

CZECH REPUBLIC

Pilot Diagnostic Review of Governance of the Private Pension Fund Sector

March 2007



THE WORLD BANK

Private and Financial Sector Development Department
Europe and Central Asia Region
Washington, DC

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This Diagnostic Review is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent.

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Abbreviations

ALM	Asset-Liability Management
APF	Association of Pension Funds of the Czech Republic
AUM	Assets under Management
CNB	Czech National Bank
CSC	Czech Securities Commission
CZK	Czech Crowns
DAC	Deferred Acquisition Costs
DB	Defined Benefit
DC	Defined Contribution
FCR	Financial Condition Report
FSAP	Financial Sector Assessment Program
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MB	Management Board, Board of Directors (<i>predstavenstvo</i> in Czech)
MER	Management Expense Ratio
MOF	Ministry of Finance
MoLSA	Ministry of Labor and Social Affairs
OECD	Organisation for Economic Co-operation and Development
OSS	Office of the State Supervision in Insurance and Pension Funds (now part of CNB)
RBC	Risk-based Capital
SB	Supervisory Board (<i>dozorci rada</i> in Czech)
UCITS	Undertakings for the Collective Investment of Transferable Securities
UK	United Kingdom
USAID	United States Agency for International Development
VAR	Value at Risk

1 USD = 24.6 CZK

Foreword

The strength and efficiency of a financial system is underpinned by the governance of its institutions and participants. Good governance contributes to creating a level playing field for all participants of the market through a rule-based system that increases its transparency and accountability. Nowhere is governance more important than in private pensions, a sector that is growing fast in developed and developing economies alike. A well-governed pension sector is particularly important for the poor who are the most vulnerable to abuses in the financial sector.

This review of the private pension sector of the Czech Republic is part of a series of financial sector governance reviews piloted by the Europe and Central Asia Region of the World Bank. It is aimed at developing insights that are helpful both to other countries and the international financial community in further identifying the key components of good governance in private pensions. Similar pilot reviews are underway for other sectors covering insurance, collective investment funds, and banking.

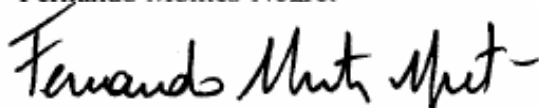
We are very pleased to work with the Czech Republic to prepare this first pilot review and would like to thank the authorities for their strong collaboration, which led to the successful completion of this exercise.

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Acknowledgements

This Review was prepared by Sue Rutledge (Regional Corporate Governance Coordinator/Senior Private Sector Development Specialist, Europe and Central Asia Region) and Rodney Lester (Program Director, Financial and Private Sector Development Network).

Craig Thorburn (Senior Insurance Specialist) reviewed the report and provided comments and suggestions. Peer review was provided by Gregorio Impavido (Senior Financial Economist, Operations and Policy Department), Anita Schwarz (Lead Economist, Europe and Central Asia Region, Human Development Department) and Mark Charles Dorfman (Lead Economist, Human Development Network.) Zdenek Kudrna of Charles University in Prague provided background information for the report. Mehmet Can Atacik (Consultant, Europe and Central Asia Region) assisted with the revisions of this report.

Executive Summary

This diagnostic review covers governance of the supplementary pension fund sector of the Czech Republic and was prepared at the request of the Czech Ministry of Finance. The review has three objectives: (1) refine an emerging set of good practices for assessing governance of supplementary private pension sectors, (2) conduct a trial diagnostic review of the governance framework of the Czech scheme against these good practices, and (3) provide recommendations on ways of further improving governance of the Czech supplementary private pension sector.

The review is based on a visit of a World Bank mission to the Czech Republic between October 2 and 7, 2005. Meetings were held with officials from the Ministry of Finance, including the then Office of State Supervision of Insurance and Pension Funds, the Czech Securities Commission (now part of Czech National Bank), the Ministry of Labor and Social Affairs, law firms, audit firms, pension funds and asset management companies. In May 2006 the Ministry of Finance hosted a workshop for representatives of the Czech pension sector during which the preliminary findings and recommendations of the review were presented and discussed. During and after the workshop, both government and private sector agencies provided many useful comments, which were incorporated into the final review.

The review begins with an introduction, including a description of the methodology employed, the key arguments for the importance of analyzing governance of pension funds, and an overview of the structure and financial results of the Czech supplementary pensions system. The review continues by looking at five key issues that relate to the governance of Czech supplementary pension funds: (1) risk management, (2) transparency and distribution, (3) supervisory boards, (4) fiduciary duties and conflicts of interest, and (5) additional governance issues that need to be considered if reforms were made to the Czech pension system. Presented for each issue are a brief overview, a diagnosis of the related weaknesses in the Czech system, and recommendations to address the weaknesses. The review is supplemented by four annexes. Annex I provides a summary list of the recommendations presented in the review. Annex II presents the detailed analysis and recommendations based on the set of good practices. Annex III provides an overview of the tax structure of contributions and withdrawals for Czech pensions. Annex IV presents the comments of the Association of Pension Funds regarding the review's analysis of annuitization under the Czech scheme.

The Czech supplementary pension fund system has grown steadily in real terms and wide coverage has been obtained, with 55 percent of eligible planholders participating in the system and few planholders suffering losses. However the real rates of return on investments have been too low to provide an adequate source of supplementary retirement income for planholders. Furthermore the accumulation of deferred assets (largely from using the multi-level distribution system through intermediaries) puts the system at risk. While the capital and reserves of the Czech pension funds are in aggregate above the minimum levels required for EU life insurance sectors (the closest comparator for the Czech private pensions schemes), they provide little margin for protection against possible adverse developments.

Czech supplementary pension funds have many of the structural characteristics of the life insurance model but they also have some provisions similar to collective investment funds (which are typically the basis of defined contribution schemes). Czech pension funds are therefore treated as hybrid financial instruments, following neither the governance provisions applicable to Czech life insurance companies nor those applicable to Czech collective investment funds. Furthermore the accounting systems used by pension companies are a hybrid between those used for banks and those of life insurance companies. As a result, significant governance weaknesses arise which leave the system vulnerable to problems of opacity, poor actuarial control, inadequate solvency, and inequity among different generations of planholders.

In particular, the risk management systems of Czech pension companies may not always provide sufficient information for pension fund management and supervisory boards to make informed decisions. The review recommends that all pension funds be required to employ actuaries that will prepare financial condition reports, estimate liability cash flows, and advise the companies if sufficient assets have been set aside. The review also recommends that annuitization rates be regularly reviewed in light of emerging experience on mortality rates.

Increased transparency in the system is also needed. Czech pension companies provide a significant amount of information on pension funds, including detailed and comparative financial statements of individual funds, details on related party transactions, and amounts spent with third party suppliers. A sophisticated and informed consumer would be able to form a view of the different funds based on the available information. However less informed consumers may have difficulties in differentiating among the various funds and products. Key recommendations are to require that pension funds publish asset and liability gap estimates and provide minimum information to consumers on expense rates and the historical gross and net investment performance for each fund.

The roles of supervisory boards of pension companies should also be broadened. Supervisory boards in the voluntary pension system act primarily as inspection organs. Key recommendations are that supervisory boards should be: (1) required to review and approve the pension company's internal controls and the actuary's report, as in the case of collective investment funds under public notice 347/2004 Sb., (2) encouraged to develop internal committees such as audit committees, and (3) required to approve related party transactions within financial groups and conglomerates.

Attention should also be placed on strengthening fiduciary duties and controlling conflicts of interest. Governing bodies of pension funds should be legally required to place their fiduciary obligations to planholders before the interests of shareholders. Key recommendations include: amending the pension fund legislation and bankruptcy law to clearly outline the fiduciary duties of both supervisory and management boards; developing a corporate governance code for pension funds; capping dealings in pension funds by staff members, officers and board members to low levels; prohibiting pension funds from owning pension fund sales and distribution companies; and expanding the application of "fit and proper" provisions to include internal auditors. In addition, employees should have a full choice of pension funds where an employer contributes to a pension fund. Also pension funds and their distribution companies should be subject to conduct of business (and conflict of interest) rules analogous to those required for collective investments.

Various proposals have been discussed to strengthen the long-term viability of the Czech private pension system and any resultant changes would have significant implications for the distribution system. Some commentators have suggested that the system move to a full segregation of shareholders' assets from those of planholders and allow pension funds to offer investment-linked contracts (thus moving toward a classical defined contribution structure). However recent experience, particularly in Latin America, indicates that this is not necessarily a panacea. This review makes several suggestions: (1) retain long-term capital and return guarantees while eliminating short term guarantees, (2) restructure the incentive system so that switching between pension funds is limited to a level that is consistent with the integrity of the system, (3) limit the period of time over which deferred acquisition costs may be written off, and (4) carry out regular resilience tests of the impacts of a sudden change in interest rates, significant switching or cashing out. Whatever solution is chosen, the proposals should be weighed carefully to ensure that adequate governance systems are put in place and that implications arising from potential transition are well understood and managed.

Introduction

This diagnostic review of the governance of the Czech supplementary pension funds was requested by the Czech Ministry of Finance to help identify key issues in the governance, and particularly the transparency, of supplementary pension funds. The review has three objectives: (1) refine the set of good practices for assessing the governance of funded individual supplementary pensions, (2) conduct a trial diagnostic review of the Czech funded-pension governance framework against these good practices, and (3) provide recommendations on ways of further improving the corporate governance of the sector. A summary of the review's recommendations is presented in Annex I and the good practices and detailed analysis in Annex II. Annex III provides an overview of the tax structure of contributions and withdrawals for Czech pensions. Annex IV presents the comments of the Association of Pension Funds regarding the review's analysis of annuitization under the Czech scheme.

The review is one of a series of pilot governance diagnostic reviews for the financial sector prepared by the World Bank at the request of the Czech Government, which has taken the lead in supporting this work. The other reviews include those on the banking, collective investment fund and insurance sectors.¹ This pension governance diagnostic review has been carried out using the *OECD Guidelines for Pension Fund Governance*, with modifications to strengthen the emphasis on risk management (under the Internal Controls Principle) and add further discussion of the role of the supervisor and stakeholder activism.²

Numerous sources have been used in preparing the review. They include the web site of the Czech Association of Pension Funds (APF), "Guidelines for Pension Fund Governance" prepared with USAID funding for a project in Bulgaria (from which some of this commentary has been drawn), various FSAP assessments of pensions sectors worldwide carried out by the IMF and World Bank, a report on the Czech pension system prepared for the World Bank in December 2003, the pilot governance reviews for the Czech insurance and collective investment fund sectors, annual reports of the Czech pension funds and various supervisory bodies, and the various papers on pension reform issued by the Czech Ministry of Labor and Social Affairs.

The report is based on the visit of a World Bank team to the Czech Republic that took place between October 2 and 7, 2005. The authors met with officials from the Ministry of Finance, including the then Office of State Supervision of Insurance and Pension Funds (OSS),³ the Czech Securities Commission (CSC), the Ministry of Labor and Social Affairs (MoLSA), law firms and audit firms. The Team also met several pension funds and asset managers, including Winterthur penzijní fond, a.s., PF České pojišťovny, PF Komerční banky, a.s., PF České spořitelny, a.s., ING Penzijní fond, a.s., and ČSOB PF Stabilita, a.s. In addition, in May 2006 the Ministry of Finance hosted a workshop with the pension sector to discuss the preliminary findings and recommendations of the diagnostic review. The World Bank would like to express its gratitude for the efforts of all parties involved in the preparation of this report.

In the Czech Republic, some momentum is gathering for pension reform, possibly including a fully-funded second pillar component, with or without a conversion of part of the first pillar to notional

¹ The governance diagnostic reviews for collective investment fund and insurance sectors can be found at www.worldbank.org/capitalmarkets. The banking governance diagnostic review has not been released for publication.

