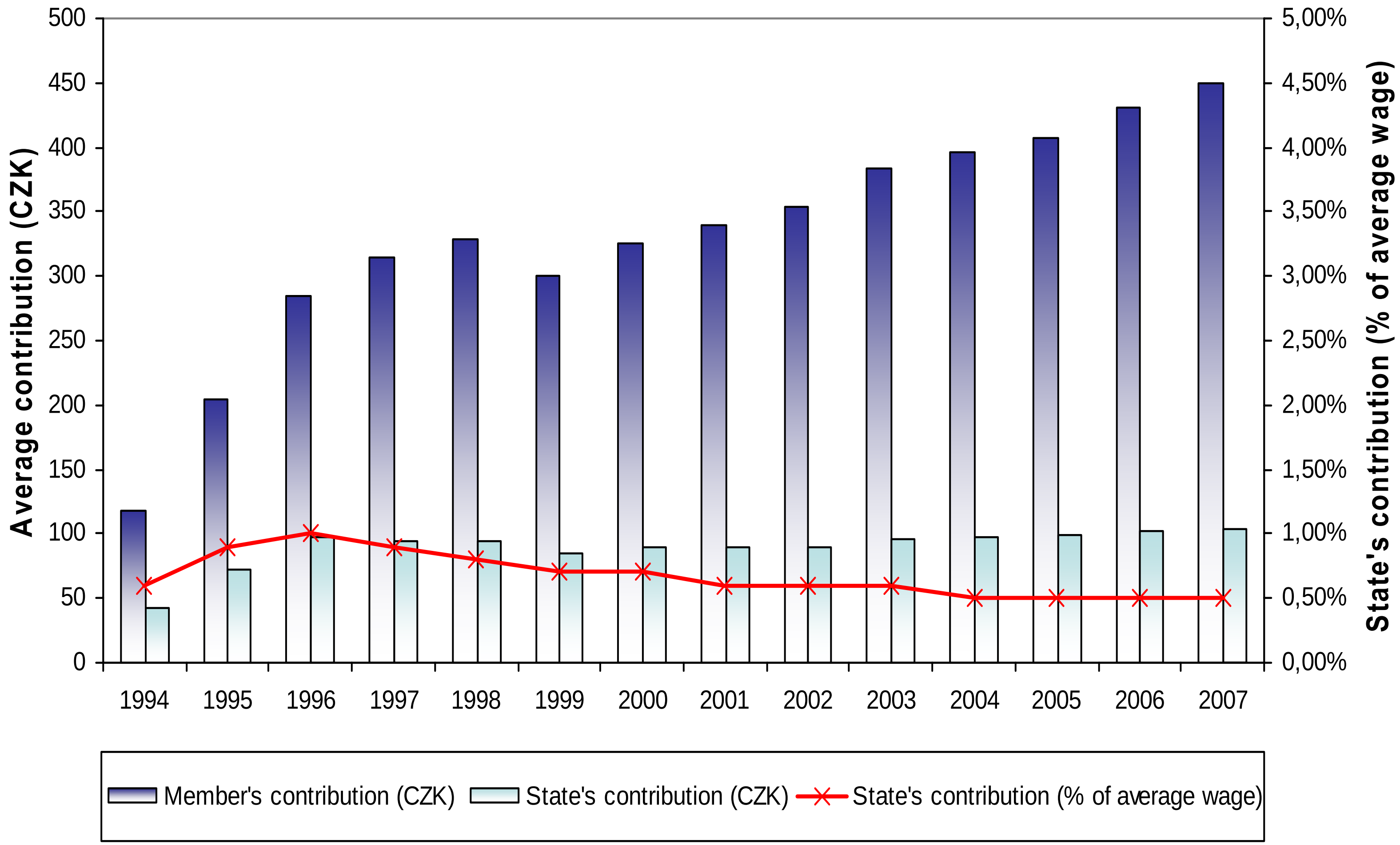
Source: APF CR

Age Structure of Participants (3.Q 2008)



