Original Article

Major pension fund reform in the Czech Republic: Creating a three-pillar system

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ABSTRACT This article examines forthcoming pension fund reform in the Czech Republic. It does so in the context of the reforms that have happened in other Central and Eastern European countries. It analyses the new mandatory funded pillar and, in particular, the choices that different sections of the Czech population will have to make regarding the pillar, the contributions that will be paid to this pillar and the different types of account that will be made available. The article also analyses the changes to the voluntary pillar and, in particular, who can participate in such arrangements. The article further evaluates how funds will be established and administered, the bodies that will undertake this, the capitalisation of such bodies and where they will be entitled to invest fund assets. Finally, it examines the tax treatment of funds and the opportunities that will arise for financial institutions in relation to this sector.

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Most of the former command economies in Central and Eastern Europe have implemented radical pension reforms over the last 15 years. In most part, this has consisted of partial privatisation of pension systems, so that some of the contributions formerly made to the State pay-as-you-go system (PAYGS) are now made

to privately managed pension funds. Such funds are normally managed by dedicated pension fund management companies, which are, in turn, usually owned by insurers and other financial institutions. The rationale behind many of the reforms was that the funds would invest heavily into domestic markets. However, the high proportion of government paper held by funds in certain countries has caused some commentators to question whether the reform is as deep seated as it may first appear.

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The economic crisis from 2008 onwards caused a number of countries to reduce the role of privately managed funds in the overall pension system. In the case of Poland, this consisted in a reduction in contribution levels. In the case of Hungary, there has been an almost whole-scale elimination of the mandatory funded pillar.

Until very recently, the Czech Republic stood out from other countries in the region by having implemented very few changes to its PAYGS. In the mid-90s, it introduced the so-called third pillar of voluntary privately managed pension funds. These offered limited tax reliefs, but did grant an additional state contribution on top of those contributions made by the individual. The system of state contributions created an incentive for large numbers of Czech citizens to contribute, but most only did so at a relatively low level. Unlike most other countries, the Czech Republic did not implement a second pillar of mandatory pension funds. This was despite the fact that there were frequent proposals for such reforms. This has finally changed.

However, the Czech Republic has passed laws substantially reforming its pension system. Because of obstructions from opposition parties in the Parliament and owing to the negative standpoint of the President towards the reform, it was not clear until the very last stage of the legislative procedure whether the reform would be approved. However, at the end of 2011, the relevant laws introducing reform were finally successfully passed by a small majority of votes in the Parliament. The new laws introduce the most significant reform of the Czech pension system, as the communist regime collapsed in 1989. The pension reform will come into effect as of 1 January 2013; however, specific provisions allowing for the establishment and licensing of new pension fund companies came into effect in January 2012.

The pension system is mostly based on the mandatory PAYGS and supplementary current Czech schemes with state contribution. Under the new law, the current PAYGS (first pillar) of the pension system will be supported by a newly created second pillar, and the current

supplementary schemes will be transformed into a third pillar.

NEW SECOND PILLAR

The new second pillar will utilise privately managed pension funds. Entry into the second pillar will be voluntary and made by individuals. Employers will play no role in the process. Each participant to the PAYGS will have to choose, before reaching the age of 35, whether to join the second pillar. Participants over 35 years of age on 1 January 2013 will have six months to decide whether to join the second pillar. Upon deciding to join the second pillar, part of the mandatory payments already made by the participants to the PAYGS will be redirected to the second pillar. In practice, participants to the second pillar will still have to remain as participants in the PAYGS (first pillar). The decision to join the second pillar will be permanent; participants will not be able to exit the second pillar.

Currently, contributions to the PAYGS are made at a rate of 28 per cent of the assessment base of salaries/incomes of the participants. In respect of those participants who are employees, the contribution to the PAYGS consists of two parts: (i) deduction from the participant's salary at a rate of 6.5 per cent of the assessment base of the participant's salary; and (ii) contribution made by the participant's employer at a rate of 21.5 per cent of the assessment base of the participant's salary. The calculation of the contributions and the transfer to the relevant authorities administering the PAYGS is made by the employer.

As noted above, the pensions reform will allow the participants of the PAYGS (first pillar) to decide whether to also participate in the second pillar. Once an individual decides to participate in the second pillar, his/her total contribution will increase by 2 per cent of the assessment base of his/her salary, that is, to 30 per cent. This 30 per cent contribution will then be split into two parts: (i) a deduction from the participant's salary in the amount of 8.5 per cent of the assessment base of the participant's salary; and (ii) a contribution made

by the participant's employer in the amount of 21.5 per cent of the assessment base of the participant's salary. Out of this 30 per cent, 5 per cent will be allocated to the participant's account at the second pillar pension fund chosen by the participant, and the remaining 25 per cent will be transferred to the PAYGS (first pillar). It should be noted that gross salary is taken into account for the purpose of these calculations.

The new law enables an individual to choose freely between different types of second pillar pension fund. The main types of funds are: standard funds, conservative funds, balanced funds and dynamic funds. The investment profile of these funds is mandated by law and will be described later.