² In July 2002 the governments of the 30 OECD member states approved the *Guidelines for Pension Fund Governance*, designed to improve the protection of individuals' retirement benefits from mismanagement and fraud. While the Guidelines are voluntary, the OECD has expressed its intent to have them adopted as international benchmarks, with their implementation monitored by member states. A copy of the Guidelines can be found at www.oecd.org.

³ As of April 2006, the OSS and CSC were merged with the Czech National Bank, which acts as an integrated supervisory agency.

defined contribution (NDC). In 2004 all major political parties submitted their proposals to an expert commission that provided calculations for their scenarios.⁴ A "National Strategy Report on Adequate and Sustainable Pensions" was published in June 2005, the last of a series of such documents. Reform is also supported by several major pension funds. For example, the 2004 annual report of Credit Suisse Life and Pensions Penzijní Fond refers to recent reforms in Slovakia and the need for reforms in the Czech Republic.

As this is a pilot diagnostic review, the final report should be seen as no more than a "work-in-progress." Nevertheless, it is expected that it will play a useful role in contributing to guidelines for strong governance of privately managed funded pensions in both developed and emerging markets. It could also contribute to further governance reforms of the Czech pensions sector and provide a baseline diagnostic review for measurement of the reforms. The report includes some recommendations on the structure of the supplementary pension sector but the focus lies with governance and transparency of the sector as it is currently structured.

Importance of Governance of Private Pension Funds

Research carried out by the World Bank and others demonstrates that many funded pension systems suffer from poor performance and weak governance. The issue is important for governments since it is they who will often have to contribute to any shortfall between what the plans may promise and what they are capable of delivering.

Similar to the general concept of corporate governance, pension fund governance deals with the delegation of property rights by one party to another party and relies on that other party's professional skills and efficient management. Pension fund governance addresses the issues of who controls the pension fund, for whose benefit, and who monitors the controller of the pension fund on behalf of the members. The standard corporate governance principles of transparency, accountability, fairness and responsibility all apply.

However some standard corporate governance principles are largely irrelevant for pension funds. Fund members (or planholders) do not typically have any direct control, such as voting power over the pension administration and asset management companies and their officers. It is difficult for pension fund members to dismiss, reappoint or change the governing body of a pension fund when the latter fails to properly discharge its duties. Thus pension funds operate in a market based on trust and involve long term commitments. The scope for members and affiliates to exit the system is often constrained. The only recourse available to members is to either switch to another fund (if that option is available), or resort to a redress mechanism.

Governance is particularly complex for pension funds due to the large number of parties involved. In funded pension plans, the parties include not only the member and the entity managing contributions, but also the plan sponsor (usually the employer) and financial institutions with significant responsibility for investing funds and ensuring the performance of the plan. Furthermore the fund (i.e. the assets backing the accrued pension liabilities) may be part of the corpus of the administrator (as is the case for a life insurance company). Alternatively the fund may be an independent legal entity or a legally separated pool of assets.

Furthermore, in some cases the sponsor may have residual responsibility for the ultimate performance of the fund against defined liabilities, which can introduce additional complexities. In the face of reduced investment returns, lengthening life expectancy, increased labor mobility and changing accounting doctrine, many sponsors worldwide have switched from defined benefit (DB) to defined contribution (DC) plans. In most countries, the switch has been gradual—from sponsored DB plans to

⁴ The expert commission maintains a website on the pension reform <http://www.reformaduchodu.cz> (in Czech).

sponsored DC plans and then to DC plans without sponsors. By contrast, the Czech Republic has moved quickly to unsponsored DC plans.

In sponsored DB plans, pension funds are overviewed by a governing body for the benefit of pension fund members and beneficiaries, with a residual duty of care to the sponsor. DC plans (both sponsored and unsponsored) often also need to deal with the inherent conflicts of interest between members and financial market players. Until relatively recently in some common law countries, the approach has also been to appoint trustees. Trustees broadly represent the interests of the members, although they typically also need to acknowledge the interests of the plan sponsor (usually an employer, industry or professional group). In practice even trustees have not always met all their mandates. While they have generally ensured that funds are not subject to malfeasance, they have not always done as well on the other two fronts, i.e. professional management of the funds in members’ interests as well as transparency and member education. Besley and Prat (see references) have modeled the styles of governance most appropriate in sponsored arrangements, depending on whether DB or DC arrangements are involved. Their results are summarized in the following matrix.

Table 1: Governance of DB vs. DC Plans

	DB	DC
Vigilance responsibility	Sponsor	Member
Role of trustee	Less	More
Nature of trustee	Experts	Caring insider
Asset allocation rights	Sponsor	Member
Funding requirements	Strict	Not defined in most cases

Despite the clear vulnerabilities for planholders, there has been a trend towards purely contractual arrangements for DC plans without any involvement by trustees. For example the stakeholder pension regime in the UK allows for both approaches—with or without trustees. In practice few trustee-based plans exist and an effective mechanism for member influence is lacking. Planholders have no equity interest in the asset-management company and individual accounts in pension funds cannot be sold or traded. The result has been what the UK National Association of Pension Funds calls a "governance vacuum" (see references).

The standard public policy response has been to over-regulate and tightly monitor the activities of DC funds. However this official overlay can mask, and even impede, the development of more efficient governance mechanisms in private pensions systems. The primary objective of pension fund governance should be two-fold: (1) protect the rights and interests of pension fund members and (2) ensure a secure source of funds to pay timely and adequate retirement benefits to those that have made contributions for their retirement. In a well-run system, the set of structures and mechanisms will provide administrative efficiency, professional portfolio management, enlightened management of operational risk, adequate member education, safe custody of pension fund assets, and timely and full payment of adequate pension benefits.

Good pension fund governance should also benefit the pension industry, by contributing to the integrity and credibility of the industry and hence consumer confidence. While the implementation of good governance and the observance of corporate ethics involve an investment of resources, they may also reduce excessive regulatory and supervisory overheads and investment constraints. It is expected that the overall welfare result will be positive. However to date there has been virtually no theoretical or empirical research done on this trade off. A comparative study by Del Guercio and Trak (see references) of US pension funds with professional trustees, and contract-based mutual funds points to superior risk-adjusted investment performance on the part of trustee-based pension funds over contract-based mutual funds. Studies have also shown that if governance is strong and the interests of managers and investors interests are aligned through incentive arrangements, hedge funds also out

perform mutual funds on a risk-adjusted basis. Evidence also comes from the corporate sector, where there is now clear empirical evidence that good governance tends to be correlated with high returns to investors and a low cost of capital.

In addition informed decision making by pension companies on their equity investments may create a positive externality. Once the governing bodies of pension funds adopt good governance practices, they may strengthen governance standards for the companies in whose stock they invest the pension funds' net cash flows.

The Czech Republic has moved to a contractual DC model, often with services sub-contracted to organizations related to the primary service provider, thus creating a “governance vacuum”. This review offers an opportunity to explore alternative approaches to pension governance in a contractual DC environment, with a view to improving the overall efficiency and performance of the sector and welfare as a whole.⁵

Legal Foundations

The Czech supplementary pension scheme was introduced in 1994 by the Supplementary Pension Act No. 42/1994 Coll. as amended. Under the Act, participation is voluntary and based on individual contracts. There is no provision for formal employer-sponsored pension plans, although a substantial number of unregulated occupational schemes are believed to exist.

The key statutes are:

- Act No. 42/1994 Coll. – State-Contributory Supplementary Pension Insurance Act;
- Act No. No. 513/1991 Coll. – Commercial Code as amended, especially Chapter V on Joint Stock Companies;
- Act No. 189/2004 Coll. – on Collective investments as amended, especially Section 21 on bank depository that applies also to pension funds and Section 82 on asset and liabilities valuation;
- Act no. 15/1998 Coll. — on Securities Commission as amended, especially Section 12 regarding their duties regarding investing and/or trading on their own account pension funds are subject to the state inspection of the Commission;
- Act No. 563/1991 Coll. — on Accounting as amended;
- Decree No. 501/2002 Coll. – on Accounting of banks and other financial institutions;
- Decree No. 270 /2004 Coll. — on Calculation of the fair value of assets and liabilities in the portfolio of mutual funds or investment funds; and
- Provisions of the Ministry of Finance No. 282/73 390/2001 and No. 282/73 391/2001 on accounting of banks and other financial institutions.

In Czech legal terminology, the funding vehicle is a pension fund, which is a joint-stock company licensed by the financial regulator. There is no legal separation between the assets of planholders and those of shareholders and the governance regime is essentially that of any other corporation subject to the Commercial Code, with some additional reporting requirements imposed by the Act No. 42/1994 Coll. (Supplementary Pension Act).

The financial regulator, in agreement with the MoLSA, licenses pension funds. The license application must include a description of the professional competence and “unimpeachability” of the proposed members of the pension fund's board of directors and supervisory board. For the purposes of the

⁵ However the Czech pension system differs from a classic DC system in that the liabilities of pension funds are not directly linked to their asset values. A governance assessment of a classic DC arrangement would differ in some areas, in particular in the areas of disclosure and risk management.

Supplementary Pension Act, a person is deemed unimpeachable if he was not officially convicted of a property crime or other deliberate crime.

Under this Act, all pension funds must contract with bank depositories to provide safekeeping and transfer of the securities held or to be held by the fund.

The Act stipulates that pension plans must be DC arrangements.⁶ The payout from the pension fund may take the form of a pension, lump-sum payment or final settlement payment. The types of pension benefits allowed by the Act include old-age pensions, disability pensions, early-retirement pensions, and survivors' pensions. An old-age pension option must be always included in the pension plan contract, although this option is rarely exercised: 95 percent of payouts are in the form of lump sum settlements and surrenders, reflecting the small amounts accumulated and a still highly redistributive first pillar.

The regulatory environment is currently in transition with all the financial regulators having come under the supervisory roof of the Czech National Bank (CNB) as of April 1, 2006. It would take approximately a year to develop a workable system and draft the relevant legislation.

Overview of the Pension Sector

The Ministry of Labor and Social Affairs administers a redistributive mandatory pay-as-you-go first pillar pension system that currently offers an average replacement ratio of approximately 45 percent (although for most low income people, the replacement rate is somewhat higher). The system covers essentially the whole population and is financed by a pay-roll tax. It is a defined benefit (DB) scheme with the pension based on the number of years in employment and other parameters. Currently, there is no reserve fund set aside to fund the future benefits although the fiscal cost is likely to rise in the long term since the Czech Republic is one of the most rapidly ageing countries in Europe. However recent parametric reforms have ensured that the system will not require government subsidy for at least 10 years.⁷

The voluntary supplementary arrangement is a unique construct and is the subject of this review. The voluntary pillar involves a hybrid corporate structure that has characteristics of both banks and life insurance companies—and that has seen problems in other jurisdictions.⁸ In the Czech Republic, the surplus declared each year has to be distributed among pension funds' shareholders, "planholders," and reserve funds. At least five percent of the surplus must be distributed to a reserve fund and eighty five percent to planholders. Losses are met out of the reserve fund, retained earnings, and capital.

In practice, pension fund companies closely resemble life insurance companies. The rules on information exchange between planholders and their pension funds follow insurance rather than investment fund principles. The benefits are called "pensions insurance" and the contracts "pension policies." Surplus distribution is determined according to rules specified in the law and the quantum involved is partly at the discretion of the boards. Nevertheless, pension fund contracts are specifically exempted from the provisions of the Act on Insurance contract No. 37/2004 Coll.⁹ However one significant difference is that the accounting for pension fund companies officially follows the rules that apply to banks.

⁶ The Act allows disability pensions based on the defined benefits principle but the authors were advised that none have been issued.

⁷ The system was slightly in deficit before these reforms were introduced.

