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REVIEW

CURRENT PROBLEMS OF THE CZECH STATE-CONTRIBUTORY SUPPLEMENTARY PENSION INSURANCE

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Abstract
State-contributory supplementary pension insurance is a popular product in the Czech Republic. According to the Association of Pension Funds of the Czech Republic, as of 31 December 2010 the pension funds kept files of approximately 4.54 million participants, with savings amounting some 216,109 billion crowns. In the long run, the pension funds show stabilized financial results (however, in return for low revenue). Although the pension funds have always reached positive or at least zero appreciation of clients' savings (as it was required by law), once you have included the inflation rate, the situation becomes very different. Regulatory restrictions on the side of the state, along with high costs on the side of the pension funds are the main reasons why the revenue allotted to the participants more or less only oscillates around the inflation rate.

The state-contributory supplementary pension insurance in its current form does not fulfil its primary function. Moreover, without significant support provided by the state the scheme is not even capable of competing with life-cycle mutual funds or other substitutes offered on the financial market. If, for the future, the supplementary pension insurance is intended to be a part (to be one of the pillars) of the pension scheme, fundamental reform is needed. Therefore, besides the analysis of the status quo, this article deals with a framework determination of necessary reform measures as well.

Key words: *pension; retirement; pension fund; supplementary pension insurance; private pension scheme; participant's contribution; state contribution*

INTRODUCTION

The amount of the retirement pension in the Czech Republic is considered to be adequate by 23% of the citizens. On the other hand, according to 77% of the respondents, the amount of the retirement pension for elderly people is inadequate, while 45% out of these respondents consider the retirement pensions to be "totally" inadequate.

The voluntary private pillar forms an additional segment in the social security system (Krebs et al. 2007). It is based on ***private voluntary insurance***, whose aim is to separate the redistribution function and the saving function.

It is based mainly on the following principles and starting points:

- voluntary contractual insurance for individuals;
- separation from the state (i.e. separation of the funding through the state budget or para-fiscal social security fund within the budget system);

- dissolution of inter-generation redistribution;
- generating insurance-technical reserves in insurance companies;
- use of the concept of equivalence between payments from the insured and the allowances to be paid out in the future.

A typical feature of a voluntary private pillar is ***keeping to the principle of equivalence and using an allowance derived from earnings***. Another characteristic feature is state support, usually in the form of tax benefits (Tröster et al. 2010).

In the Czech Republic, ***state-contributory supplementary pension insurance*** was introduced within the voluntary private pillar (as a supplementary pension scheme).

Its aim was to help people when they retire – it was planned that a certain amount of money would be added to their state pension every month. However, it does not work this way at all. As soon as the saving period expires, an overwhelming majority of the participants collect the lump-sum settlement, while regular pensions are rather rare. The state contribution and the tax benefits are really helpful as the product is used by over 4.54 million active participants, but the average amount of savings per participant is a mere 47,600 CZK.

The average monthly contribution paid by a participant (net of the state support) does not even reach 500 CZK despite the great support given to the companies – employers – who contribute for their employees participating in supplementary pension insurance.

It is obvious that the ***direct support provided by the state to this product does not seem to be money that is being spent functionally***.

The characteristics of state-contributory supplementary pension insurance

State-contributory supplementary pension insurance is, in a way, a specific Czech particularity. It has features of life insurance but it is not life insurance. It looks like regular investing but the pension funds are not allowed to follow the rules of regular investing. In short, the state-contributory supplementary pension insurance follows special rules.

The state-contributory supplementary pension insurance was introduced in the Czech Republic by Act No. 42/1994 Coll., the State-Contributory Supplementary Pension Insurance Act on state-contributory supplementary pension insurance and certain acts related to its introduction, as amended.

According to the above-specified act, ***state-contributory supplementary pension insurance*** means the collection of financial contributions from participants in supplementary pension insurance (and from the state as provided for the benefit of the participants), management of such financial contributions, and the payout of supplementary pension insurance benefits. Supplementary pension insurance cannot be carried on by any entities other than pension funds. A natural person may become a participant if he is over 18 years of age and has permanent residence in the Czech Republic. The supplementary pension insurance policy must be concluded in writing with a pension fund.

The act on supplementary pension insurance defines two types of pension plans:

- defined-contribution pension plan;
- defined-benefit pension plan.

The pension plan is conceived as a defined-contribution pension plan if the size of the pension benefits is dependent on the sum of the contributions remitted in the participant's favour, on the participant's share of the pension fund's revenues, and on the age from which the pension benefits are to be provided.

In the case of the defined-benefit pension plan, the pension amount is determined ahead of time and is not dependent on the sum of the contributions remitted (the pension fund guarantees an agreed amount if the conditions for entitlement to such pension are met).