NEW THIRD PILLAR

The third pillar of the pension system will be created by a substantial reform of the current system of supplementary schemes. The current supplementary schemes will be converted into so-called 'transformed pension funds' and will not be permitted to accept any more new participants. In parallel, a new type of third pillar supplementary fund with state contribution will be created. Participation in these new third pillar supplementary funds will be voluntary. Participants will be allowed to join, in addition to participation in the first and second pillars. In contrast to the second pillar, participants will be allowed to join and exit the third pillar at any time. The participants can join a third pillar fund after they reach the age of 18. Contributions to third pillar supplementary funds will be made by the participants. However, upon consent by a participant, contribution on behalf of the participant to the third pillar supplementary fund can either entirely or partially be made by the participant's employer.

ADMINISTRATION OF SECOND AND THIRD PILLAR FUNDS BY PENSION FUND COMPANIES

The administration of both second and third pillar funds will be handled by pension fund companies, which will be created either by

the transformation of the existing pension funds providing supplementary pension insurance or by establishing completely new pension fund companies. Each pension fund company will have to obtain a special licence for its activities within the second pillar and/or the third pillar from the Czech National Bank. Each second pillar pension fund company will have to offer four types of pension funds (with different investment limits, portfolio structure and associated risk): a standard pension fund; a conservative pension fund; a balanced pension fund; and a dynamic pension fund. Each third pillar pension fund company will have to offer at least one conservative pension fund; other types of funds can be offered by the third pillar pension fund company depending on its business strategy.

Under the new laws, the pension fund companies will be entitled to two types of remuneration for administration of the second pillar and third pillar funds: (i) remuneration for the administration of assets of the funds, and (ii) remuneration for increase of value of the funds.

The remuneration for the administration of assets of second pillar funds cannot be higher than: 0.3 per cent of the average yearly value of the fund's equity in respect of standard pension funds; 0.4 per cent of the average yearly value of the fund's equity in respect of conservative pension funds; 0.5 per cent of the average yearly value of the fund's equity in respect of balanced pension funds; and 0.6 per cent of the average yearly value of the fund's equity in respect of dynamic pension funds.

The remuneration for the administration of assets for third pillar funds cannot be higher than: 0.4 per cent of the average yearly value of the fund's equity in respect of conservative funds; and 0.8 per cent of the average yearly value of the fund's equity in respect of other funds.

Remuneration for the increase of value in respect of second pillar and third pillar funds cannot be higher than 10 per cent of the difference between the average yearly value of a pension unit in the respective time period and the highest average yearly value of the pension unit in

years, preceding the respective time period starting from the establishment of the fund, multiplied by the average yearly number of pension units. The remuneration for the increase of value for second pillar funds can be charged only in respect of conservative, balanced and dynamic pension funds.

MINIMUM INITIAL CAPITALISATION

The minimum initial capitalisation of a second pillar pension fund company is CZK 300 000 000 (approximately EUR 12 000 000). The minimum initial capitalisation of a third pillar pension fund company is CZK 50 000 000 (approximately EUR 2 000 000). The initial capitalisation is defined as the sum of the paid-up registered capital of the company plus paid-up issue premium. The registered capital and the issue premium of a second pillar pension fund company, or a third pillar pension fund company can be paid up only in the monetary form (that is, non-monetary contributions to the registered capital or the issue premium are not allowed).

INVESTMENT OF FUND ASSETS

Funds are entitled to invest in Czech and non-Czech assets. The legislation envisages detailed restrictions on the maximum amounts that can be invested in certain classes of assets. As a general rule, conservative funds can only invest in bonds issued by the Czech Republic, by the Czech National Bank, by other EU or OECD states and certain bodies such as the World Bank. Conservative pension funds have a similar profile, but permit investment in certain other financial instruments (that have an investment level rating) and in mutual fund units. Balanced pension funds may invest in shares accepted for trading on regulated markets and certain other securities, but these must not exceed 40 per cent of the value of the fund assets. Dynamic funds have a very similar profile to balanced funds, but may also invest in

securities issued by collective investment funds. Further regulations will be issued prescribing in greater detail the amount that can be invested into particular asset classes.

TAX TREATMENT

Czech law provides for several tax benefits in respect of pension savings in the second and third pillar funds. Individuals may deduct their pension savings contributions in an amount up to CZK 12 000 (approximately EUR 480) from their tax base (this applies to both second and third pillar). Furthermore, employers may deduct pension savings contributions paid in favour of their employees in an amount up to CZK 24 000 (approximately EUR 960) from their tax base (this applies to third pillar only). It should also be noted that pensions (incomes from payments of pension funds under the second and third pillar) shall not be subject to income tax. Pension funds are, however, subject to corporate income tax.

BUSINESS OPPORTUNITIES

The pension reform will offer significant business opportunities for existing life insurance companies and new market entrants. Life insurance companies may benefit, because having reached retirement age participants to the second pillar and some participants to the third pillar will receive payments via pension insurance policies concluded with insurers duly licensed to provide such types of life insurance in the Czech Republic. In addition, the pension reform will bring new business opportunities for banks that will be allowed to act as depositories for both the second pillar and third pillar pension fund companies, and for various types of intermediaries (such as capital markets brokers and so on) who will be allowed to act as distributors for the new products generated by the second and third pillar pension fund companies.