⁸ See UK Penrose report on a UK insurer, Equitable, that was managed along lines similar to Czech pension funds. A copy can be downloaded from http://www.hm-treasury.gov.uk/independent_reviews/penrose_report/indrev_pen_index.cfm

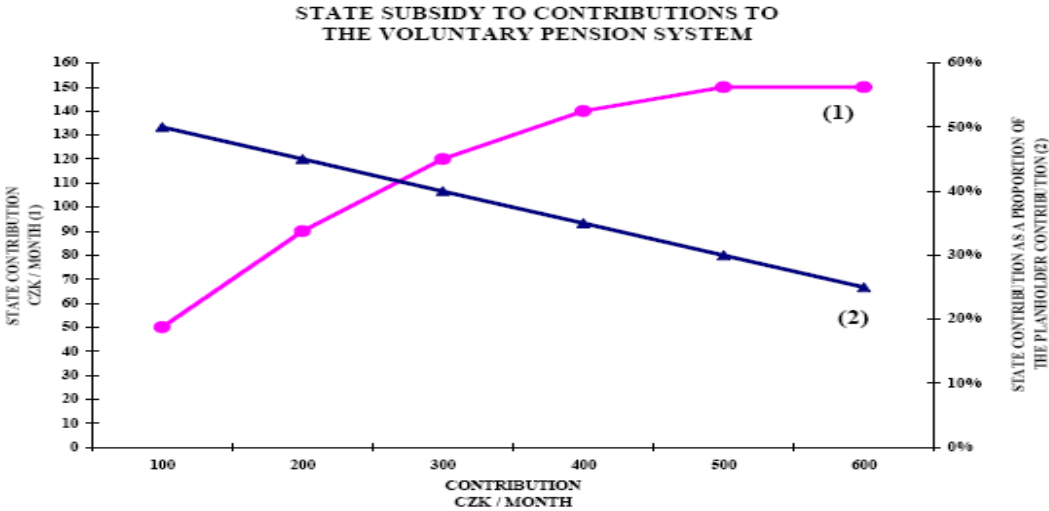
⁹ See (42/ 1994, Chapter 4, Section 12(2)) of the Act.

To date, supplementary pension funds in the Czech Republic have been partly driven by their tax structure, which is a TTT system.¹⁰ TTT means that contributions are partially paid from an after-tax income, the income of the fund is taxed, and benefits are partially taxed. The middle "T" in the Czech scheme is very small, amounting to a five percent withholding tax. Within the supplementary pension scheme, employers have tax incentives to contribute to the individual pension plans of their employees, since such contributions are not subject to assessment for social insurance taxes and are deductible up to a limit (see Annex III). Approximately 27 percent of individual contracts currently benefit from employer contributions, which do not attract a government subsidy. One area of concern is that, due to their contributions, employers have been able to exercise some leverage over choice of pension fund for their employees.

The supplementary pension system has been successful in attracting a wide participation at all levels of society and creating a source of supplemental pension income while guaranteeing zero losses to planholders. However the supplementary system is also widely seen as having failed to significantly raise retirement income replacement rates. About 55 percent of planholders save under 500 Kč per month, which is the level where the state's contribution is capped. Fewer than 8 percent save the 1,500 Kč per month that maximizes the tax subsidy. As noted in Figure 1, state subsidies decline with contribution levels¹¹ leading to a decline in return to an employee as his or her contributions increase. However other considerations are also important, notably the typically short savings periods for Czech pension funds, a lack of a public understanding of the importance of supplementary saving for retirement, and relatively generous first pillar benefits for those on low incomes.

At the end of 2005 after 11 years of operation, more than 3 million planholders (or 55 percent of eligible individuals) were participating in the scheme, which is a creditable result. However funds under management amounted to only 4 percent of GDP.¹² The average impact on replacement ratio has been generously projected at between 1.9 percent (10 years' contributions) and 7.5 percent (30 years' contributions) of final salary. Actual average real rates of return (less than 0.5 percent each year on average) for planholders have typically been lower than those used in the projections.

Figure 2: State Subsidies vs. Planholder Contributions



Source: Iglesias-Palau, 2003

¹⁰ TTT system means contributions are paid from an after-tax income, the income of the pension fund is taxed, and the ultimate benefits are taxed. An optimal system has an exempt tax structure (EET) in which only the ultimate benefits are taxed.

¹¹ Direct state subsidies are usually designed to help low income lowly taxed people gain access to the supplementary retirement income system.

¹² Hungary started behind the Czech Republic but introduced a second pillar in 1997. By the end of 2004, Hungary had 6.6% of GDP in supplementary pension funds.

The current supplementary pension system has essentially been a short to medium term subsidized savings arrangement, with an average aggregate contribution in 2005 of approximately 2.7 percent of net wages (down from 4.3 percent in 1995). Recent changes, including the imposition of increased benefit eligibility ages, tax penalties on early cashing out (from January 1, 2006) and enhanced tax incentives, have moved the scheme more towards a effective retirement arrangement. However an increased ability for the providers to invest in higher risk assets offering higher returns, and targeted tax incentives, will be required to produce adequate retirement balances and encouragement for planholders to take pensions rather than lump sum payments.

There are currently nine pension funds in operation, of which six account for more than 90 percent of assets under management (AUM). More consolidation is possible, but the number is expected to stabilize at around eight. Numerous pension funds have failed commercially and been merged with their more successful rivals. Two pension funds became bankrupt, with approximately 40,000 planholders losing most of their contributions of approximately 400 million CZK.¹³ In at least one case there was suspicion of fraud. The surviving pension funds are all parts of financial groups and are, with one exception,¹⁴ 100 percent owned by their parent companies. The greater part of AUM is managed by subsidiaries of reputable international groups or substantial local groups. Two funds, each with slightly different risk-return profiles are associated with one financial group, ČSOB. ČSOB also bought two other small pension funds (Hornický and Zemský). ČSOB is expected to either consolidate the new funds into one of its existing two pension funds or use them for further risk-return profile diversification.

Expense rates relative to assets have dropped considerably but, possibly due to increasing average distribution costs, expense levels have remained relatively steady compared to contributions (Table 2).

Table 2: Cost Trends

	2000	2001	2002	2003	2004	2005
Total Costs/ Assets %	4.9	3.9	2.9	2.1	1.7	N/A
Operating Costs/ Assets %	2.5	2.1	2.2	1.8	1.5	1.4
Operating Costs/ Contributions %	9.7	8.9	11.2	10.0	9.0	10.1
Number of Funds	19	14	13	12	11	11

Sources: APF Annual Reports, OSS Annual Reports¹⁵

A concern going forward is likely to be sustaining an adequate level of competition (Table 3). This has become an issue in many countries with specialized pension providers since there are clear economies of scale in the funds management business. Once break-even is reached, profit levels can become very high. One approach to this issue has been to mandate full transparency on costs and to reduce costs by building relevant incentives through the switching rules.¹⁶ Such innovations would mean a relatively extensive re-engineering of the Czech supplementary pensions model.

¹³ No pension guarantee system is in place and the authors support this policy stance.

¹⁴ EBRD owns 20% of Winterthur (Credit Suisse) and is expected to eventually sell its interest to Credit Suisse.

¹⁵ Note that CNB defines operating costs differently from APF. The APF values have been used.

¹⁶ Mexico has specified that planholders may only switch to lower cost funds than their current funds (after their first switch within a two year period). This restriction has had a dramatic—and positive—impact on the level of competition.

Table 3: Ownership of Pension Funds

Name	AUM CKZ Million 30/12/05 ¹⁷	Market Share of Net Funds Credited to Planholders 2005 %	Ownership
Winterthur penzijní fond, a.s.	26,626	23.3	Winterthur Leben AG, Švýcarsko – 79.97%, European Bank for Reconstruction and Development, Velká Británie - 20%
PF České pojišťovny, a.s.	25,491	21.7	Česká pojišťovna, a.s. - 100%
PF České spořitelny, a.s.	16,086	13.4	Česká spořitelna, a.s. - 100%
PF Komerční banky, a.s.	15,712	13.3	Komerční banka, a.s. - 100%
ING Penzijní fond, a.s.	14,643	11.8	ING Continental Europe Holdings B.V. – 100%
ČSOB PF Stabilita, a.s.	10,805	9.1	Československá obchodní banka, a.s. - 100%
Allianz PF, a.s.	5,181	4.3	Allianz pojišťovna, a.s. - 100 %
ČSOB PF Progres, a.s.	1,785	0.9	Československá obchodní banka, a.s. - 100 %
Hornický PF Ostrava, a.s.	1,137	0.9	Československá obchodní banka, a.s. - 100 %
Generali PF, a.s.	1,096	0.9	Generali Holding Vienna AG, Rakousko - 100 %
Zemský PF, a.s.	606	0.4	Mostecká uhelná společnost, a.s., právní nástupce – 100 %
Total	119,168	100.0	

Source: APF web site

Note: Zemský and Hornický have been taken over by ČSOB.

The Czech pension funds generally adopt conservative investment and accounting strategies, as seen in the industry balance sheet in Table 4, although some smoothing is allowed. These policies reflect the relatively strong short term capital preservation guarantees that pension funds must offer under the Act. In case of a balance sheet shortfall, it would be the pension fund shareholders that must make up the difference. In effect the pension fund's shareholders are the default sponsors of the pension plan.

The financial positions of the leading pension funds are burdened by the high acquisition costs incurred through the use of “multi-level” selling systems, whereby planholders act as distribution agents selling policies to other planholders. This means that a non-tangible item representing deferred acquisition costs can be a significant balance sheet asset—an asset only maintainable as long as the planholder does not switch pension funds. Switching is a free and continuous option for planholders. One problem is that switching may become subject to non-transparent incentives. Such incentives are commonly seen where company officials have the ability to choose the pension fund for employees and multi-level sellers are able to use high-pressure tactics to acquire new business (both of which are currently permitted in the Czech Republic.) Sales commissions have escalated from 25 percent of the first year contribution to 100 percent in some cases, as increasing saturation of the market has combined with competition among multi-level sellers. Deferral of acquisition costs has stretched out accordingly with the amortization period expanding from four years (the standard for commercial enterprises) to the period remaining until the planholder's retirement.¹⁸

¹⁷ Based on liquid assets under management

¹⁸ For example, for contracts written before 2001, Winterthur (Credit Suisse) defers cost for 5 years. This extends to 10 years for business written between 2001 and 2003, and to the lifetime of the contract for business written thereafter.

Despite the options embedded in supplementary pension contracts, there appears to be no formal requirement for actuarial involvement in asset-liability management or in setting economic capital levels of the pension funds. It is also of concern that the current regulations do not require that tangible investment holdings be set at a minimum proportion of the planholders' account balance. In addition, capital and retained earnings, taken together, are low for some pension funds. The system appears to be exposed to macroeconomic shocks and there is a small but non-negligible potential for contagion, given that three banks are shareholder guarantors of their subsidiary pension funds.

Another guarantee involves the annuitization of lump sums. Given the small number of retirees opting for pensions, annuitization is not currently of great concern. However it will be significant if higher levels of saving are achieved than is the case today. Annuities already have a greater capital offset than lump sums for tax purposes because the government contribution is taken into account. The pension funds have now been given some increased flexibility in specifying the mortality and discount rate assumptions at the time the annuity is taken out, but some plans have already issued guarantees well in advance of retirement dates. A better alternative may be to require that annuities are only underwritten by licensed and adequately capitalized life insurers (although in a separate fund or account). To support this, a continuous mortality investigation, differentiated between policyholders and annuitants, should be implemented by the pension and insurance sectors (see section on risk management).