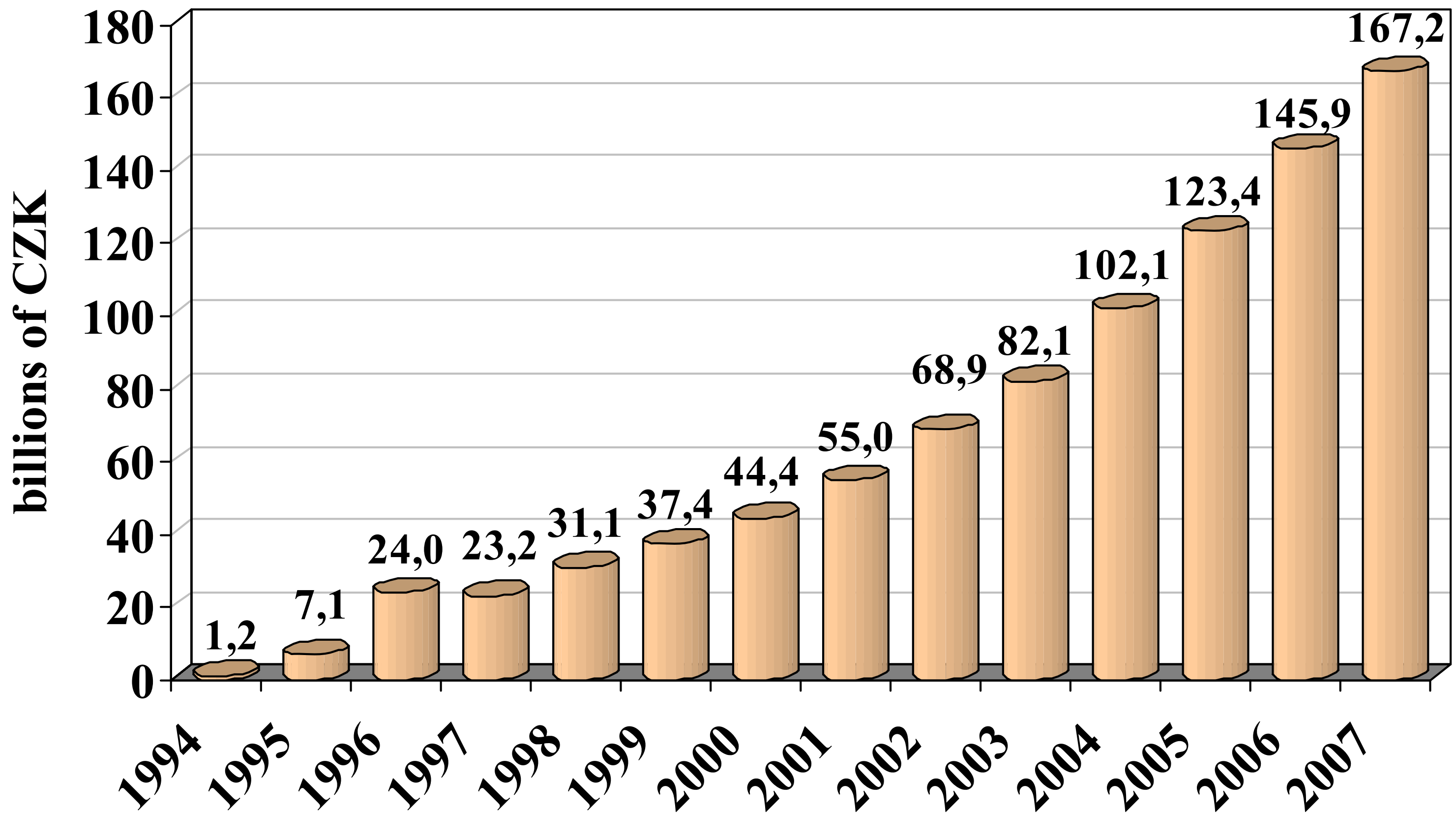
Source: Ministry of Finance

Average Contribution



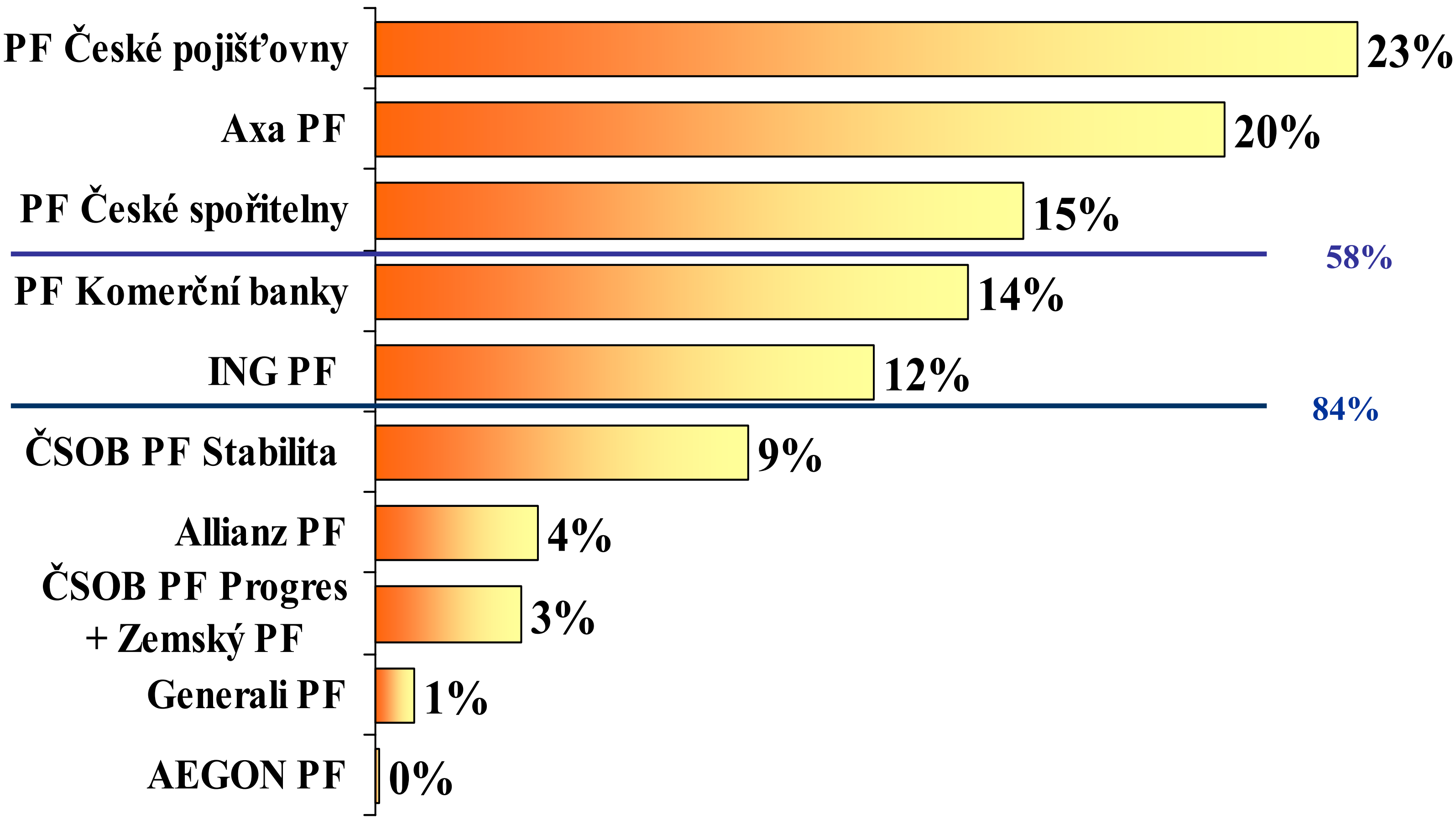
Source: Ministry of Finance

Pension Funds Assets
(billions of CZK)