The act on supplementary pension insurance determines the scope of the ***benefits from the supplementary pension insurance*** which can be provided to participants in supplementary pension insurance, as well as the general conditions of entitlement to these benefits (the specific conditions are included in the pension scheme).

There are three types of allowances paid from the supplementary pension insurance:

- **Lump-sum settlement**

The allowance which shall be paid to the participant in supplementary pension insurance instead of a pension. It is the total of the sum saved by a participant (which consists of the contributions paid in by the participant and by his employer, of relevant state contributions, and of the share of the pension fund's revenues corresponding to the amount of the contributions from the participant and the employer).

- **Termination settlement**

The allowance which shall be paid to the participant in supplementary pension insurance or to the natural persons appointed in the policy. The amount of the termination settlement consists of the total of the sum saved by a participant (again, it comprises the contributions paid in by the participant and by his employer) and of the share of the pension fund's revenues corresponding to this amount. Neither the state contribution sums nor the pension fund's revenues from the state contributions are paid out to the participant within the termination settlement.

- **Pension**

A regular payment of a financial amount for a period determined by the pension plan (usually a lifetime payment). By law, the following types of pensions may be provided from supplementary pension insurance (the scope of pensions cannot be further extended by the pension fund):

– old-age pension;
– early-retirement pension;
– disability pension;
–survivors' pension.

A participant in supplementary pension insurance is obliged to pay contributions to the supplementary pension insurance pension fund. The size of a participant's contribution must not be lower than the amount establishing entitlement to a state contribution. A third party (usually the employer) may remit contributions, or a portion thereof, on behalf of a participant.

State support

The state contribution in the Czech complementary pension insurance represents an unusual instrument as in economically developed countries the state support normally means a deduction of the remitted insurance amount from the income tax base.

The state contribution is credited to a participant's account maintained by the pension fund and is included in the base (capital) which is used for determination of the size of the allowance. The state contribution is provided proportionally – it is dependent on the size of a participant's monthly contribution. The currently valid amount of the state contribution provided to the private pension scheme is shown in Table 1.

Table 1. Amount of the state contribution

Monthly participant's contribution (in CZK)	Monthly state contribution (in CZK)
100–200	50 + 40% of the amount over 100
200–299	90 + 30% of the amount over 200
300–399	120 + 20% of the amount over 300
400–499	140 + 10% of the amount over 400
500 and more	150

Source: Act No. 42/1994 Coll.

It is planned in the amendment to the act on supplementary pension insurance that the amount of the state contribution will be altered from 1 January 2013 so that the state will contribute to a participant only if the monthly participant's contribution is at least 300 CZK, and the participants whose monthly contribution is 1,000 CZK or more will receive a contribution amounting 230 CZK from the state.

Another significant support provided to supplementary pension insurance by the state (in addition to the state contribution) is tax relief – both for ***employees*** and for ***employers***.

Taxation

The latest factual changes in terms of taxation of the supplementary pension insurance are included in the amendment to the act on income tax, implemented by Act No. 261/2007 Coll., from 1 January 2008.

Tax relief for participants in supplementary pension insurance

Participants in supplementary pension insurance are allowed to lower their income tax base by a sum of contributions remitted during the taxable period as supplementary pension insurance, reduced by 6,000 CZK (pursuant to Sec. 15 (5) of Act No. 586/1992 Coll., on Income Tax, as amended, up to 12,000 CZK may be deduced from the income tax base).

The tax deduction of the contributions to the supplementary pension insurance can be claimed either by means of a participant's tax return or through his employer within the annual accounting of tax advance payments.

The eligibility for the deduction must be demonstrated by:

- acknowledgement of the amount of remitted contributions by the pension fund;
- supplementary pension insurance policy.

Taxation in terms of employer's contributions to employees (participants in supplementary pension insurance)

By amendment of the act on income tax, beginning from the year 2008, a common ceiling for exemption from tax on income in employer's payments to supplementary pension insurance and life insurance was introduced, amounting to 24,000 CZK (Sec. 6 (9) (p) of the Act on income tax).

Payments up to the above-mentioned limit:

- are exempted from employee's income tax (provided that the employee is a participant in supplementary pension insurance);
- are exempted from contributions to the social security system and health insurance system;
- can be claimed as the employer's costs, on condition that the contributions are mentioned in the collective agreement or the internal regulation (Sec. 24 (2) (j), clause 5 of the Act on income tax).

Payments over the limit:

- are not exempted from the employee's income tax;
- are not exempted from contributions to the social security system and health insurance system;
- can be claimed as the employer's costs in any amount, on condition that the contributions are mentioned in the collective agreement or the internal regulation.