Table 4: Sector's Balance Sheet – June 30, 2006

Asset Account	CZK Billions	Liability Account	CZK Billions
Liquid assets: Cash	10.5	Planholders' Account	125.3
Bonds	100.4		
Shares	14.6		
Receivables	0	Payables, other liabilities and trade reserves	0.5
Accruals	2.6	Reserves	1.5
Intangibles	1.1	Undistributed annual surplus declared	1.8
		Other	0.9
Total Assets	130.1	Total Liabilities	130.1

Source: APF website¹⁹

From an actuarial perspective, a planholder's account differs little from a demand deposit, and is subject to measurable draw down probabilities. From a financial economics point of view, a planholder's account has a continuous "put" option to the pension fund. However infrequent public reporting and a degree of opacity inherent in pension fund accounting make it difficult (if not impossible) for the planholder to know when the option comes into the money (that is, when the cash—or switching value—is greater than the value of the underlying assets). Despite their contractual features, not all pension funds employ asset-liability risk management techniques. Indeed some funds are likely to have mismatched asset and liability durations that are not fully covered by capital set according to internationally acceptable value at risk (VAR) criteria. Furthermore, the current law is not clear regarding the respective rights of shareholders and planholders to the accumulated reserves and any unrealized gains, both at the time of surplus distribution and upon wind up.

¹⁹ These figures are based on data published by the APF and are not official.

Key Issues

Risk Management

In the Czech Republic, pension funds are single-purpose joint stock companies with no separation of shareholders' assets from those of planholders. Nevertheless the accounting rules require that a "planholders' account" should be shown on the balance sheet of the pension fund company. The planholders' account equates to the roll-up of all contributions (including the government subsidy) and accrued allocated surplus credits. The actual liability is difficult to determine given that at least three generic options are granted to planholders under the Act (see Box 1). Securities are placed on the balance sheet at their market values.

Box 1: Embedded Options

The relationship between the planholder and the pension fund is mediated entirely through a contract and the fund's statute. The contract, known as a retirement benefit plan, explicitly includes the pension plan which is a public document. Under the Act, some flexibility is allowed in certain parameters of the contract but the underlying structure is invariant. In particular the pension fund is required to write a series of options in favor of the planholder. These are:

- Surrender (lump sum settlement) after 12 months or upon death – receive own and employers' contributions plus accrued declared earnings, but lose tax benefits accruing after January 1, 2006.
- Switching of total funds, including the government contribution from one pension fund to another, although this has to date been constrained in practice, particularly if the employer is contributing. In addition the full accrual is payable once the minimum eligibility requirements (5 years and age 50 for many long-standing planholders) are achieved.
- Various pension options covering combinations of life, fixed term and survivorship annuities. Under current rules, pensions may be claimed after 15 years of contributions have been paid.

Of these, the switching and cash surrender options are easily the strongest as they are effectively continuous and apply early on, while the others are deferred, and in the case of annuities have some adjustment capacity built in. Capital guarantee insurance contracts and employer based DB funds in most other jurisdictions have a capacity to reduce surrender or transfer values at early durations to cover unrecovered costs and, in some cases, adverse market developments. By contrast, in most countries DC funds typically transfer market and credit risk to the planholder, but have relatively low expense levels.

At least one pension fund has strict controls over the duration of its asset portfolio, based on the emerging experience of liability duration. A notional gap analysis of assets and liabilities is illustrated in some balance sheets (including that of the largest player). However the notes to the financial statements state that liability cash flow buckets cannot be determined.²⁰ Other balance sheets refer to duration analysis and VAR but these appear to be restricted to the asset side of the balance sheet. The resultant uncertainties may serve to prevent investment in some desirable assets including non-OECD foreign securities.

Some analysts also argue that since pension liabilities are payable on demand, pension funds cannot do asset-liability matching. This is inconsistent with current IASB thinking on the next phase of IFRS 4 (Insurance Contracts). In the absence of detailed requirements for risk management the supplementary pension law currently defines upper limits on asset allocation (see Box 2). The Supplementary Pension

²⁰ The World Bank team believes that after more than 12 years of accrued experience in the Czech Republic, there should be sufficient experience and data to develop projections of liability cash flows.

Act requires that a pension fund must act prudently.²¹ In particular a pension fund must "manage its assets with due care and attention and with the aim of securing dependable revenues". In addition valuation rules are specified. However a prudent man approach²² as opposed to strict limits could be adopted under a less constrained liability structure.

Box 2: Investment Rules

Prudential management for Czech supplementary pension funds is largely seen in terms of market and liquidity risk. For example, Credit Suisse (Winterthur) states in their 2004 annual report under Risk Management, "The basic instruments for risk management are limits on the proportion of individual types of financial instruments in the Company's portfolio ..."

Asset allocation rules occupy most of Chapter 8 (Financial Management) of the Act namely article 34 whereas article 33 states explicitly the types of assets permissible. The supervisor must be notified if the limits are breached. The allocation rules are largely in line with traditional limits seen in many markets. No more than 10 percent of investments may be placed in property and movables or exposed to one issuer and at least 70 percent of the liabilities must be matched by currency.

A striking gap in the rules is seen in related party transactions, where there appear to be no restrictions on transfers of securities to or from related firms or in investments in related firms.

Over 90 percent of the supplementary pension market is represented by insurance companies which use IFRS in the preparation of their financial accounts—and thus must employ actuaries—but not all pension funds do so. There is no formal requirement for actuarial involvement in setting economic capital levels, determining surplus distributions, or preparing an annual financial condition report (FCR)²³. The only formal requirement for actuarial involvement has been in determining retirement pensions (i.e. annuitization factors) and related accounting transfers. This is not a major issue at the moment as most planholders take lump sums. However as discovered in other countries, the annuity option can become very valuable to planholders in certain circumstances. Reflecting this, and given evidence of increasing longevity, pension funds have recently been given additional flexibility in determining annuitants' prospective mortality. A better approach, followed in many other countries, would be to require that annuities be written by properly capitalized insurers, backed up by a continuous mortality investigation and appropriate asset structures.

In practice crediting rates are determined partly by competitive force,²⁴ but allow for implicit and explicit (the five percent rule) reserving against embedded option values and potential write off of deferred acquisition costs. The implicit reserving has been partly in the form of a hold back of unrealized capital gains on the fixed interest portfolio. Hence low real accounting returns have been credited to plans and even the shareholders have seen a poor real running return, (averaging less than one percent p.a. to date²⁵) based on the pension company distributions. However shareholders can also make returns by outsourcing activities to related firms and possibly through residual equity in accumulated explicit and hidden reserves (see discussion of Transparency below).

²¹ See Chapter 8 – Pension Funds' Financial Management (S 31(1)).

²² A prudent man approach is a legal term that refers to the requirement that a trustee, investment manager of pension funds, treasurer of a city or county, or any fiduciary (a trusted agent) must only invest funds entrusted to him/her as would a person of prudence, i.e. with discretion and care.

²³ A Financial Condition Report (FCR) provides an assessment of the key risks and issues impacting on the financial condition of a fund. This includes providing the insurer or the pension fund with implications of issues identified and, where these implications are adverse, proposing recommendations designed to address the issues. (Source: Australian Prudential Regulation Authority)

²⁴ Quarterly reports on the APF web site enable the pension funds to monitor each others' performances.

²⁵ At least 90% of declared surplus must be distributed to planholders and a reserve but free funds are typically substantially less than 10% of total assets.

Implicit liability-side safety margins in the planholders' account balances are impossible to determine in the absence of actuarial studies. However Table 5 illustrates two approaches to one commonly used prudential measure, namely liquidity margin. The table compares the sector's planholders' account to: (1) liquid assets and (2) liquid assets plus government bonds. The liquidity margin deals with a very extreme and unlikely situation, namely a run on one or more pension funds following a severe economic or operating disruption. In the Czech Republic, the liquidity margin appears to be conservative under both approaches.²⁶

Table 5: Illustrative Liquidity Margin (as of June 30, 2006) CZK Millions

Pension Funds	Liquid Assets	% Planholders' Account	Liquid Assets plus Government Bonds	% Planholders' Account
Total Sector	10,505	8.4	84,730	67.6

Source: APF website²⁷

The major current threat to the system is a sudden increase in interest rates. The most vulnerable pension funds would be those that have both large deferred acquisition costs and asset durations exceeding liability durations (the latter being potentially relatively short in periods of instability). Pension funds with substantial balances in deferred acquisition costs are more vulnerable to sudden movements in large volumes of business (than funds without large deferred costs) due to a potential nexus between employer contributions and high commission levels.²⁸ Heavy switching from one pension fund to another could cause heavy write-offs of deferred acquisition costs, possibly involving redistribution of the costs to the remaining planholders—and possibly creating scope for a run, similar to a run on bank deposits. Such entities are most likely to see a call being made on the shareholder guarantee.

The Equitable Case and subsequent Penrose Report in the UK have demonstrated that determining crediting rates for planholders' accounts (which in turn is partly a function of the reserving process) raises the issue of reasonable expectations and the trade-offs between: (1) prudential management and equity between generations of planholders and (2) planholders and shareholders. The trade-offs becomes critical when statutory capital is thin relative to risks, as is the case in the Czech Republic supplementary pension system.

Two key governance issues arise from the above analysis:

- 1) Planholders in Czech pension funds—and industry analysts—should have access to sufficient financial information to estimate the real performance and risk levels of the pension funds in which they invest (transparency) and
- 2) Pension fund supervisory and management boards should be legally obliged to obtain expert advice so as to make careful and informed decisions (accountability).

The approach used in the United Kingdom may be a useful guide with regard to accountability and the use of expert advice. In the UK a participating life insurer's supervisory board of directors is obliged to receive separate advice on the distribution of surplus. In other words, the actuary preparing the reserves is relieved of the duty of reconciling the trade-offs between generations of policyholders and between policyholders and shareholders.

²⁶ In countries without developed and liquid capital markets, a minimum liquid asset ratio of 20% is not uncommon. Where capital markets are well developed and have deep liquidity, liquidity measures are often not specified.

²⁷ It should be noted that these figures are based on unofficial industry data rather than official statutory returns showing fair values.

²⁸ Multi level sellers allegedly offer incentives to company officials to move all of a company's employees.

This review recommends that in the Czech Republic a financial condition report (FCR) be submitted by an appointed actuary to a profit (surplus) distribution committee, including members of both the management and the supervisory boards of the pension fund. This committee would then prepare a brief note explaining how it reached its decision regarding distribution. While the note would not be a public document, the management and supervisory boards would be required to lay out their reasoning regarding profit distribution at the annual meeting and briefly in the annual report. The FCR would also be available to the supervisory agency.

Table 6 provides a summary of the aggregate levels of free capital and surplus in the Czech pension sector compared to the planholders' accounts. However Czech pension companies maintain different levels of capital adequacy,²⁹ thus highlighting the need for close supervision by the financial regulators (and careful attention by the pension funds' supervisory and management boards.) The Act effectively relegates the financial regulators to an inspection and back-up database maintenance role.³⁰ However if a risk-based approach were in place, the different levels of capital adequacy would provide some indication as to where the supervisory agency, and the relevant pension fund boards, would need to concentrate their attentions. In particular, attention should be paid to the levels of free capital plus surplus compared to the planholders' account for each pension company.

Table 6: Illustrative Free Capital and Surplus Levels (as of June 30, 2006) CZK Millions

Pension Funds	Planholders' Accounts	Free Capital & Surplus
Total Sector	125,300	3,157

Note: Free capital and surplus is net assets less intangibles and accruals. It includes accruals of CZK 2,617 million.

Source: APF website³¹

Although Czech pension funds are (currently) not life insurance companies under the law, the pension funds' business model is, as has been noted, similar to that of life insurers. For life insurance companies, a key risk-based concept is economic capital, which is a measure of the safety margin required to give the company boards (and the supervisory agency if necessary) sufficient time to deal with adverse developments. For traditional life insurance, the minimum required in Europe has been between four percent and five percent of policyholder liabilities (which may be supplemented, based on stress or resilience tests). Higher amounts tend to be indicated in risk-based capital (RBC) jurisdictions. Capital and surplus margins for the Czech pension funds appear to be relatively thin although they vary considerably among pension funds. For some pension funds this may create an additional duty of care on the management and supervisory boards—and place an additional burden on the supervisory agency. However the generally conservative investment and liquidity strategies currently adopted and strong parent companies mitigate this exposure. In addition a fair value actuarial liability would normally be somewhat less than the planholder account value.