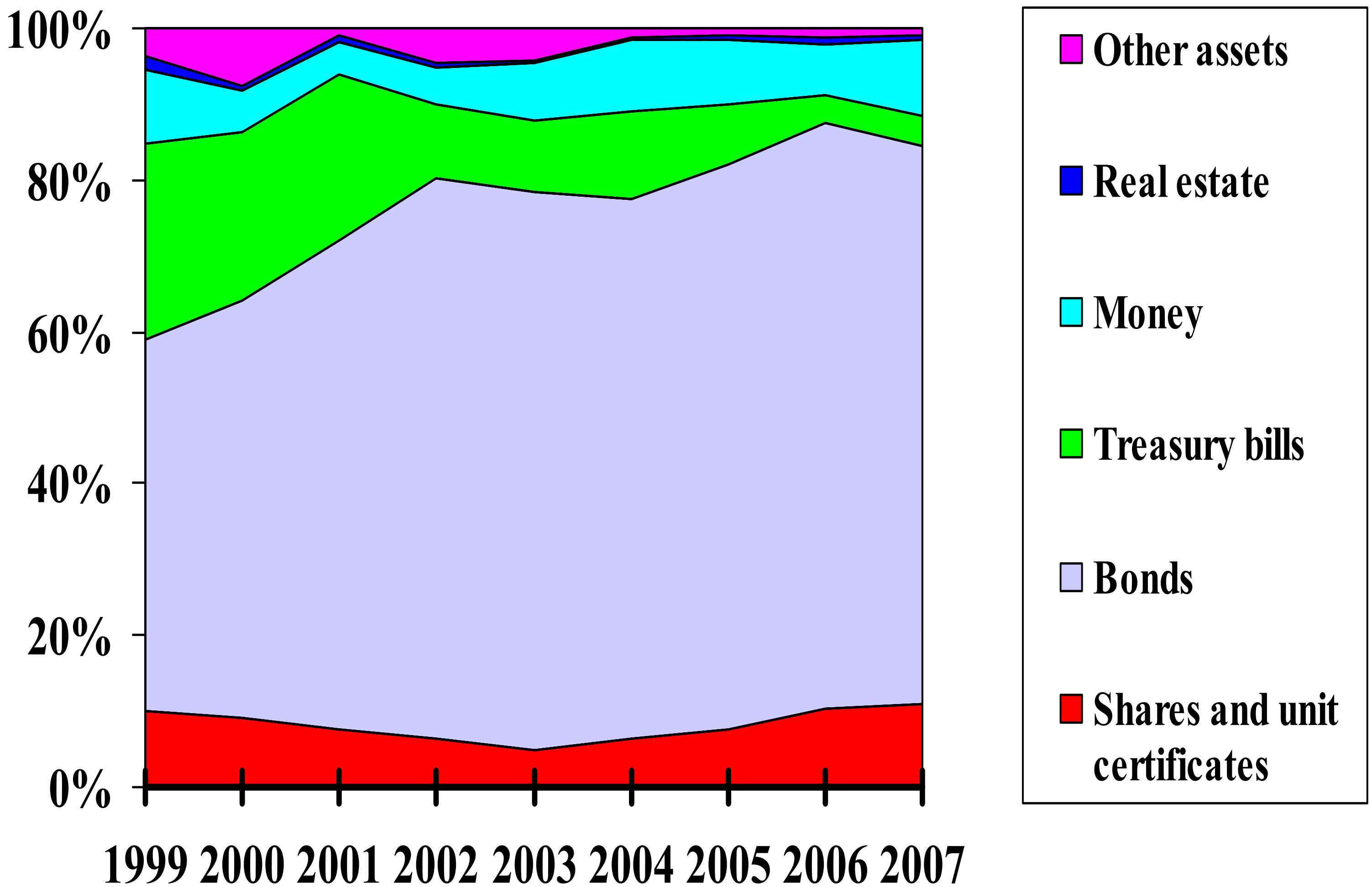
Source: APF

Pension Funds Assets (4. Q 2007)