Tax applied to allowances from the supplementary pension insurance

The tax applicable to allowances from supplementary pension insurance is determined in Sec. 36 (2) (n) and (s) and Sec. (8) (6) of the Act on income tax. Neither the state contribution nor the participant's contribution is subject to tax liability (but the revenues from the contributions and the employer's contributions are subject to tax liability). Beginning from the taxable period 2008, a unified tax rate amounting to 15% was introduced:

- in the case of the lump-sum settlement, the tax on revenue from contributions and the tax on employer's contributions is 15%;
- in the case of the termination settlement, the tax on revenue from contributions and the tax on employer's contributions is 15% (neither the state contribution nor the revenue from the state contribution is paid to the participant);
- in the case of pensions, the tax on revenue from contributions is 15% and the tax on employer's contribution is equal to zero.

Data about the state-contributory supplementary pension insurance

There are a total of 10 active pension funds in the Czech Republic (the number of the pension funds has decreased from originally

44 to the now active 10 pension funds, while the key positions in nearly all of them are held by foreign stockholders with strong capital). Their general economic characteristics and the positions on the market offering services in the field of supplementary pension insurance are shown in Tables 2 through 4.

Table 2a. Selected indicators related to pension funds as to 31 December 2010

Pension fund	Number of partici-pants	Funds registered in favour of participants (mil. CZK)		Registered capital (mil. CZK)	Reserve fund (mil. CZK)	Total assets (mil. CZK)
		Participants' contributions including revenues	State contributions including revenues			
AEGON PF	116,444	3,125	607	50.0	20.100	4,233.40
Allianz PF	156,211	7,970	1,426	60.0	91.571	10,556.76
AXA PF	456,348	28,544	4,341	398.5	493.000	36,279.00
ČSOB PF Progres	308,873	7,833	1,438	320.0	34.000	10,134.00
ČSOB PF Stabilita	431,741	15,009	2,754	297.0	151.000	19,346.00
Generali PF	55,499	2,264	369	50.0	21.000	2,854.00
ING PF	429,126	20,550	3,361	50.0	170.000	25,492.00
PF České pojišťovny	1,179,881	44,203	7,922	214.0	323.000	55,305.00
PF České spořitelny	907,803	29,854	5,319	350.0	194.000	37,624.00
PF Komerční banky	501,199	24,407	3,977	200.0	250.000	30,602.00

Source: Association of Pension Funds of the Czech Republic 2010 – publications issued by the pension funds

Table 2b. Selected indicators related to pension funds as to 31 December 2010

Pension fund	Profit (loss) for accounting period after taxation (in thousands of CZK)				Participants' finance (in thousands of CZK)			
	2007	2008	2009	2010	2007	2008	2009	2010
AEGON PF	–18,449	–50,282	–35,818	52,568	45,057	597,489	2,186,250	3,731,665
Allianz PF	201,200	220,181	251,099	309,752	6,073,898	6,706,299	8,015,142	9,538,982
AXA PF	790,438	9,682	790,469	565,630	32,228,016	33,840,522	33,138,995	33,245,247
ČSOB PF Progres	121,031	–1,339	84,369	100,256	5,466,257	6,950,335	8,128,251	9,270,520
ČSOB PF Stabilita	338,713	7,988	258,572	286,427	14,223,520	15,783,721	16,704,947	17,762,848
Generali PF	52,172	34,396	52,015	57,567	1,275,274	1,640,051	2,119,323	2,632,701
ING PF	509,642	8,767	21,255	518,418	18,857,648	21,617,431	22,808,906	23,910,458
PF České pojišťovny	938,616	81,354	619,012	1,147,390	37,182,519	44,154,556	47,812,388	52,124,745
PF České spořitelny	775,563	127,447	458,531	807,354	24,424,229	29,672,440	32,513,101	35,173,368
PF Komerční banky	562,256	165,158	74,606	726,815	22,667,727	25,735,997	27,178,729	28,718,275

Source: Association of Pension Funds of the Czech Republic 2010 – publications issued by the pension funds

The number of the participants in supplementary pension insurance towards the end of the year 2010 was 4.543 million, which means an inter-annual increase by 3.37%. Thus the supplementary pension insurance is still developing, although the trend is decreasing (see the following Table 3 and Table 4).

Table 3. Total numbers of valid pension insurance policies during the period 2000–2010 (mil. pieces)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number	2.372	2.534	2.622	2.740	2.964	3.280	3.594	3.936	4.207	4.395	4.543

Source: Association of Pension Funds of the Czech Republic 2010

Table 4. Numbers of pension insurance policies (thousand pieces) and inter-annual development (%) during the period of 2000–2010

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number	595	408	347	372	436	544	559	586	590	525	495
Increase (+) Decrease (–)	–	–31.4	–14.9	7.2	17.2	24.8	2.8	4.8	0.7	–11.0	–5.7

Source: Association of Pension Funds of the Czech Republic 2010

The reasons why during the two last years the interest in supplementary pension insurance is attenuating – which is indicated by the decreasing number of new contracts (although the results are still satisfactory, in comparison with the previous years) – could be, along with the stagnating economy, the relatively high unemployment rate and the slowly growing wages/salaries, and also the not very clear government strategy in terms of the reforms to be implemented in the pension system, as well as very low appreciation of the savings in the pension funds during recent years (mainly in 2008). Another obvious factor is the saturated market.