As mentioned earlier, one necessary consumer protection feature under a non-transparent contractual DC model is free unlimited switching between pension funds. However, this is a feature of limited real utility. Queisser (see references) has pointed out that switching generally reflects promotion and sales pressure rather than an informed understanding of fund performance. In addition a fund switch requires that the pension fund being dropped must immediately write off the deferred acquisition costs

²⁹ The figures allow for the “valuation differences” item appearing in the balance sheets of pension funds. This is the excess or shortfall of the market value of fixed interest securities over (or under) the balance assumed for surplus declaration purposes. Given the current model and risks, the authors believe that pension fund management teams have had little choice but to hold unrealized gains back to supplement statutory capital and reserves. However the basis on which this is done—and the related equity and solvency issues—are not transparent.

³⁰ The back-up system, SDPF II, emerged in 1994 from the need to validate requests for government subsidy. It is refreshed quarterly, which may be too infrequent by current standards.

³¹ As with the liquidity measure discussed above, this table is based on unofficial industry data and is presented for illustrative purposes only.

related to that planholder. One pension fund indicated that despite a stable client base and low cost distribution, the average duration of its contracts is only four years. For this reason the authors recommend that no sales commission or other sales incentives should be payable on second or subsequent switches over, say a 24 month period. In addition a cap should be placed on the period over which acquisition costs may be written off. The maximum period should be based on liability duration, but in any event should be no more than five years.³² Recent changes in the tax regime to discourage easy cashing out are also steps in the right direction.

In an environment of high levels of transparency, consideration could be given to further switching restrictions, following the approach now being adopted in Latin American. For example, the second and subsequent switches in a defined period could be limited to pension funds that satisfy defined solvency and expense rate requirements (see footnote 16).

One additional issue relates to annuitization and estimates of mortality rates (see Annex IV). Mortality rates have not been stable for many decades and, in many countries, mortality rates during the 20th century have improved dramatically for the young population. Recently in developed countries, longevity has increased in the old population as well. In addition annuitants generally have a better mortality experience than life insurance policyholders and the population as a whole, due to self-selection. Recent work by actuaries in a number of developed life annuity markets has shown that mortality rates at a given age can be relatively volatile, measured over annual periods. Thus there are considerable dangers in using deterministic general population statistics—and in anticipating annuitants' mortality too far ahead. Furthermore in most markets, assets to fully match against projected annuitant cash flows are not available.

The major conclusion from this analysis is that the system requires further review to ensure that appropriate mechanisms are in place for adequate internal and systemic risk management. The following measures are recommended:

- 1) Liability cash flows should be estimated and formal asset liability risk management introduced, including requirements for adequate economic capital.
- 2) Surplus distribution should be based on a formal Financial Condition Report (FCR) submitted to a joint management and supervisory board committee.
- 3) Annuities should not be determined until the date of retirement, or just before retirement
- 4) Annuity factors should be regularly reset in light of emerging experience. This experience would ideally be generated by a continuous mortality investigation jointly managed by the actuarial profession and the Office of Statistics.
- 5) There should be scope to reset life annuities in the event of egregious changes in pensioner mortality or investment reinvestment returns. Product design could allow for these uncertainties. For example, an annuity with a fixed term could be followed by a life annuity when the pensioner is of old age. One legitimate role for government would be to act as reinsurer for annuitants who reach extreme old age.
- 6) To maximize competition, full transparency of annuitization rates should be required of pension funds, or preferably insurance companies.

³² It is likely that International Financial Reporting Standards will not allow deferred acquisition costs for insurance contracts.

- 7) Capital levels should reflect the risks incurred in underwriting annuities – possibly restricting the issuance of annuities to well-capitalized life insurance companies with assets set aside in a separate fund.³³

Transparency & Distribution

There is an impressive amount of public information available about individual pension funds, and the system as a whole. Information in the public domain includes planholder policies, the incorporation of the pension plans, and related statutes (on pension fund websites), extensive data about the growth and trends in the sector (on the MOF web site) and relatively detailed and comparative financial information about the individual pension funds (on the APF web site, where it is updated quarterly). In addition planholders receive annual statements showing contributions, returns and balances.

Annual reports are comprehensive with detailed balance sheets and profit and loss statements and relatively comprehensive notes. Pension funds disclose related party transactions (as per the Commercial Code), amounts paid to third party suppliers such as asset managers and insurers, in some cases estimated cash flows within future “time buckets”³⁴ for assets. Thus an informed consumer is in a position to form a broad view as to the operating performance and financial strength of a pension fund.

However there are a number of areas where transparency could be significantly improved, particularly with regard to distribution practices. Recommendations are given below.

- 1) The funds should be obliged to publish full asset and liability gap and duration data in the notes to their published financial accounts.
- 2) Pension funds and their distributors should be subject to rules analogous to the "Investment Intermediaries Conduct of Business Rules" or, at the very least, to the training and licensing rules governing insurance intermediaries. Retirement incomes planning is a form of financial advice and pension advisors should be subject to business conduct rules. Relevant sections of the investment advisor rules require that intermediaries be professionally qualified and that they disclose how the intermediary is remunerated, ensure that the customer’s individual conditions are taken into account, avoid conflicts of interest, explain the risks and guarantees involved in an investment, and provide equal and fair treatment to all customers.
- 3) Where an employer contributes to a pension fund on behalf of employees, mechanisms should be in place to ensure that the employee has a full choice of pension funds. One way to achieve this would be to make it illegal for officers of the employer to receive any remuneration from an intermediary. In addition, intermediaries should be prohibited from entering work premises, or alternatively have their access limited to "pension fairs" where several pension funds present their plans to employees at the same time. This would, at least in part, remove the potential for kick backs and possibly reduce the potentially unhealthy market power of the multi-level sales force (as would a strengthening of business conduct rules).
- 4) While the FCR would not be a public document, the pension fund's management and supervisory board would be required to lay out their reasoning regarding profit distribution at the annual meeting, and, more briefly, in the annual report. The FCR would also be available to the supervisory agency.

³³ The Association of Pension Funds provided comment on an early draft of the report and discussed annuitization. Their comments are included in Annex IV.

³⁴ “Time buckets” is a term used by accountants to refer to groupings of cash flows over certain time periods.

- 5) Pension funds should be required to publish on their web sites the current annuitization factors for each pension fund. In addition the funds should be required to quote current annuitization factors at the time of sale--and when a planholder indicates a desire to switch to that fund.
- 6) A number of basic requirements applicable to other jurisdictions (such as minimum print size, proper contrast of print and paper color, key facts summaries and controls over illustration assumptions) could usefully be introduced to the Czech Republic supplementary pension system.
- 7) A standardized management expense ratio covering the operating expenses allocated to planholders³⁵ should be introduced to increase public understanding of the impact of funds' costs on planholders' balances and provide relevant benchmarks. The ratio would need to allow for all costs allocated to the planholder account, including distribution costs and write offs. Investment related costs should be offset against investment income and pension funds should be required to disclose their actual net nominal and real returns in their annual reports.

Supervisory Boards

The corporate governance scandals of Ahold and Parmalat in Europe (and Enron and WorldCom and others in the United States) have encouraged advocates of corporate governance reform to review the mechanisms for oversight of company managers. Traditionally the corporate governance advocates in Anglo-American systems and those in continental systems have taken different approaches to corporate governance reform. While major differences continue to exist, both are paying attention to increasing the effectiveness of the supervisory or oversight board. In the unicameral system, the key issue is to increase the representation and effectiveness of those board members who are independent of company management. In Europe, the dual-tiered board structure has already establishes an oversight board (or "supervisory board") that in general excludes members of the executive management. The key issue then is to increase the authority and responsibilities of the supervisory board.

The Czech Commercial Code establishes a board of directors (in Czech "*predstavenstvo*"), which is the statutory organ for a joint stock company. The board of directors decides all company matters, unless they fall within the powers of the general meeting or supervisory board under the Code or the company's statutes. Thus under the Czech law, the board of directors is effectively a management board. The supervisory board (in Czech "*dozorci rada*") monitors how the board of directors exercises its range of powers and how the business activity of the company is conducted. However under the Commercial Code, the supervisory board of a joint stock company is primarily an inspection organ. The diagnostic review therefore assumes that the effective board of directors is essentially the management board, consisting of the company's executive management, and having responsibility for day-to-day matters. There appears to be no explicit fiduciary responsibility by management or supervisory boards to planholders or policyholders specified in any Czech Law, except to the extent that a claim has become manifest and a creditor status created.

One key way of increasing the effectiveness of supervisory boards is through the establishment of committees within the boards. Establishment of an audit committee has become a standard minimum requirement for US-listed companies, following the provisions of the Sarbanes-Oxley legislation. It is also a reportable item under the German Corporate Governance Code. Best practice thus suggests that the supervisory boards of all financial institutions (including pension funds) in developed markets such as the Czech Republic should also include audit committees.³⁶ Other committees may also be useful, including a remuneration committee to consider levels of remuneration for members of both

³⁵ The pension fund has the option of allocating more than 85% of surplus declared to the planholders.

³⁶ If the supervisory board is at least 50% independent, it could fill this role.

boards, and a nomination committee to review the performance of supervisory board members and identify new members for consideration by the shareholders' meeting.

While the European Commission is still developing recommendations on supervisory boards, it may be helpful to review the work done to date. The Commission's proposed Directive of October 2004 discusses collective board responsibility. The February 2005 Recommendation on Non-Executive or Supervisory Directors suggests that the non-executive or supervising directors should have a key role in overseeing executive or managing directors and in dealing with situations involving conflicts of interest. The Recommendation further defines independence of the supervising directors as "the absence of close ties with management, controlling shareholders, and the company itself." In small tightly-knit economic markets, it may be difficult to identify sufficient directors with no ties with a major corporation. However the focus on independence of judgment and freedom from material conflicts of interest is a key issue in establishing an effective oversight function.

The following measures are recommended:

- 1) Supervisory boards of pension fund companies should be required to review and approve the systems of internal controls of the pension funds, as is required under the legislation for collective investment funds. Supervisory boards should also review the report of the actuary, as part of its discussions with the external auditor.
- 2) Supervisory boards should be encouraged to develop internal committees such as audit committees (although this may not be necessary if the supervisory board is small and the full board carries out this function – see footnote 36).
- 3) Related-party transactions within financial groups or conglomerates should be subject to the approval of pension funds' supervisory boards and be fully disclosed on a case by case basis to the depository and in the annual report.

Fiduciary Duties & Conflicts of Interest

As noted above, the thin margins above minimum capital requirements place particular emphasis on the fiduciary duties of the pension funds concerned, and in particular on their supervisory and management boards. Strong fiduciary duties set by law are a first step to ensuring that supervisory and management board members are accountable to planholders and other stakeholders. In addition to requiring due care and attention, the pension legislation (or the company law) should stipulate that the board members are obliged to place the interests of planholders ahead of those of other stakeholders, including the pension company's own shareholders and its creditors, by securing the assets underlying the planholder account. In addition, the bankruptcy legislation should clarify that in the case of a wind-up of the pension fund company, planholders are considered to be superior creditors.³⁷ In addition, boards should be required to obtain expert advice from licensed actuaries on the distribution of profits, as described above.

To further clarify the fiduciary duties of the board members of pension fund companies, it may be helpful for the APF to develop a corporate governance code, tailored to the requirements of the pension sector. As a starting point, the APF may wish to apply the corporate governance code used by the Prague Stock Exchange with reference to companies officially listed on the Stock Exchange. However additional details would be needed to address the particular fiduciary obligations applicable for financial institutions receiving long-term funds from the general public.

³⁷ Some countries establish a special compensation fund to ensure that regardless of the financial circumstances of the pension fund company, planholders are always paid out in full. However the authors see this as a second best solution.