Source: APF

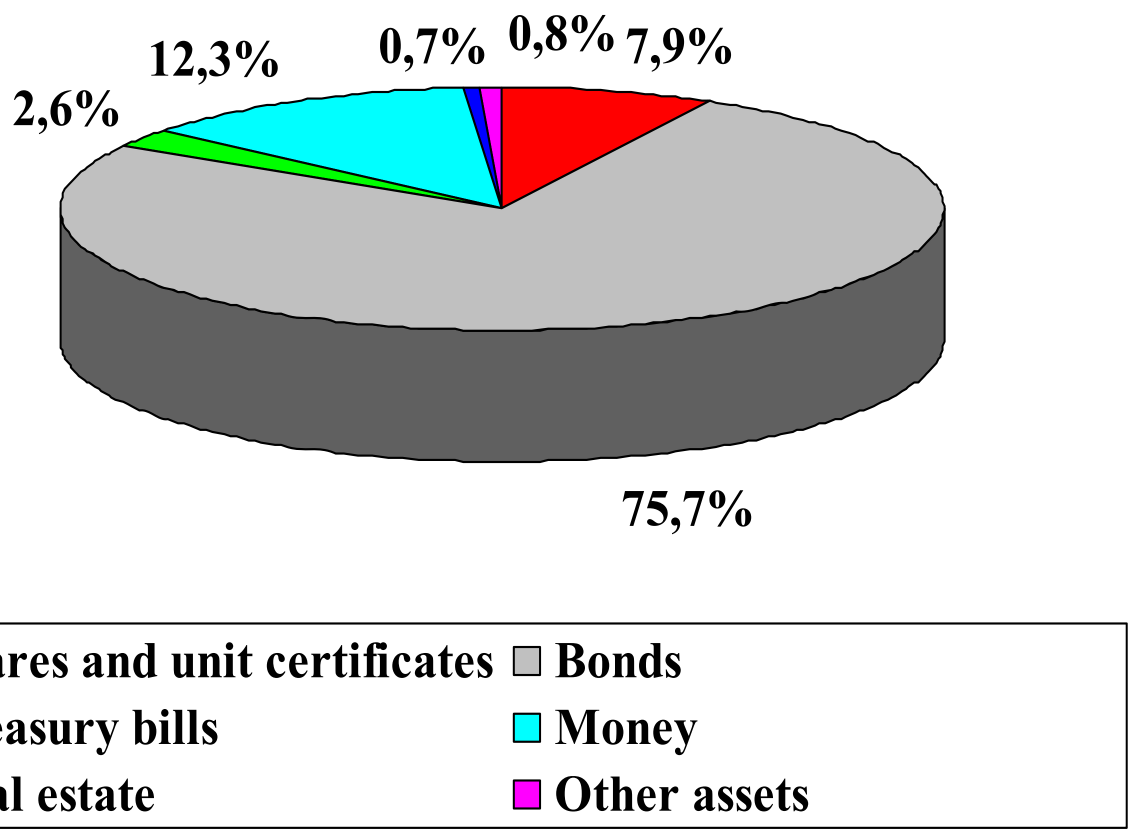
Pension Funds' Investment Portfolio



Source: APF

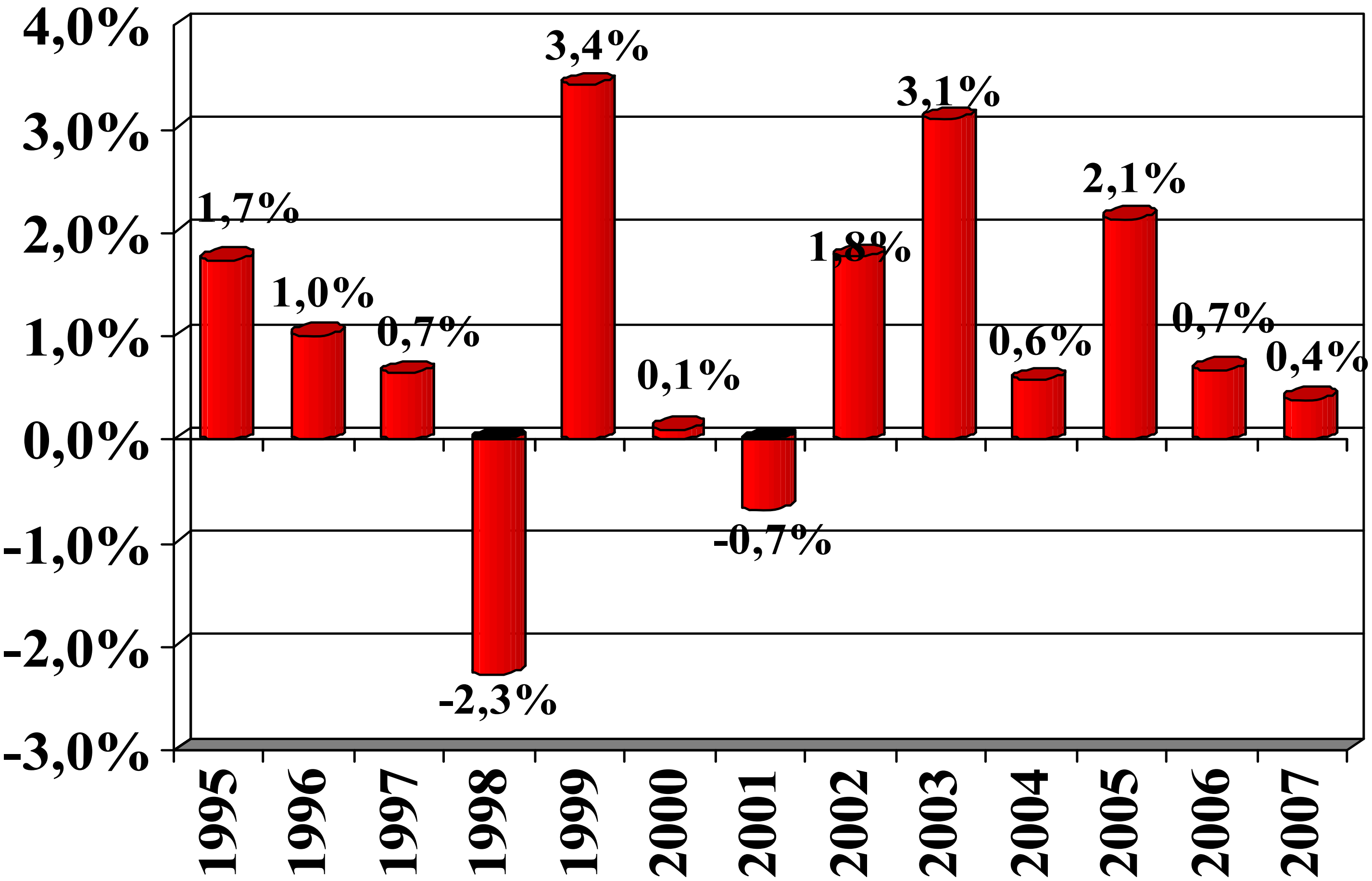
Pension Funds' Investment Portfolio

3.Q 2008

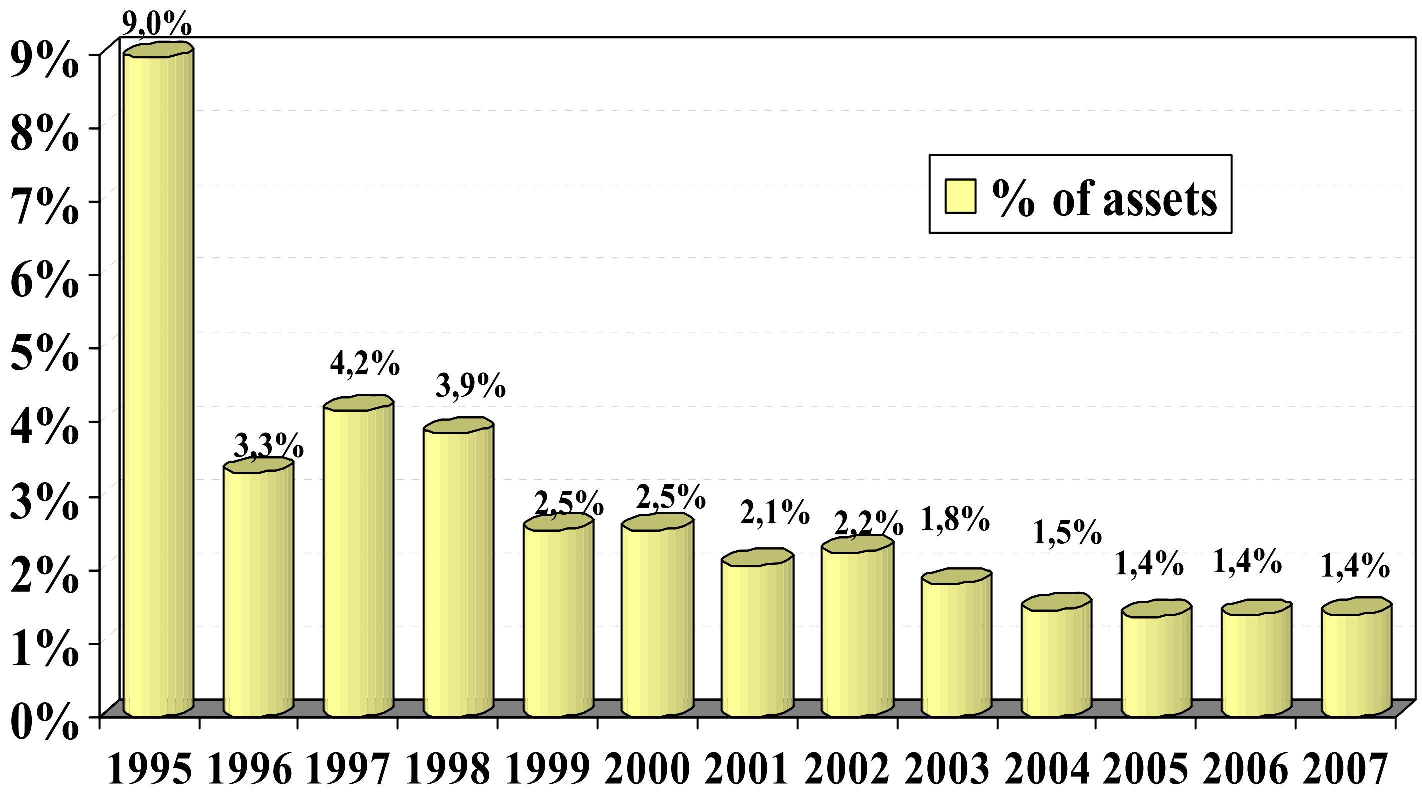


Source: APF

Real Average Return

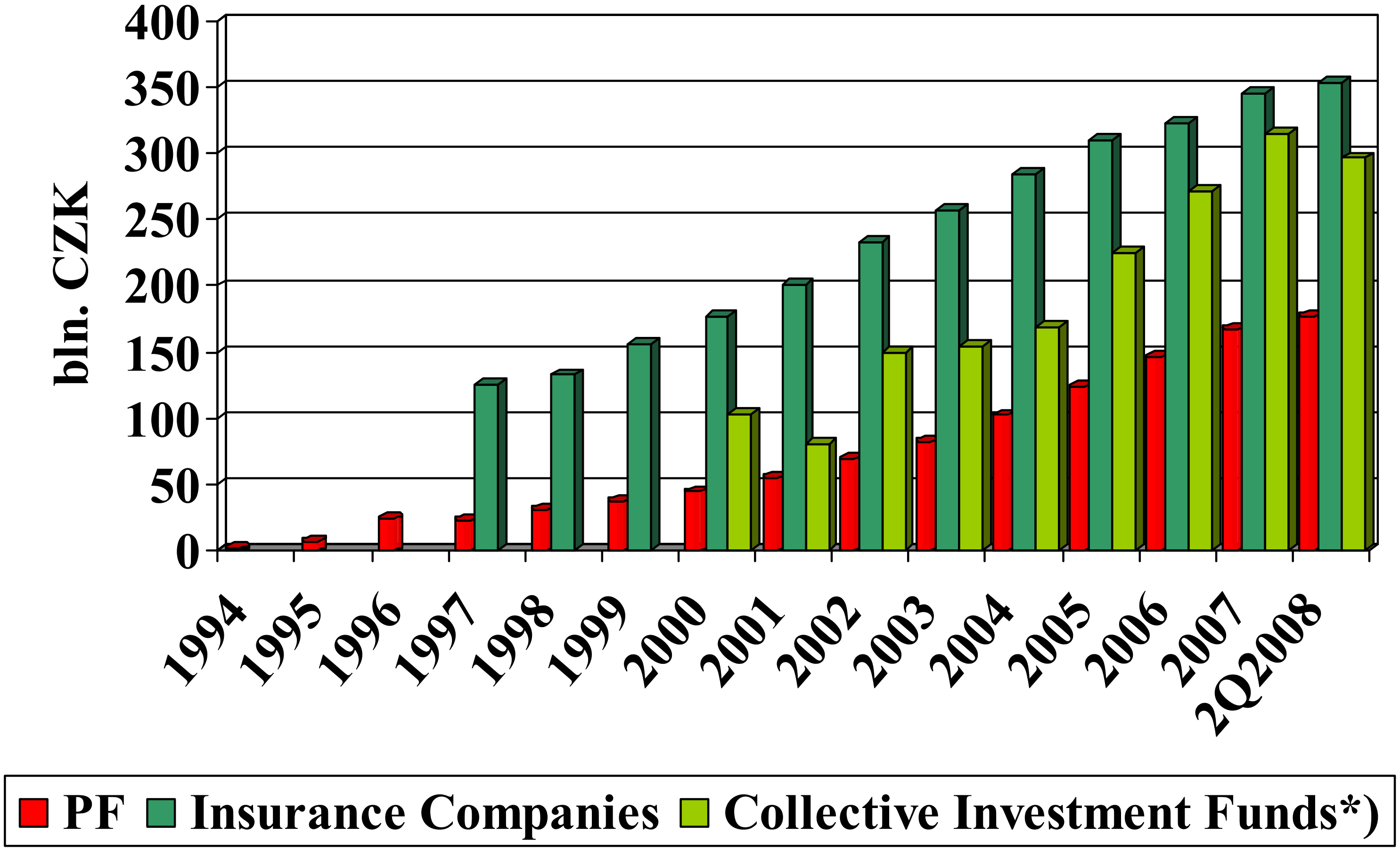


Operating Costs



Source: APF

Assets under Management



Source: APF, Ministry of Finance, Czech National Bank

*) Since 2002 including foreign entities

Legal Status of Pension Funds

- Pension fund is a legal entity (joint-stock company)
- Minimum registered capital – CZK 50 million
- Licensing : CNB in agreement with MLSA
- Status and pension plan - an integral part of the license
- Status includes: aims and objectives of investment policy, management principles, method of distribution of profit, custodian bank, method of publishing reports
- Distribution of profit: at least 5% into the reserve fund, max.10% according to the decision of shareholders

Pension Plan Must Include

- Types of pensions;
- Conditions for entitlement to benefits and their payment;
- Method of calculation the benefits;
- Reasons for contract’s cancellation;
- Rules for contribution’s payment;
- Rules for deferment of or interruption in contribution’s payment and changes in the amount of contribution’s payment;
- Rules and methods of payment of contributions and the procedures affecting non-remittance or late or incorrect remittance;