In addition, companies that often contribute to their employees have slackened their efforts (see Table 5).

Table 5. Numbers of supplementary pension insurance policies with registered employer's contributions (thousand pieces) and inter-annual development (%) during the period of 2000–2010

Year	2000	2001	2002	2003	2004	2005
Number	416.57	567.75	650.21	779.99	801.63	927.93
Increase	–	36.3	14.5	12.0	10.1	15.8
Year	**2006**	**2007**	**2008**	**2009**	**2010**	
Number	1,028.85	1,129.62	1,222.64	1,261.52	1,284.74	
Increase	10.9	9.8	8.2	3.2	1.8	

Source: Ministry of Finance CR 2005

The financial volume of contributions remitted by the participants (i.e. net of the employers' contributions paid in favour of the employees) is growing, although during the last three years the trend is decreasing (see Table 6).

Table 6. Development of the volume of participants' contribution (thousand million CZK) net of the employers' contributions paid in favour of the employees, and inter-annual development (%) during the period of 2000–2010

Year	2000	2001	2002	2003	2004	2005
Volume	9.084	10.040	10.957	11.770	13.146	15.335
Increase	–	10.5	9.1	7.4	11.7	16.7
Year	**2006**	**2007**	**2008**	**2009**	**2010**	
Volume	17.607	20.211	21.887	22.955	23.218	
Increase	14.8	14.8	8.3	4.9	1.1	

Source: Ministry of Finance CR 2005

Continuous growth within the system of the supplementary pension insurance is indicated by the annual amount paid in by the state (Table 7). In 2010, the state paid in 5.51 billion CZK, which is an increase by 3.04 billion CZK in comparison with the year 2000.

Table 7. State contributions paid during the period of 2000–2010 (billion CZK)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
State contri-bution	2.470	2.658	2.770	2.930	3.222	3.683	4.162	4.651	5.088	5.347	5.510

Source: Ministry of Finance CR 2005

Weak points of the state-contributory supplementary pension insurance

In spite of the relatively favourable development of the system of supplementary pension insurance, there are significant issues and weak points:

- **Age structure of the participants in supplementary pension insurance**

The age structure of the participants in supplementary pension insurance does not reflect the age distribution of the population, which is shown in the following overview of the development of the age structure of the participants in supplementary pension insurance during the period 2005–2010 (Table 8).

The average age of a participant in supplementary pension insurance oscillates around 48 years of age, which is considerably higher than the average age in the pension systems in developed countries. Younger employees (under 40) are not covered much, which means a considerable risk as this is the generation which will be heavily affected by the consequences of the planned reform of the pension system (i.e. the pension guaranteed by the state) and will be therefore more dependent on additional sources of old-age pension. Of the total number of 4,543,125 participants, 47% are males and 53% are females.

Table 8. Age structure of the participants in supplementary pension insurance and its development during the period of 2005–2010

Age	Proportional share of age groups during the period of 2005–2010					
	2005	2006	2007	2008	2009	2010
18–29	11.63	12.60	12.63	12.70	12.61	12.36
30–39	18.35	19.09	19.98	20.60	21.11	21.33
40–49	21.50	20.46	19.74	19.20	19.10	19.16
50–59	28.38	26.91	25.31	24.20	22.94	22.04
60 and higher	20.14	21.38	22.32	23.40	24.23	25.10

Source: Association of Pension Funds of the Czech Republic 2010

- **Low average contributions into the system**

The too low average contributions into the system represent a substantial weak point of the present system of supplementary pension insurance. This amount does not even reach the level of 2% of the average gross wage and under no circumstances would it provide significant compensation for the slump in income connected with retirement, which contradicts the purpose and the primary function of supplementary pension insurance. Most of the participants (approx. 30%) save between 500 and 599 CZK monthly so that they draw the state support in full and the tax relief in part (the tax relief is provided for contributions between 500 and 1,500 CZK), but they do not save much for old age. A monthly contribution higher than 1,500 CZK, eligible for maximum tax relief, is saved by nearly 6% of the participants in supplementary pension insurance. The development of the average participant's contribution and the state contribution during the period of 1995–2010 is shown in Table 9.

Table 9. Development of average participant's contribution and state contribution during the period of 1995–2010

Year	Average monthly participant's contribution (CZK)	Average monthly state contribution paid to a participant (CZK)
1995	262	93
1996	305	103
1997	333	97
1998	333	95
1999	324	92
2000	326	89
2001	340	90
2002	354	90
2003	384	96
2004	397	98
2005	408	99
2006	431	102
2007	450	104
2008	451	105
2009	444	105
2010	440	105

Source: Ministry of Finance CR 2005

In general, people should save five to ten percent of their wages for the whole time of their productive age. Then they will be able to eliminate the slump in their living standard when they retire (of course not in full) (Sušanka 2011).