In addition, pension funds should apply particularly stringent provisions on related-party transactions. Related-party transactions within financial groups or conglomerates should be subject to the approval of pension funds' supervisory boards. Any transactions in a pension fund's assets by staff members, officers or board members of the pension fund company should be subject to low caps, require supervisory board approval and be fully disclosed to the fund's depository and to the public, through the annual report.

In addition, the Financial Conglomerates Act that was passed in 2005 included most financial institutions but not pension funds. Pension funds should also be subject to the Financial Conglomerates Act. Furthermore, the supervisory agency should establish tight thresholds and special approval processes on all related-party commercial contracts involving pension funds. Pension funds should also be explicitly prohibited from owning (in part or in full) distribution companies and directors of pension funds should not be permitted to have ownership or other interests in distribution companies

The law provides for strong "fit and proper" provisions for members of supervisory and management boards of pension funds. Such provisions should also apply to all key officers, including internal auditors of the pension fund.

The following measures are recommended:

- 1) The pension fund legislation should be amended to specify that the governing bodies of private pension funds have superior fiduciary obligations to planholders relative to general creditors and shareholders. Similarly the Act and the bankruptcy law should specify that planholders are superior creditors in the event of a wind-up. In this regard a compensation fund may need to be considered if the current system structure is retained and the weak prudential regime is maintained. However this is a second best solution at best, and weaker than the alternative of strong prudential and governance regimes.
- 2) The fiduciary responsibility of management and supervisory boards to planholders should be clearly stated in the relevant laws. In addition, a corporate governance code for pension funds could be developed. One approach would be for the APF to start with the existing corporate governance code applicable for listed companies and expand it to cover the specific types of fiduciary obligations applicable to the governing bodies for pension funds.
- 3) Any dealings in a pension fund's assets by a staff member, officer or board member of that pension fund should be capped at a low level, and subject to the same approval and disclosure rules as for related party transactions. Pension funds should be subject the Financial Conglomerates Act.
- 4) Pension fund companies should be obliged to disclose any relationship with asset-management companies and securities companies that provide third party services. The law might also incorporate similar provisions found in the legislation on collective investment funds. All the materials should be provided in a manner that is digestible to the average citizen.
- 5) Pension funds should be explicitly prohibited from owning (in part or in full) companies that sell and distribute pension funds. In addition, directors of insurance companies should have no financial or other interests in distribution companies.
- 6) The "fit and proper" provisions that apply to members of supervisory and management boards of pension funds should also apply to internal auditors.

Transition Issues

A number of industry players told the World Bank team that they would like to move to: (1) full segregation of shareholder from planholder assets and (2) the ability to sell investment-linked contracts. However these changes would have major implications for the distribution system, and probably for market shares, since investment-linked contracts are not consistent with expensive agency systems. Thus long-term capital guarantees could be retained as a valuable long term policyholder benefit and as an acknowledgement of the ultimate purpose of the supplementary pension system. However, as already noted, they should be combined with a regulatory requirement that liabilities are set on an actuarial basis, adequate (preferably risk-based) capitalization is maintained, investment policies allow for asset and liability management considerations, risk reporting is comprehensive, and a full annual FCR is prepared for the pension fund management and supervisory boards and the financial regulators. In addition resilience tests should be carried out on the impacts of a sudden change in interest rates and significant switching or cashing out of planholders' accounts. Efforts should also be made to legally segregate the planholder assets of each pension fund from those of the owners of the pension fund, or at least adopt the EU life insurance wind up rules.

If segregated funds and investment-linked products were to be considered, the transition between the current and the new systems would raise new governance issues. The existing legislation is not designed for such an environment. Different sets of risk management skills would be required of management and boards. Regular (probably weekly in the initial stages) monitoring mechanisms would need to be established by the APF or possibly by a supervisory agency. In addition most of the capital, risk management and market conduct regulations applying to investment companies and mutual funds would need to be applied to pension funds.

Another issue would involve the disposition of assets and treatment of guarantees in any split of the planholder account from the pension fund balance sheet (i.e. the planholder account ceased to be fictive). In practice, it seems unlikely that existing contracts could be abrogated and any transition would need to involve voluntary switching to the new arrangements.³⁸ Those contracts with limited or no residual deferred acquisition costs could be switched at face value, with a liquidity facility backed up by the government (and secured against the assets of the pension funds) to ensure that assets could be realized. A further issue is equity among pension funds. All parties may need to agree on a fixed proportionate allocation of any freed government subsidy regardless of the size of the deferred acquisition cost asset.

Switching of a recently sold plan could be allowed at a discount to the accrued accounting balance. The issue then becomes the writing off of the relevant deferred acquisition costs. There are three possible sources of funds for this: (1) the accrued government contributions, (2) the accrued reserves and (3) any unrealized capital gains or hidden liability surplus. Any analysis will require both legal and actuarial input. A comprehensive reform in this area should include the establishment of two working groups to separately cover legal and actuarial issues. The working groups should be responsible for preparing briefing papers for the policy makers. Issues to be considered are the distribution of intangible assets and potentially offsetting liabilities over the pension funds, the true actuarial liabilities of the pension funds, liquidity considerations, and the ownership of deferred acquisition costs.

Such reforms would put the Czech supplementary pension sector on a solid footing, ready to meet the future needs of its working and retired population. The measures proposed in this report would help strengthen transparency and accountability in supplementary pensions, make financial analysts and the

³⁸ Sales of the existing demand deposit style contracts could be either terminated, or the contractual terms for new contracts changed so that reduced cash surrender values are payable over a reduced deferred acquisition costs write-off period.

public aware of the risks of continuing with the existing system, and build the necessary support for substantive reform.

The following measures are recommended:

- 1) Switching between pension funds should not attract sales commissions or incentives after the first switch within a 2 year period.
- 2) A cap should be placed on the period over which acquisition costs may be written off (for example, 5 years.)
- 3) Long term capital guarantees could be retained but with strong prudential and transparency requirements. The provisions should require that liabilities are set actuarially, adequate (preferably risk-based) capitalization is maintained, investment policies allow for asset and liability management considerations, resilience tests are carried out regularly, and a full annual FCR is prepared for the management and supervisory Boards and financial supervisory agency.

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Annex I: List of Review's Recommendations

Risk Management

- 1) International financial reporting and auditing standards should be applied to pension funds and should be specified in the pension fund legislation. The current hybrid of bank and life insurance accounting should ideally be resolved in favor of life insurance accounting. Priority: Medium
- 2) In order to improve public oversight, the financial supervisory body should have the authority to establish a list of approved auditors for pension funds and should specify an approach to determining liability valuations. Assets should all be valued at fair value in accordance with public notice 270/2004 Sb. The rotation of auditors should follow the EU's 8th Company Directive. Priority: Medium
- 3) All pension funds should be required to contract actuaries to assess their accumulation phase liabilities (including contingent liabilities), determine if the investment strategies are appropriate and confirm that the levels of economic capital are adequate, particularly in light of resilience testing. Priority: High
- 4) A full financial condition report (FCR) should be submitted by an appointed actuary to a profit (surplus) distribution committee, which should include members of both the management and the supervisory boards. This committee would then prepare a brief note explaining how it reached its decision regarding distribution. While the FCR would not be a public document, the pension fund's management and supervisory board would be required to lay out their reasoning regarding profit distribution at the annual meeting, and briefly, in the annual report. The FCR would also be available to the supervisory agency. Priority: High
- 5) Actuaries working on pension funds should have whistle-blowing responsibility—initially to the pension fund's management and supervisory boards and then, in the absence of action, to the financial supervisors. Priority: High
- 6) Annuities should not be determined until the date of retirement, or just before retirement. Annuitization factors should be regularly reset in light of emerging experience. This experience would ideally be generated by a continuous mortality investigation jointly managed by the actuarial profession and the Office of Statistics. Priority: High
- 7) There should be scope to reset annuities in the event that there are egregious changes in pensioner mortality or investment reinvestment returns. Product design could allow for these uncertainties – for example an annuity with a fixed term could be followed by a life annuity when the pensioner is very old. One legitimate role for government would be to act as reinsurer for annuitants who reach extreme old age. Priority: High
- 8) Capital levels should reflect the risks incurred in underwriting annuities—possibly restricting the issuance of annuities to well-capitalized life insurance companies with assets set aside in a separate fund.³⁹ Priority: High

³⁹ The Association of Pension Funds provided comment on an early draft of the report and discussed annuitization. Their comments are included in Annex IV.

Transparency & Distribution

- 1) A standardized management expense ratio covering the operating expenses allocated to planholders should be introduced to increase public understanding of the impact of funds' costs on planholders' balances and provide relevant benchmarks. The ratio would need to allow for all costs allocated to the planholder account, including distribution costs and write offs. Investment related costs should be offset against investment income and pension funds should be required to disclose their actual net nominal and real returns in their annual reports. Priority: High
- 2) Distribution companies of pension funds should be subject to conduct of business rules analogous to those of other financial sector distribution companies (i.e. "Investment Intermediaries Conduct of Business Rules.") Relevant sections of the investment advisor rules should include a requirement that intermediaries be professionally qualified, explain how the intermediary is remunerated, ensure that the customer's individual conditions are taken into account, avoid conflicts of interest, explain the risks and guarantees involved in an investment, and provide for equal and fair treatment to all customers. Priority: High
- 3) Where an employer is contributing to a pension fund on behalf of employees, mechanisms should be in place to ensure that employees have a full choice of pension fund. Employers should not be in a position to influence the planholder's choice of plan, even when contributing on behalf of the planholder. Officers of the employer should not be permitted to receive any remuneration from an intermediary. In addition, intermediaries should have their access limited to "pension fairs" where several pension funds present their plans to employees at the same time. Priority: High
- 4) A number of basic requirements that are appearing in other jurisdictions (such as minimum print size, proper contrast of print and paper color, key facts summaries and controls over illustration assumptions) should be introduced. Priority: Medium
- 5) Pension funds should be required to publish full asset and liability gap and duration data in the notes to their published financial accounts. Priority: High
- 6) To maximize competition, full transparency of current annuitization rates on offer should be required by pension funds. Priority: High

Supervisory Boards

- 7) Supervisory boards of pension fund companies should be required to review and approve the systems of internal controls of the pension funds, as in the case of collective investment funds under public notice 347/2004 Sb. Supervisory boards should also review the report of the actuary, as part of its discussions with the external auditor. Priority: Medium
- 8) Supervisory boards should be encouraged to develop internal committees such as audit committees. Priority: Medium
- 9) Related-party transactions within financial groups or conglomerates should be subject to the approval of pension funds' supervisory boards and be fully disclosed on a case by case basis to the depository, as well as appearing in the annual report. Priority: High

Fiduciary Duties & Conflicts of Interest

- 10) Either the Commercial Code or the pension fund legislation should be amended to specify that the governing bodies of private pension funds have superior fiduciary obligations to planholders relative to general creditors and shareholders in so far as funds backing planholder liabilities are concerned. Priority: Medium
- 11) The relevant laws should state in that management and supervisory boards have a fiduciary responsibility to planholders. In addition, a corporate governance code for pension funds could be developed. One approach would be for the APF to start with the existing corporate governance code applicable for listed companies and expand it to cover the specific types of fiduciary obligations applicable to the governing bodies for pension funds. Priority: High
- 12) Any dealings in a pension fund's assets by a staff member, officer or board member of that pension fund should be capped at a low level, and subject to the same approval and disclosure rules as for related party transactions. Pension funds should be subject the Financial Conglomerates Act. Priority: High
- 13) The "fit and proper" provisions that apply to members of supervisory and management boards of pension funds should also apply to internal auditors. Priority: High
- 14) Pension funds should be explicitly prohibited from owning (in part or in full) companies that sell and distribute pension funds. In addition, officers and directors of insurance companies should have no financial or other interests in distribution companies. Priority: High
- 15) Pension fund companies should be obliged to disclose any relationship with asset-management companies and securities companies that provide third party services. The law might also incorporate similar provisions found in the legislation on collective investment funds. All the materials should be provided in a manner that is digestible to the average citizen.
- 16) The APF should research policy regarding shareholder activism to guide its members. Priority: Low