- Conditions for acceptance of financial means from supplementary pension insurance with another pension fund and the adjustment of entitlement on the basis of such acceptance;
- Principles according to which the beneficiaries including pension recipients participate in the distribution of pension fund's revenues.

Consumer Protection

- Special law and specialisation of pension funds
- Licensing, including pension plan approval
- Investment rules
- State supervision (Ministry of Finance and Czech National Bank)
- Custodian bank, auditing, annual reporting
- Code of good practice of the APF
- Only DC type of plans
- Easy change of PF and possibility of lump sum payment instead of annuity

Investment Rules

Financial means (at least 95%) may be placed in:

- Bonds issued by OECD member states or by central banks of OECD member states
- Bonds issued by EIB, EBRD, IBRD or another financial institution of which the CR is a member
- Participation certificates of mutual funds
- Securities traded on regulated market of a country in OECD, which market is permitted by authority of member state
- Movables constituting guaranteed safe deposit of financial means (with exception of securities)
- Real estate providing a guarantee of reliable placement of financial means and serving for commercial or residence purposes
- Deposit accounts, books at bank or branch of foreign bank in territory of CR or member states of OECD

Investment Rules (cont.)

- Fund is allowed to own < 20% of the nominal value of securities issued by 1 issuer (with exemption of bonds)
- Maximal value of securities by 1 insurer < 10% fund‘s assets (with exemption of bonds)
- Maximal value of cash deposited with one bank < 10% fund‘s assets or CZK 20,000,000
- Total value of movables and real estate < 10% assets
- At least 70% of fund’s assets must be invested in assets denominated in currency in which liabilities to participants are stated
- Total value of participation certificates , securities traded on regulated market, movables and real estate < 70% assets

State Contribution

Participant's contribution	*State contribution*
CZK 100 – 199	CZK 50 + 40% of the amount over CZK100
CZK 200 – 299	CZK 90 + 30% of the amount over CZK 200
CZK 300 – 399	CZK 120 + 20% of the amount over CZK300
CZK 400 – 499	CZK 140 + 10% of the amount over CZK 400
CZK 500 and more	CZK 150

Tax Relief

- **pension fund** – on its revenues
- **participant** who pays more than CZK 6,000 a year can deduct the contributions exceeding CZK 6,000 from his tax base, up to a maximum of CZK 12,000
- **employer** can include contribution paid on behalf of an employee in costs
- **employee** is exempt from income tax on the contribution paid by the employer, max. CZK 24,000

Weeknesses of the Private Pension Pillar

- Underdevelopment of private savings
- Short – term character of savings
- Low returns of pension funds