- **Low appreciation of savings**

The too low appreciation of savings is a fundamental problem of supplementary pension insurance as it does not contribute to its attractiveness (for the young generation). No wonder – the interest appreciation allocated to the clients hardly compensates for inflation.

At first sight, the appreciation of the savings in the way it is presented by the pension funds looks very attractive, which is shown in the following overview of nominal appreciation of the savings during the period of 1995–2010 (Tables 10a, 10b) and the pension funds use it quite successfully during their marketing activities (mainly when "hunting" for new clients).

Table 10a. Overview of nominal appreciation of the savings (in %) during the period of 1995–2002

Pension fund	Nominal appreciation of savings during the period of 1995–2002 (%)							
	1995	1996	1997	1998	1999	2000	2001	2002
AEGON PF	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Allianz PF	–	–	8.90	9.10	6.00	3.80	4.36	3.71
AXA PF	12.80	11.45	11.20	10.10	6.50	4.10	4.25	3.41
ČSOB PF Progres	0.00	16.40	8.00	10.90	7.70	5.62	3.90	4.26
ČSOB PF Stabilita	10.40	10.90	10.30	10.02	6.10	4.20	3.20	3.00
Generali PF	10.30	10.61	14.60	11.40	5.30	3.60	4.60	4.10
ING PF	12.80	12.10	11.00	9.34	6.00	4.40	4.80	4.00
PF České pojišťovny	10.30	9.20	9.60	9.72	6.60	4.50	3.80	3.20
PF České spořitelny	4.00	8.10	9.05	8.33	4.40	4.20	3.80	3.50
PF Komerční banky	9.44	8.36	9.10	9.50	7.20	4.89	4.40	4.63

Source: Association of Pension Funds of the Czech Republic 2010

Table 10b. Overview of nominal appreciation of the savings (in %) during the period of 2003–2010

Pension fund	Nominal appreciation of savings during the period of 2003–2010 (%)							
	2003	2004	2005	2006	2007	2008	2009	2010*
AEGON PF	0.00	0.00	0.00	0.00	4.50	3.50	2.10	1.50
Allianz PF	3.00	3.00	3.00	3.11	3.00	3.00	3.00	3.00
AXA PF	3.36	3.10	3.70	2.50	2.20	0.00	2.00	1.50
ČSOB PF Progres	4.30	5.30	5.00	2.30	2.40	0.02	1.00	1.00
ČSOB PF Stabilita	2.30	4.30	4.00	2.80	2.40	0.05	1.37	1.40
Generali PF	3.00	3.00	3.81	3.74	4.10	2.00	2.40	2.10
ING PF	4.00	2.50	4.20	3.60	2.50	0.04	0.10	2.00
PF České pojišťovny	3.10	3.50	3.80	3.30	2.40	0.20	1.20	2.00
PF České spořitelny	2.64	3.74	4.03	3.04	3.10	0.40	1.28	2.00
PF Komerční banky	3.40	3.50	4.00	3.00	2.30	0.58	0.24	2.20

Source: Association of Pension Funds of the Czech Republic 2010

** As the data shown in the table above reflect the authors' estimation based on the economic results achieved in the year 2010, it can't be ruled out that some of the funds will allocate extraordinary appreciation to their clients (which was done e.g. by AEGON PF).*

However, the relatively favourable situation was fundamentally changed by inflation (unfortunately, for the worse). The inflation rate during the period of 1995–2010 is shown in the following table (Table 11).

Table 11. Inflation rate (in %) during the period of 1995–2010

Year	1995	96	97	98	99	2000	01	02	03	04	05	06	07	08	09	2010
Infla-tion	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.1	2.8	1.9	2.5	2.8	6.3	1.0	1.5

Source: Czech Statistical Office 2011

The real appreciation of savings (i.e. the appreciation of the savings with inclusion of inflation) is low, and its level does not correspond to the parameters anticipated for long-term investment (Tables 12a, 12b).