Supervision

- 17) Financial regulators should use a risk-based approach to supervision rather than an inspection approach, as was planned for the second half of 2006. On-site supervision should be based on off-site risk analysis. Priority: Medium
- 18) The proposed MOF program to create a financial services ombudsman should be encouraged and any office of the ombudsman provided with adequate resources. Priority: Medium
- 19) The financial supervisors should strengthen their review of the capability of depositories to value complex financial instruments. Priority: Medium

Transition Issues

- 20) Switching between pension funds should not attract sales commissions or incentives after the first switch within a 2 year period. Priority: High
- 21) A cap should be placed on the period over which acquisition costs may be written off (for example, 5 years.) Priority: Medium

- 22) Long term capital guarantees could be retained but with strong prudential and transparency requirements. The provisions should require that liabilities are set actuarially, adequate (preferably risk-based) capitalization is maintained, investment policies allow for asset and liability management considerations, resilience tests are carried out regularly, and a full annual FCR is prepared for the management and supervisory boards and financial supervisory agency. Priority: High

Annex II: Comparison of Rules and Practices in the Czech Republic against Good Practices for Private Pension Fund Sector

Principle 1. Identification of responsibilities	
<p>There should be a clear identification and assignment of operational and oversight responsibilities in the governance of a pension fund. To the extent that a pension entity is established that owns the pension fund on behalf of plan/fund members, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in the pension entity's statutes, by-laws, contract or trust instrument, or in documents associated with any of these. If the pension fund is established as a separate account managed by financial institutions, the pension plan or contract between plan sponsors/members and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund.</p>	
Description	<p>The Act of Supplementary Pension Insurance specifies that pension funds are joint stock companies, governed by the Commercial Code. The Act constrains the equity of the company from being listed or charged and tightly controls movements of significant (greater than 10 percent) blocks. Employee and preference shares may not be issued.</p> <p>Planholders have no voting rights or any other voice in the management of the pension fund as a going concern. A depository (which has to be a bank) must be appointed to handle assets and monitor cash flows – this is perhaps the main effective planholder protection mechanism built into the system. A pension fund's employees may not make up more than one third of the boards of the depository but there is no requirement that the depository be part of a separate financial group – although in practice it usually is by implicit industry agreement. There was some doubt expressed to the authors that all depositories were capable of valuing complex instruments.</p> <p>It is also not clear that pension funds have the right to delegate asset management to other firms, and in practice the relationship is characterized as being "advisory". Pension funds monitor the investment activities of their asset-management companies on a daily basis. In addition the pension funds themselves are required to be able to prove that all transactions occur at fair market values and that transaction costs are reasonable.</p> <p>A pension fund must "manage its assets with due care and attention and with the aim of securing dependable revenues"⁴⁰. In addition it must not "manage its assets in a manner contravening planholders' interests" although it is not made clear what "planholders interests" means.</p> <p>Planholders have an exit option, which allows them to transfer all their contributions, accrued returns and state contributions to another pension fund⁴¹ at any time. They may also cash out after 12 months on less generous terms. It has been alleged that where employers are contributing on behalf of planholders, the planholder's right to switch can be constrained.</p> <p>The Act (section 9) requires that full details of the statute and pension plan are generally available for inspection. The statute includes the general rules for operating the pension fund including investment policy, surplus distribution, details of the depository and reporting to planholders. The plan describes the benefits being provided, notice serving protocols, general policy terms and conditions, and specifies that it shall be a DC arrangement (with the possible exception of disability benefits).</p> <p>Before a policy is signed the future planholder must be familiarized with the pension fund's articles of association. The pension plan forms part of the</p>

⁴⁰ This objective is not necessarily consistent with the maximization of long term returns to planholders.

⁴¹ See Section 24 of the Act. Once benefits start to be paid, the planholder would have to cash them in and transfer the cash to other fund.

	<p>policy.</p> <p>Information provided as part of the sales process does not have to include financial information on the pension fund, including expense rates, investment performance and capital strength.</p>
Recommendations	<p>The employer should not be in a position to influence the planholder's choice of plan, even when contributing on behalf of the planholder. The financial supervisory agency should strengthen its review the ability of depositories to value complex and sophisticated financial instruments. The law should specify the use of an independent depository and the establishment of a highly professional central depository should be considered. Pension funds should be required to provide at least minimal information on their expense levels, investment performance against benchmarks and financial strength (and such information should be publicly available), and disclose any relationship with asset-management companies and securities companies that provide third party services, at the time of sale.</p>
<p>Principle 2. Governing body</p> <p>Every pension fund should have a governing body or administrator vested with the power to administer the pension fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries. The responsibilities of the governing body should be consistent with the overriding objective of a pension fund which is to serve as a secure source of retirement income. The governing body should not be able to completely absolve itself of its responsibilities by delegating certain functions to external service providers. For instance, the governing body should retain the responsibility for monitoring and oversight of those service providers.</p>	
Description	<p>The relationship between the planholder and the pension fund is mediated by the terms of the policy, the statute and the Commercial Code. The Commercial Code requires that joint stock companies establish separate management boards and supervisory boards. The Code envisages that supervisory boards are primarily an inspection organ with limited oversight authority over management boards. A pension fund must have at least 5 MB members and 3 SB members, with the number of SB members being a multiple of 3.</p> <p>Section 194 of the Commercial Code requires that members of the board of directors (MB) conduct their duties with "due managerial care" and thus with due diligence. Section 194 also establishes joint and several liability for members of boards of directors and with Section 66 (2) clarifies that board members should conduct their duties in the interests of the company and its creditors. It is not clear that planholders are creditors at law, at least until a claim becomes payable. In any respect they appear to have no special precedence.</p> <p>Articles 65 and 196 of the Commercial Code stipulate limitations on competitive conduct for members of boards of directors and supervisory boards, but the code does not provide for other restrictions related to conflicts of interest. Section 7 of the Act specifies the people who cannot sit on a pension fund board. These include members of parliament and government, employees and officers of other types of financial institution that could have dealings with the pension fund, employees and officers of other pension funds, and people who are not "unimpeachable". Unimpeachability is a relatively weak requirement relating to criminal history.</p> <p>Members of pension fund bodies (i.e. directors) may not engage in property and chattel dealings with that pension fund. The sanctions section of the Act specifies that any dealings in the assets of a pension fund (over CZK 5,000) by any member of a pension fund body of the pension fund constitute misdemeanors. This is a fundamental issue of trust and a more serious response to such actions is indicated.</p> <p>Article 187 of the Commercial Code states that the shareholders' meeting has the authority to appoint and recall members of the MB (and SB) and set their remuneration—although the company statutes may authorize the</p>

	<p>supervisory board to appoint the management body.</p> <p>The MB is the governing board of the pension fund. Members of the MB are required to exercise their range of powers with due managerial care and are liable jointly and severally for damages arising from breach of their legal duties⁴². Selection of candidates for governing bodies and succession planning depends entirely on the activity of the pension fund shareholders. Given that nearly all funds have only one shareholder, they simply pick and appoint directors from their own human resource base. The Commercial Code stipulates only that members of the governing bodies are elected by the general meeting and limits the tenure of MB and SB members to 5 years⁴³. The Act adds the requirement of approval by the financial supervisory agency.</p> <p>The duty of the pension fund, i.e. of its MB, is to manage its assets with due care and attention and with the aim of securing dependable revenues. It must not manage its assets in a manner contravening planholders' interests, a contradiction in terms over the long run, as the MB is virtually forced to adopt a short term loss minimization strategy under other provisions of the Act.</p> <p>There are also no regulations preventing pension funds from absolving themselves of responsibilities by delegating functions to external service providers. For example it appears that the pension funds are not responsible for the selling practices of the multi-level agents that some employ.</p> <p>Members of the pension funds' MBs and SBs are often employees at various positions within the parent financial group, which may blur the lines of responsibility. However, the supervisor does have the right to approve these members.</p> <p>As the pension fund is a joint-stock company established according to Commercial Code, its employees (if there are more than 50 of them) elect one third of the Supervisory Board. However, the Act stipulates that no employee may be a Supervisory board member therefore employees may elect external/independent individuals only.</p> <p>The industry stakeholders are associated in the Association of Pension Funds of the Czech Republic that includes all 11 active pension funds (representing 100 percent of industry assets)⁴⁴. This body has issued a code of conduct, although this is somewhat dated.</p>
Recommendations	<p>Either the Commercial Code or the pension fund legislation should be amended to specify that the governing bodies of private pension funds have superior fiduciary obligations to planholders relative to general creditors and shareholders, in so far as the assets backing the planholder account are concerned. The bankruptcy law should specify that planholders are superior creditors in the event of a wind-up. Any dealings in a pension fund's assets by a staff member, officer or board member of that pension fund should be capped, disclosed and subject to Supervisory Board approval. Any dealings between financial institutions and pension funds in the same group should be subject to disclosure and Supervisory Board approval.</p> <p>The definition of pension fund body should be extended to include all management.</p>
<p>Principle 3. Expert advice Where it lacks sufficient expertise to make fully informed decisions and fulfill its responsibilities the governing body could be required to seek expert advice or appoint professionals to carry out certain functions.</p>	
Description	There are no provisions requiring the boards of pension funds to seek expert advice where needed to carry out their functions.

⁴² Section 194(5) of the Commercial Code.

⁴³ Sections 194 and 200 of the Commercial Code respectively.

⁴⁴ KPMG, major auditor of pension funds and insurance companies, is an associate member of the APF CR.

	<p>The World Bank team was advised that nine out of the then 11 pension funds use asset-management companies. However in all cases, the asset-management companies are part of the same financial group as the pension fund.</p> <p>An unwritten industry agreement requires that the pension funds use depositaries from outside the financial group containing the pension fund. However some groups provide reciprocal depositary services. In addition there appear to be no restrictions on financial institutions and pension funds in the same group from selling assets to and buying assets from each other (although reporting requirements exist under the Commercial Code). At the time of the mission there was some evidence of this in one group.</p> <p>Section 11 of the Pension Law requires that all pension funds use “actuarial principles” to assess pension benefits and contributions. However few, if any, funds employ full time fully-trained certified trained actuaries (see Actuaries below). It is not clear that boards receive sufficiently detailed actuarial reports to appropriately manage the pension funds’ risks for the purposes of both determining asset-liability management and economic capital.</p>
Recommendations	All funds should be required to use certified external experts where internal expertise is not capable of analyzing an issue and making professional recommendations. Examples include actuaries and systems analysts.
<p>Principle 4. Auditor An auditor, independent of the pension entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement. Depending on the general supervisory framework, the auditor should report promptly to the governing body and - if the governing body does not take any appropriate remedial action - to the competent authorities wherever he or she becomes aware, while carrying out his or her tasks, of certain facts which may have a significant negative effect on the financial situation or the administrative and accounting organization of a pension fund. The competent authorities should have the power to specify the accounting and auditing standard to be applied and to establish a list of approved auditors.</p>	
Description	<p>The Act is silent on the issue of external audit. Under the Act on Accounting, joint stock companies must have their annual financial statements reviewed by an auditor. This generic provision applies to pension funds as well. The Act on Auditing requires auditors to act independently while providing the audit.</p> <p>The Act specifies that asset valuations are subject to a special law covering investment companies and mutual funds. . There appears to be no restrictions on reclassification of fixed interest securities between categories. A valuation basis for planholder contracts is not specified, although an item called planholders’ account shows accumulated planholder contributions and surplus distributions. The treatment of actuarial liabilities appears to depend on the pension plan and the external auditor used. As one audit form tends to dominate this business and does use actuarial input, it is likely that a relatively consistent approach is being employed.</p> <p>Auditors are obliged to report to the governing body of the pension fund any circumstances potentially: (i) suggesting that regulations were breached; (ii) having a substantial adverse effect on the pension fund’s results; (iii) affecting the pension fund as a going concern; (iv) not leading to unqualified opinion; or (v) suggesting that an economic criminal act, bribery or criminal act affecting property may have been committed.</p> <p>Moreover, the auditor must report immediately all these circumstances, but (v), to the financial supervisory agency as well. The same rule applies to problems identified in any accounting entity in which the pension fund holds 20 percent or more voting rights, or of the registered capital, or forms a business grouping together with it.</p>
Recommendations	International financial reporting and auditing standards should be applied to pension funds. The current hybrid of bank and life office accounting should be resolved in favor of life office accounting, at least as long as the current