V. Pension Reform Perspective

1st Stage of the Pension Reform

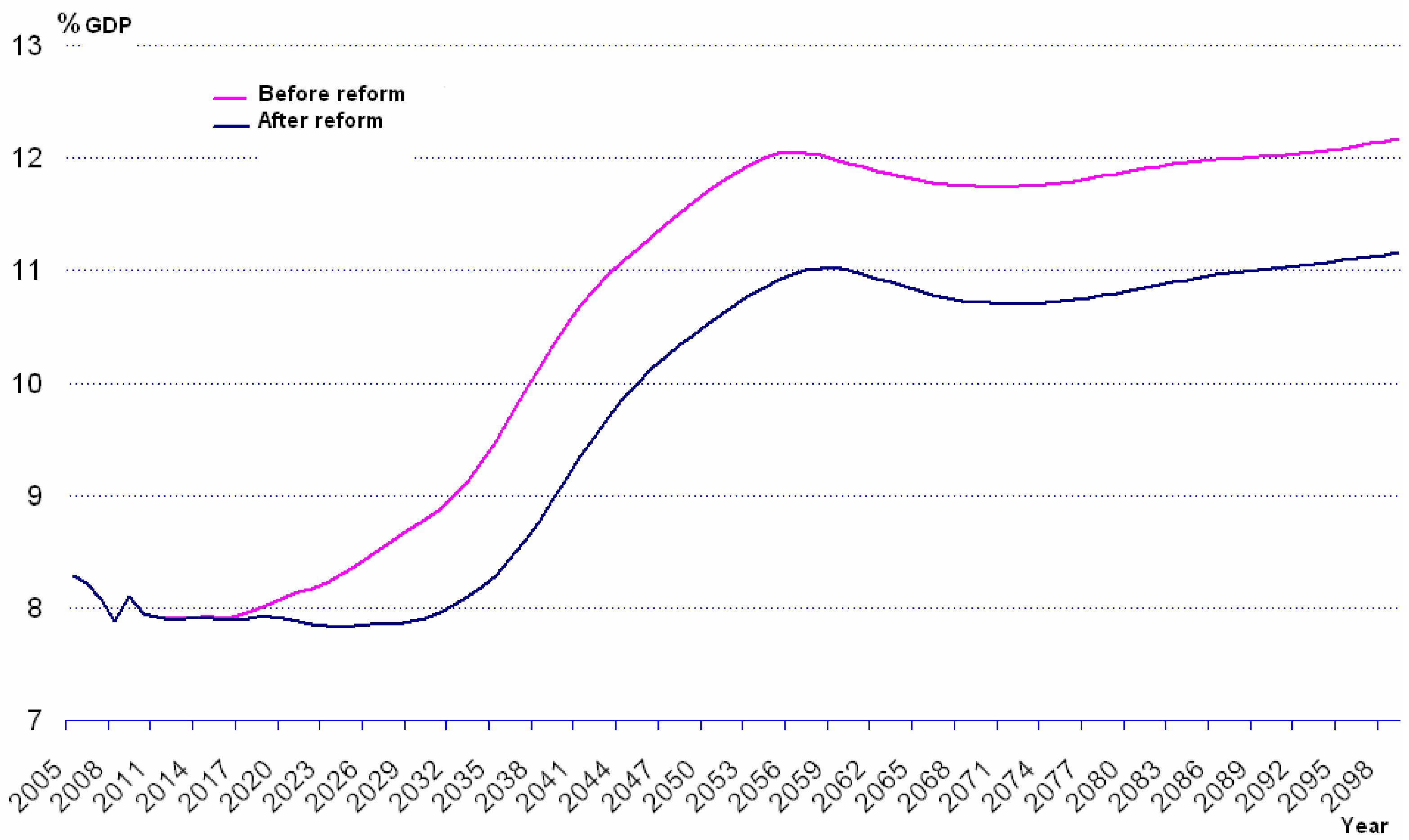
Law No. 306/2008 Coll., effective 1/1/2010

Main Measures

- Continuation of gradual increasing of the retirement age to 65 years for men and women with no or one child and 62 to 64 years for women with more children.
- Extension of the insurance period required for entitlement to the old age pension to 35 years (20 years) for insured persons retiring after 2018.
- Reduction of non-contributory periods (period of studies will no longer be taken into account as a non-contributory insurance period, crediting of non-contributory insurance periods for entitlement to the old-age pension will be limited to 80%).
- Changes in invalidity pensions.
- Period for early old-age retirement will be gradually extended from 3 to 5 years and the reduction of the percentage-based assessment in the case of early retirement will be higher.

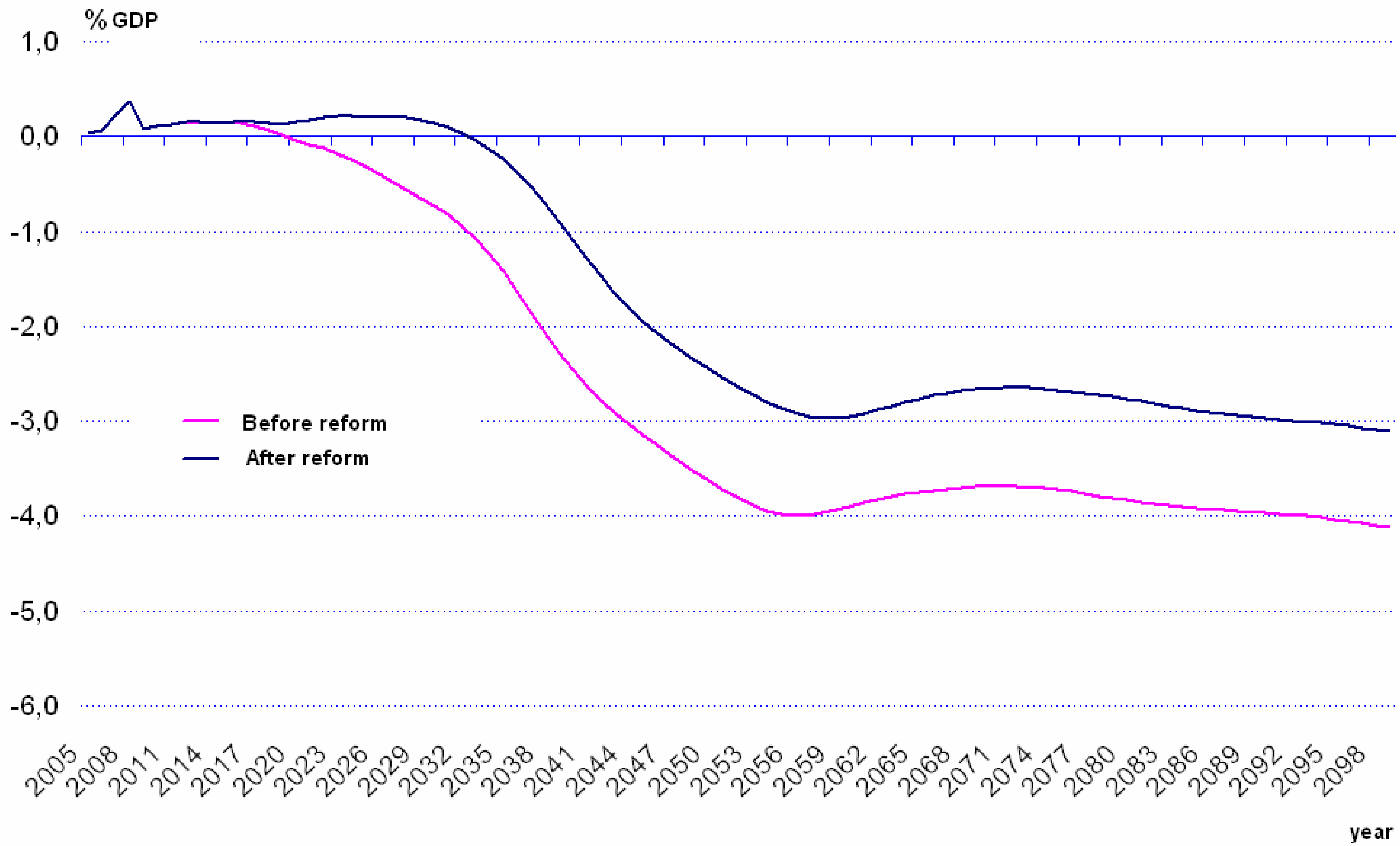
Expenditure on pensions

as % GDP before and after the adoption of parametric changes (Act No. 306/2008 Coll.)



