Pension System Reform in the Czech Republic

April 1st, 2011

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Design of the Czech Pension System

-The Czech Republic is one of the last European countries to carry out Pension System Reform

-Absence of II. Pillar (Occupational Pension Funds or Fully Funded) and Direct State Subsidy in III. Pillar are the main differences from standard EU pension systems

- Strong willingness of politicians to implement Pension System Reform

<table>
<thead>
<tr>
<th>Criteria</th>
<th>I. Pillar</th>
<th>III. Pillar</th>
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<tbody>
<tr>
<td></td>
<td>Pension Insurance</td>
<td>Pension Funds</td>
</tr>
<tr>
<td>State Guarantee</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Personal Coverage</td>
<td>all working population</td>
<td>individual</td>
</tr>
<tr>
<td>Participation</td>
<td>mandatory</td>
<td>voluntary</td>
</tr>
<tr>
<td>Financing</td>
<td>pay as you go</td>
<td>fully funded</td>
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<tr>
<td>Type of Plan</td>
<td>defined benefit (DB)</td>
<td>defined contribution(DC)</td>
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<tr>
<td>Benefits</td>
<td>depends on service years and level of wage</td>
<td>depends on contribution and return</td>
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<tr>
<td>Tax Incentives</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>State Subsidy</td>
<td>no</td>
<td>yes</td>
</tr>
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Key Weaknesses of the Czech Pension System

- State PAYG is unsustainable from even a medium term perspective:
  - Demographic trends among the worst in Europe
  - State budget pension deficit, appearing over the past two years (almost 1% GDP yearly despite high social security payments), would become significantly larger without reform
- Lack of diversification due to absence of other substantial retirement sources (94% of pensioner sources come from PAYG)
- PAYG Pillar payout is too egalitarian: Pension levels almost the same regardless of level of contribution
- Due to design, current III. Pillar does not represent a sufficient additional source for retirees
- Little willingness to save money for retirement at all, let alone the minimum funds necessary to maintain standard of living

- THEREFORE, REFORM IS UNAVOIDABLE; While reform is being prepared by the government, it is unfortunately badly communicated and lacks political consensus
Overview of the Pension System Reform (PSR)

- PSR is similar to reforms already implemented in other CEE countries and has three stages:
  - "Small" Reform – Changes in I.pillar (PAYG system)
  - "Big" PSR – Creation of II.pillar: Fully funded system planned from 1.1.2013
  - Transformation of current III.pillar Pension Funds into Pension Companies

**Proposed structure of CR Pension System from 1.1.2013**

**I. pillar**
Current State Pension
- Pay as you go (PAYG)
- Social insurance payments: 28% of employee tax base, 21.5% paid by employer and 6.5% by employee
  (2010 – EUR 12 bln. collected, EUR 1.2 bln. deficit)

**II. pillar**
Newly Created Funded Pillar – Private Providers, Voluntary Participation
- Opt – out: Transfer of 3% of social insurance payments from state pillar + 2% employees’ own contribution
- Pension companies will manage four funds:
  - Conservative
  - Balanced
  - Growth
  - CZ Government bonds

**III. pillar**
Supplementary Pension Insurance – Voluntary
- Pension companies with/without transformed fund (current PFs)
- At least 1 new fund to be created, in addition to existing funds awaiting transformation
- Direct state subsidy to remain

**Other Sources**
- Life insurance
- Buildings savings
- Mutual funds etc.
Why has the Czech government opted for the ´out of date´ World Bank Three-Pillar Model (with several exceptions)

- Time constraints precluded complete rebuilding of current pension system; NDC system not proposed due to negative impact expected on below-average wage earners (2/3 of the working population); Current PAYG system is more generous to below-average earners than need be

- Intended reduction of high labour tax burden and increase of Czech economic competitiveness; Occupational pensions are therefore not proposed

- Voluntary participation without II.pillar opt-out, a compromise between mandatory and voluntary pensions, results from differing views of government coalition parties

- Lessons learned from CEE experience: 3% transfer from PAYG (limited level of deficit) and long-term financing by VAT harmonization at 17.5% (from 10% and 20%)

- PAYG to remain main source for retiree pensions; Parametrical changes – such as later retirement age as per life expectancy and reduction of early retirement – to be introduced

- Government also sought to increase level of personal savings, therefore introduced an additional 2% of employee contributions

- Current pension funds infrastructure to be used in implementation (EUR 9bil. of AUM)

- Investment advisors and financial intermediaries to be allowed to operate and distribute upon regulator approval; Level of commission to be regulated

- Key Questions: Will the Czech government realize the reform? Will the reform survive changes in government?