Table 12a. Real appreciation of savings during the period of 1995–2002

Pension fund	Real appreciation of participants' means (%)							
	1995	1996	1997	1998	1999	2000	2001	2002
AEGON PF								
Allianz PF			0.40	–1.60	3.90	–1.10	–0.34	1.91
AXA PF	3.70	2.65	2.70	–0.60	4.40	0.20	–0.45	1.61
ČSOB PF Progres		7.60	–0.50	0.20	5.60	1.72	–0.80	2.46
ČSOB PF Stabilita	1.30	2.10	1.80	–0.68	4.00	0.30	–1.50	1.20
Generali PF	1.20	1.81	6.10	0.70	3.20	–0.30	–0.10	2.30
ING PF	3.70	3.30	2.50	–1.36	3.90	0.50	0.10	2.20
PF České pojišťovny	1.20	0.40	1.10	–0.98	4.50	0.60	–0.90	1.40
PF České spořitelny	–5.10	–0.70	0.55	–2.37	2.30	0.30	–0.90	1.70
PF Komerční banky	0.34	–0.44	0.60	–1.20	5.10	0.99	–0.30	2.83

Source: Association of Pension Funds of the Czech Republic 2010, Czech Statistical Office 2011, our calculation

Table 12b. Real appreciation of savings during the period of 2003–2010

Pension fund	Real appreciation of participants' means (%)							
	2003	2004	2005	2006	2007	2008	2009	2010*
AEGON PF					1.70	–2.80	1.10	0.00
Allianz PF	2.90	0.20	1.10	0.61	0.20	–3.30	2.00	1.50
AXA PF	3.26	0.30	1.80	0.00	–0.60	–6.30	1.00	0.00
ČSOB PF Progres	4.20	2.50	3.10	–0.20	–0.40	–6.28	0.00	–0.50
ČSOB PF Stabilita	2.20	1.50	2.10	0.30	–0.40	–6.25	0.37	–0.10
Generali PF	2.90	0.20	1.91	1.24	1.30	–4.30	1.40	0.60
ING PF	3.90	–0.30	2.30	1.10	–0.30	–6.26	–0.90	0.50
PF České pojišťovny	3.00	0.70	1.90	0.80	–0.40	–6.10	0.20	0.50
PF České spořitelny	2.54	0.94	2.13	0.54	0.30	–5.90	0.28	0.50
PF Komerční banky	3.30	0.70	2.10	0.50	–0.50	–5.72	–0.76	0.70

Source: Association of Pension Funds of the Czech Republic 2010, Czech Statistical Office 2011, our calculation

** As the data shown in the table above reflect the authors' estimation based on the economic results achieved in the year 2010, it can't be ruled out that some of the funds will allocate extraordinary appreciation to their clients (which was done e.g. by AEGON PF).*

The level of the real appreciation of the savings (including the inflation) shows – especially during the first five years – a considerably decreasing trend (quasi-hyperbolic function relationship). At the same time, there is an inverse proportion between the amount of the savings and the level of their real appreciation; in other words, the higher the annual savings, the lower the real appreciation (based on a model projection, it is estimated that after approx. 40 years of saving, with annual savings over 6,000 CZK, the level of the real appreciation does not reach 1%).

According to Jiří Rusnok, President of the Pension Fund Association, the low real appreciation of the savings administered by pension funds is rightfully criticised. However, it is a kind of defrayal for the system stability (by law, the pension funds must keep to at least zero nominal appreciation).

To a certain degree, the low appreciation of the savings is influenced by the Act on supplementary pension insurance, which regulates the operation of pension funds and sets numerous limits in terms of the scope of activities performed by the pension funds.

By law, pension funds are limited in allocation of investments, while the most serious obstacle is not the limits set for specific types of assets (for example, the volume of stock cannot exceed 25% of the asset portfolio). The fundamental barrier is the duty to show a positive annual economic result (if a pension fund is loss-making, the stockholders must pay the difference).

By law, pension funds must allocate at least 85% of the revenue in favour of their clients, the reserve fund must be increased by 5% of the revenue, and the remaining 10% may be distributed to stockholders (up to now, none of the pension funds have paid out any dividends to their stockholders).

A pension fund may allocate even more money to their clients than the required above-mentioned minimum limit (like e.g. AEGON PF). This is an effective marketing instrument, used to attract clients, as they will "respond positively" to the idea of high revenue; of course they will not try to find out why it is so high.

The legislation ordering the pension fund stockholders to bear the risk connected with compensation of the loss on an annual basis (in fact, a temporary loss is not admissible), determines the ***investment strategy*** of the pension funds quite strictly. The (very logical) result is that the administrators prefer safe investments to higher revenue. Therefore, the majority portion of the pension fund portfolios consists of safe yet less profitable assets, see Table 13.

Table 13. Portfolio of pension fund assets as to 31 December 2010

Asset	% portion
Real estates	0.80
Bonds	84.00
Monies on bank accounts and term deposits	7.60
Participation certificates	3.70
Stock	0.80
Short term bonds	0.50
Other assets	2.60

Source: Association of Pension Funds of the Czech Republic 2010

The distinctively conservative investment strategy does not give younger participants with a longer investment horizon much chance to choose a ***more aggressive strategy*** *with an accent upon stock, which could be continuously modified into a more conservative one in order to "protect" the gained profit.*

The reason why the legislation forces the pension funds to allocate financial means in a way that is not very effective (in many other countries, the funds allocate over 40% of their assets to stocks and other long-term investments) is probably the general apprehension that in older citizens who are involved in the system the outputs from the proportion of "revenue versus risk" would not result in success due to higher volatility on the stock market (stock means higher risk but a considerable part of the risk is eliminated by diversification and long-term investment).