Balance of the pension system

as % GDP before and after the adoption of parametric changes (Act No. 306/2008 Coll.)



2nd Stage of the Pension Reform

Law under preparation, effective since 2010

Goals of the 2nd stage of PR

Measures concerning the public basic insurance (1st pillar):

- To create a reserve for pension reform.

Achieved by the amendment of the Act on Budget Rules, effective 3/2008.

Measures concerning supplementary private pensions, mainly:

- To separate assets of participants and shareholders.
- To extend pension funds' portfolio with the possibility of higher returns.
- To create incentives for life annuities.

Steps Taken to Achieve the Goals (supplementary private pensions)

- In 2006, a working group of experts from the Ministry of Finance, Ministry of Labour and Social Affairs, Czech National Bank and Association of Pension Funds was set up.
- In October 2008, the government adopted a draft document ‘Thesis For the Preparation of a New Act on Supplementary Pension Insurance’.
- In December 2008, the Ministry of Finance prepared a proposal of the Act on Pension Savings that should come into effect 1/2010.

Main Principles of the Pension Savings Scheme

Parallel structure

- A new scheme of pension savings will be implemented alongside the existing scheme of supplementary pension insurance.
- Supplementary pension insurance scheme will continue to exist (without any time constraints), however, it will be closed for new participants (in twelve months after the Act comes into effect).
- Participants of supplementary pension insurance will have a choice to stay in this scheme or to switch to the pension savings scheme.

Main Principles of the Pension Savings Scheme (2)

Transfer of financial means from old to new scheme

- Transfer of participant's financial means to the new scheme will follow the same rules as in the case of such transfer between pension funds in the supplementary pension insurance scheme.

- Transfer will be possible:
  - Free of charge in case of transfer of financial means from a pension fund to a pension company of the same business group as the pension fund.
  - With fee in case of other pension company.

Main Principles of the Pension Savings Scheme (3

Pension company and participants' funds

- Assets in participants' funds will be managed by new entities - management companies.

- Management company can set up and manage several participants' funds with different investment strategy
  - 3 compulsory funds (conservative, mixed and dynamic).
  - In compulsory conservative fund will be allocated also financial means of participants who 1) will be entitled to pension in 5 years, 2) are entitled to pension and 3) are drawing a fixed-term pension.

- Pension company can charge a management fee (max. 2% of the yearly average value of the pension fund's shareholders' capital) and other fees (in cases defined by law, e.g. transfer of financial means).

Main Principles of the Pension Savings Scheme (4)

Participant’s financial means in participants’ funds

- Participant’s financial means can be placed in one or more participants’ funds of the same pension company.
- Participant will be credited with corresponding number of pension units according to the value of his financial means.
- Value of the pension unit can vary according to the situation on financial markets.
- A fee may be charged for transfer of financial means from one to another pension company (depending on the duration of contract with one pension company).

Main Principles of the Pension Savings Scheme (5)

Benefits

- Pension company pays out:

    fixed-term old-age pensions
    fixed-term invalidity pensions
    lump sum payments
    termination settlements

- Insurance company pays out:

    lifetime pensions
    fixed-term pensions with fixed amount

Incentives for Higher Contributions and Lifetime Pensions

Saving in the pension savings scheme will be supported by state by means of direct state contribution and tax reliefs (same as in the supplementary pension insurance scheme).

Implementation of the new scheme will be accompanied by:

- change in provision of state contribution – increase in participant's contribution limits for entitlement to state contribution (at least CZK 300);
- change in Act on Income Taxes
  - exemption of lifetime pensions from tax,
  - increase in limit for tax exemption of employer's contributions (from CZK 24,000 to 36,000).

3rd Stage of the Pension Reform

Concept prepared, effective ??

Goals of the 3rd stage of PR

To create additional pillar of the pension system with the possibility to (partly) opt-out from the 1st pillar.

Diversification of sources of income in old-age (combination of pay-as-you-go and capital funding).

The concept was prepared by MLSA and presented to the government in January 2009.

Main Principles

Voluntary decision to join the 2nd pillar

- Insured persons may decide to join the 2nd pillar; part of their compulsory pension contributions will be transferred to their individual accounts and invested.
- One choice to join and one option to leave the 2nd pillar
- Those who decide to opt-out from the 1st pillar will pay higher contribution rate (4+2% to 2nd pillar).
- Pension from the 1st pillar will be reduced, however, the level of protection in the pension system will be maintained (e.g. coverage of non-contributory periods, basic pension amount).

Main Principles (2)

Saving phase

- Management companies –all institutions that obtain a special licence, e.g. existing institutions will be involved.
- Only one fee – management fee.
- Management companies will have to offer at least 3-5 participants' funds with different investment strategies; automatic transfer of financial means to conservative strategy at a given age.
- Anonymous relationship client-management company.
- Key role of the pension public administration authority (stays between insured person and management company, individual accounts, contribution collection).

Main Principles (3)

Payout phase

- Only old-age pensions (annuities).
- One compulsory type of annuity (lifetime pension, constant amount), possibility to provide for other types of annuities.
- Pensions form the 2nd pillar will be provided by institutions with special licence, mainly life insurance companies.
- Anonymous relationship client-pension provider.
- Role of the pension administration authority – to offer annuities to participants, to pay out pensions (the role is not to render financial advice).

Thank you for your attention