The key factor that significantly affects the level of appreciation of savings is the related costs (in the long horizon, the costs along with the inflation absorb the biggest part of the clients' profit). At present, the pension funds in the Czech Republic do not charge any official fees for administration of the collected money to their clients. However, their assets (the stockholders' assets) are connected with the clients' assets, which makes the costs non-transparent and the result is devaluation of potential revenue from the clients' savings.

According to economists from the IDEA science centre under the Economics Institute of the ASCR, this is one of the reasons why Czech pension funds have the worst financial performance in central Europe.

The operating costs of private pension funds are high. Although the average operating costs compared to total assets show a decreasing trend (Table 14), it is still unbearable (according to the practice in other countries, costs amounting to 1% of the assets mean consumption of 15–20% of the amount of the contributions collected). The costs in the best pension funds in the world reach 0.1% of the value that was entrusted to them (Švejnar 2011).

Table 14. Proportion between average operating costs and total assets administered by pension funds in the period of 1995–2010 (in %)

Year	1995	96	97	98	99	2000	01	02	03	04	05	06	07	08	09	2010
Costs	8.95	3.31	4.15	3.85	2.54	2.53	2.05	2.24	1.80	1.45	1.37	1.38	1.39	1.49	1.44	1.42

Source: Association of Pension Funds of the Czech Republic 2010

According to the estimation made by the Association of Pension Funds of the Czech Republic, the costs of management of the financial means within the supplementary pension insurance consist of:

- Administration of investments
  0.1–0.2% of the assets of the fund
- Administration of clients
  0.3–0.7% of the assets of the fund
- Distribution and promotion
  0.5–0.8% of the assets of the fund

On principle, the highest portion of the costs goes to headhunting as all funds try to attract clients of other funds. This job is done by financial consultants (who earn a lucrative commission for each new client). On the other hand, the pension funds need somebody to pay for that, and the "somebody" is the present clients (and the appreciation of their savings).

Low number of pensions

Another significant weak point of the private pension scheme for the whole time of its existence is the fact that the participants mostly terminate the contractual relationship by means of a lump-sum settlement, thus the number of old-age pensions assessed from this system is very low (Table 15). In fact, the supplementary pension insurance plays the role of "saving with a state contribution" and does not fulfil its function and its mission.

There are several causes of this alarming situation. The benevolent legislation, despite the generous state support, de facto does not make the participants in supplementary pension insurance ever use the life-long pensions, which lets the pension funds, making every effort to gain clients, put an accent on mainly short-term advantages of supplementary pension insurance (i.e. the preference of insurance with lump-sum fulfilment to insurance on a life-time pension basis).

Table 15. Number of pensions paid as to 31 December 2010

Pension fund	Number of pension recipients, including inheritance pensions
AEGON PF	47
Allianz PF	592
AXA PF	2,927
ČSOB PF Progres	390
ČSOB PF Stabilita	1,555
Generali PF	11
ING PF	772
PF České pojišťovny	563
PF České spořitelny	3,034
PF Komerční banky	no data

Source: Association of Pension Funds of the Czech Republic 2010

Legal structure of pension funds

As a result of the present legal structure of pension funds, the system is not transparent. The stockholders' assets are not separated from the participants' assets thus the distribution of the profit between the stockholders and the participants is not transparent (despite the fact that there is a formal ceiling in terms of the share of the profit to be distributed among the stockholders). It means that the space for drawing from the sources created by the participants in supplementary pension insurance is still relatively large (mainly in terms of the costs).

CONCLUSION

In the Czech Republic, nearly 4.55 million people are participants in the state-contributory supplementary pension insurance and they have saved over 216.1 billion Czech crowns in pension funds. As regards the present market for supplementary pension insurance, there is an obvious trend towards concentration in the hands of several leading pension funds controlled by foreign financial groups (the portion of the 7 largest pension funds which belongs to 5 financial groups in the total number of the participants is approximately 85%, and in the total assets of all pension funds approximately 83%). As a result of this trend, the level of competition is very low.

The state support provided to state-contributory supplementary pension insurance in the Czech Republic is the highest in the OECD member countries. According to expert estimation, the state support in 2010 may have exceeded 11 billion CZK. Besides the direct state support amounting 5.51 billion CZK, there is the tax bonus as well, i.e. a reduction of the public revenue due to the tax allowance, while from the economic aspect this is a part of the public expenses designed for pensions (Vostatek 2010).

The state-contributory supplementary pension insurance in its present condition does not fulfil its primary function. What is more, without significant support by the state it cannot compete with life-cycle mutual funds or other substitute instruments offered on the financial market.

The crucial problem is that it is a product fully controlled by the state (it is the state who makes decisions on legislation, i.e. on the amounts of the state contributions, tax bonuses and employer's contributions exempted from taxation) and it is very difficult to anticipate what the politicians will push through in the future (from this point of view, for the future, the state-contributory supplementary pension insurance de facto represents a risky product).

If the government, despite the conclusions made by the World Bank, which recommends that EU countries apply a Pan-European pension system, is successful in implementation of their vision of pension reform, the current state-contributory supplementary pension insurance may become a product suitable for people who, for some reason (mainly for the reason of insufficient income), cannot afford to ***disengage from the public pillar in favour of the fund system*** (i.e. the "opt-out" system) (or they will not trust it, but they will want to save some financial means to improve their financial situation when they retire (Holman et al. 2006).

If the current state-contributory supplementary pension insurance is kept as a part of the government concept of pension reform, it will be necessary to reform this product or to transform it into life insurance (Vostatek 2010).

According to latest information, it seems that the state-contributory supplementary pension insurance is going to be a part of the government concept of pension reform (Sušanka 2011). *It is proposed that the maximum amount of the state contribution should be increased from 150 CZK to 230 CZK. It means that the participants in supplementary pension insurance would receive up to 2,760 CZK per year from the state. To be eligible for the maximum state support possible, it will be necessary to save at least 1,000 CZK every month. The bill on supplementary pension insurance maintains the tax allowance for the future. However, the tax support will be applied to monthly participant's savings in the range from 1,000 to 1,500 CZK, compared to the present 500 to 1,000 CZK. The aim of the proposed changes is to strengthen the role of the supplementary pension insurance in the system of creating savings for old age.*

To enable the supplementary pension insurance to fulfil its primary function and become a real benefit along with the pension paid from the standard system, mainly the following measures are necessary:

- Along with the afore-mentioned separation of the assets of the pension funds from the financial means of their participants, (for the reason of increase of the financial effectiveness of the assets and thus increase of the real appreciation of participants' savings), the pension funds must be allowed to create diversified life-cycle funds ("special funds for each age group"), which means adjustment of the investment allocation to a participant's age (the fund may adjust the allocation of the assets by aging of the participants so that as to the date of assumed termination of the saving programme the volatility of administered financial means is minimised, which would considerably eliminate an inappropriate "revenue versus risk" proportion for different age groups).
- It is necessary to establish a state pension fund on a non-profit basis (administered by e.g. a special department of the Czech National Bank) that would invest anywhere in the world (which would enable achieving both the highest diversification of the risk and costs under 0.30% of the value entrusted to the fund), and would become a real alternative to the present private pension funds (whose main weak point is, besides the low real appreciation of savings, the high costs).
- A life-long pension must be the basic fulfilment and other forms should be available only within precisely defined cases (partial drawing when reaching a certain age, depending on the total amount of the money saved, etc.). Along with that, the long-term aspect of the system must be accentuated (by increasing of the sanctions in the area of the state support, which would effectively prevent early drawing from the monies being saved).
- The savings of a participant who dies before he is entitled to annuity should, on principle, be transferred to the pension account of the appointed person.
- The state support should be limited to the tax bonus derived from the contribution remitted by a participant and his employer (up to 10% of the average wage). The aim is to increase the participant's motivation to pay higher contributions while the direct state support is decreased.
- The settlement should be burdened by income tax at a deduction rate of 15% (other options may be to impose a one-off deduction tax at the rate of 15% on employer's contributions and entire revenues from the savings as to the date of the fulfilment, or, exemption from income tax in the case of choosing fulfilment in the form of lifelong annuity).

- For the purpose of calculation of lifelong annuity, a unisex death rate table should be applied (at present, estimations in terms of life expectancy made by the pension funds are fundamentally different).
- It is necessary to introduce a system of "guaranteed savings" in the field of supplementary pension insurance in case of a pension fund bankruptcy, thus to strengthen the trust in the product – the trust in the private pension scheme system – in the participants (the state should guarantee at least the participant's contributions up to the remitted principal).
- The safety of the system must be increased (it is necessary to establish efficient state supervision over the pension fund management).

The afore-mentioned proposals on development of the private pension scheme cannot be implemented without preparation and adoption of a new legal norm. Any reform of private pensions is an organic part of a ***complex pension reform*** and changes in the public and private pillars must be coordinated.

We should not omit or marginalize another important thing, and that is the fact that reforms in the field of social security (primarily pension reform) are perceived extremely sensitively, and the proposals in this area often have to face misunderstanding and misinterpretation, resulting in protests on the side of citizens, trade unions or interest groups. However, starting the reforms means establishing a factor that is taken into account in terms of assessment of fulfilment of Maastricht fiscal convergence criteria and softening of sanctions for non-fulfilment due to reforms.

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