	<p>system remain in place. In order to strengthen public oversight, the financial supervisory agency should have the authority to establish a list of approved auditors for pension funds and should specify an approach to determining liability valuations. Assets should all be valued at fair value in accordance with public notice 270/2004 Sb. The pension fund legislation should specify the accounting and auditing requirements for pension funds.</p>
<p>Principle 5. Actuary An actuary should be appointed by the governing body for all defined benefit plans financed via pension funds. As soon as the actuary realizes, on performing his or her professional or legal duties, that the fund does not or is unlikely to comply with the appropriate statutory requirements and depending on the general supervisory framework, he or she shall inform the governing body and - if the governing body does not take any appropriate remedial action - the supervisory authority without delay.</p>	
<p>Description</p>	<p>Pension funds are not required to appoint an actuary.</p> <p>While the Pension Fund Act specifically defines pension funds as “defined contribution” programs, the Act also requires a minimum positive return of zero to planholders over any period from the last surplus distribution. This is a relatively strong capital guarantee. In addition a second guarantee for some planholders exists regarding the annuitization of lump sum payments at retirement. Another potential guarantee exists through the provision of defined disability benefits. The defined benefit elements are minor components of the Czech supplementary pension insurance but the pension guarantee is potentially valuable.</p> <p>A number of the pension funds review their asset and liability management policies using actuarial principles, supported in some cases by a “Big Four” audit firm. If necessary a supplementary liability for pensions is created under the “valuation differences” heading (although the APF quarterly analyses show this as being part of free funds).</p> <p>There is no whistle-blowing responsibility for actuaries working on pension funds.</p>
<p>Recommendations</p>	<p>All fund managers should be required to contract an actuary to assess their liabilities (including contingent liabilities) and establish appropriate investment strategies and levels of economic capital. Such an actuarial analysis is likely to provide economic support and justification for extending the statutory guarantee from being continuous after one year, to a longer term formulation, thus reducing the riskiness of system—and the economic capital needed. Actuaries working on pension funds should have whistle-blowing responsibility – initially to the pension funds’ boards and then, in the absence of action, to the financial supervisory agency.</p>
<p>Principle 6. Custodian Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.</p>	
<p>Description</p>	<p>Legally, there is no separation of the pension fund own assets and assets of planholders that would be managed by custodian. However, some functions of the custodian are performed by the depository bank that all pension funds are obliged to use. The Act does not require the depository to be independent of the pension fund, although this is standard practice. The depository has to be approved by CNB , and may be changed by CNB in certain instances.</p> <p>The role of the depository bank is defined mutatis mutandis under the Act on Collective investment; it requires that depository banks “review” asset valuations and ensure compliance with the laws and regulations, including the rules on investment allocation and risk distribution. The Act also provides for specific fiduciary duties for depository banks. They must act independently, with proper professional care and exclusively in the interests of planholders.</p>

	<p>In the case of pension fund depository banks all transactions are meant to be pre-approved by the depository before they are completed.</p> <p>The depository bank can not absolve itself of its responsibilities under the statutory legislation and the contract with the pension fund.</p> <p>The World Bank team noted that the depositaries have different levels of financial expertise and in some cases relied on the fund manager to determine market values for sophisticated financial instruments (such as asset-backed securities and instruments with embedded options).</p> <p>The Czech Republic has a central securities registry, which will soon be combined with a centralized depository with full payments and settlements clearing capacity.</p>
Recommendations	The capability of depositories of valuing complex and sophisticated financial instruments should be monitored more closely.
<p>Principle 7. Accountability The governing body should be accountable to the pension plan members and beneficiaries and the competent authorities. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as a benefit provider. In order to guarantee the accountability of the governing body, this should be legally liable for its actions.</p>	
Description	<p>The concept of pension funds implies a strong trust relationship—which needs to be clearly incorporated into pension fund legislation.</p> <p>As noted earlier the accountability of a Czech’s pension fund’s governing body is almost entirely based on the Commercial Code provisions for joint-stock companies. In summary the MB and SB are accountable to the shareholder(s), although the articles of association can make the MB to be accountable directly to SB. The MB must follow the principles and instructions approved by the general meeting, provided that they conform to the statutory provisions and the statutes. There is no direct legal accountability to planholders or beneficiaries.</p> <p>The Commercial Code does include some provisions on fiduciary responsibility of joint stock company governing bodies. The Code requires that members of management boards must act with due managerial care and they bear the burden of proof in case some doubts are raised about their decisions. The Act adds that management boards must manage pension fund assets with due care and attention, with the aim of securing dependable revenues and they must not manage assets in a manner that would contravene planholders' interests⁴⁵.</p> <p>If there is a dispute about whether a particular member of the board of directors exercised due managerial care (due diligence), the burden of proof is borne by such member. Members of the MB who cause damage to the company by breaching legal duties while exercising their powers are liable for such damage jointly and severally.</p> <p>However beyond these general principles, the standards of care are clarified only by court rulings. Several cases of bankrupt pension fund are in the courts and the court rulings will help market planholders interpret the generally stated professional standards. However, these cases generally take many years to settle. Furthermore the early versions of the Czech financial sector laws included many loopholes that allowed practices that are today considered incompatible with any professional and ethical standards.</p> <p>To assist the courts in determining if board members have met their fiduciary duties in specific cases, it would be helpful if a detailed corporate governance code were developed for pension funds. The Association of Pension Funds prepared a basic ethics code in 1997 but a detailed code of corporate governance is desirable.</p>

⁴⁵ Section 31 of the Act.

	<p>The MBs meet as often as is necessary, but there is no requirement for regular meetings, apart from regular participation at the general meeting. The MB decides all company matters, unless they fall within the powers of the general meeting or SB as stipulated by the Code and the company's articles of association. It also ensures proper management of the company's business, including bookkeeping, and compliance with the statutes, and submits proposal and financial statements to the SB and general meeting. The Commercial Code requires the SB only to attend the general meeting⁴⁶, but there is no requirement for regular meetings.</p>
Recommendations	<p>Fiduciary duties of the management board and in particular, the supervisory board to plan planholders should be clearly and unequivocally stated in the legislation. In addition, a corporate governance code for pension funds should be developed. One approach would be for the APF to start with the existing corporate governance code applicable for listed companies and expand it to cover the specific types of fiduciary obligations applicable to the governing bodies for pension funds.</p>
<p>Principle 8. Suitability The governing body should be subject to minimum suitability standards in order to ensure a high level of integrity and professionalism in the administration of the pension fund.</p>	
Description	<p>The Commercial Code and the Act stipulate that only individuals who are over 18 years of age, are capable of conducting acts in law, are unimpeachable, professionally qualified, are not senior public officials⁴⁷, and who have been granted CNB 's prior approval are eligible to be members of the pension fund governing bodies.</p> <p>The Act provides that while directors must be "professionally qualified" there are no specific levels of professional attainment or experience specified.</p>
Recommendations	<p>The CNB has developed extensive fit and proper procedures. It would be helpful if the same provisions were applied to pension funds as they have at least the same level of fiduciary responsibility—due to the long-term nature of the investments and the absence of guarantee arrangements equivalent to deposit insurance. The fit and proper requirements applicable to banking and securities markets should be applied to the pension fund governing bodies.</p>
<p>Principle 9. Supervisory oversight The regulatory system should require that the supervisor will monitor the governance mechanisms of supplementary pensions through both off-site analysis and on-site inspection.</p>	
Description	<p>The CNB has no independent regulatory powers in this field except the right to issue regulations: There had been no such a decree at the time of the World Bank mission. The CNB has the power to impose fines and apply organizational sanctions for breach of certain investment related rules and non-performance of a depository.</p> <p>The financial supervisory agency has carried out on-site and off-site supervision. Off-site inspections focus on the management of planholders' funds and assets. Regular reports and statistical reports of pension funds are examined within offsite inspections. In the event of any doubts, the CNB requires extraordinary reports.</p> <p>The CNB has used its information and controlling system to monitor compliance with the Act and with conditions stipulated in respective pension plans. The information system is updated on a 3monthly basis: this has make it possible to control compliance with the insured period and age for benefit payments, the sum of paid-out state contributions and provided other useful information on individual contracts⁴⁸.</p> <p>The on-site inspections are conducted according to a plan of activities and have been focused mainly on management, and compliance with the statutory condition stipulating that the pension fund must be managed with</p>

⁴⁶ Section 201 of the Commercial Code.

⁴⁷ See Section 7(3) of the Act for the full specification.

⁴⁸ Information on supervision is based on the [2003 Annual Report of the Office](#).

	<p>due diligence and with the aim to generate reliable revenue. The inspection typically reviews: (1) information systems (recording of state and planholders' contributions, employers' contributions, returned state contributions, and performance of contractual relations between the pension fund and planholders); (2) contracts between pension funds and contractors so as to examine whether the volume of financial performance was adequate; and (3) pension fund internal regulations and their compliance with law.</p> <p>Typically pension plans have been inspected once every two years. In 2003 administrative action was started in two cases based on the results of inspections. No fine was imposed because shortages were minor only and of administrative nature. Corrective measures were ordered in stipulated timescales to remedy the defects.</p> <p>If the Office discovers that a pension fund is breaching or not fulfilling its obligations it may, depending on the severity and nature of the discovered irregularities, use one of the following enforcement tools⁴⁹:</p> <ol style="list-style-type: none"> 1. instruct the pension fund to eliminate such irregularities within a specified period of time and inform the Office about the progress of the measures taken; 2. replace members of pension fund bodies by a specified deadline; 3. suspend the authorization of MB to administer the pension fund's assets for a defined period up to a maximum of six months and to a defined extent, and appoint an administrator for such period to take charge until (i) the general meeting appoints a new MB or (ii) restores the original authority of the previous board of directors, or (iii) until the pension fund's liquidation is entered in the Commercial Register. 4. reduce, for a limited period of time of up to two years, the part of the profit that is distributed under a resolution of the general meeting (10 percent of profit); 5. (d) revoke the license if the following reasons are in place: (i) the license application deliberately contained false information which was decisive for the granting of the license; (ii) continuance of the pension fund's activities would jeopardize planholders' claims because the pension fund is committing a grave breach of its obligations as stipulated by this Act, the statutes or the pension plan; (iii) the financial results of the pension fund reveal serious failures; or (iv) the pension fund has not taken the appropriate measures to restore its ability to cover supplementary pension insurance entitlements within the determined period; or (v) the pension fund has failed to conclude a new depositary agreement within one month of the effective date of ministry's ruling on a change of depositary. <p>The CNB is authorized to request any information from a pension fund about its business activities in the scope necessary for the exercise of state supervision⁵⁰. Governing bodies, their members and employees of a pension fund are be obliged to provide the Office with requested documents and written materials necessary for the state supervision of pension funds, and to furnish all the necessary information and explanations.</p> <p>The CNB has the right to issue fines:</p> <ol style="list-style-type: none"> 1. up to CZK 100 000 (~USD 4000) to members of governing bodies for the breach of no-conflict clause and to all employees for the breach of confidentiality clause; 2. up to CZK 20 million (~USD 800 000) for carrying pension fund activity without the license; 3. up to CZK 5 million (~USD 200 000) for various other offences such as: <ul style="list-style-type: none"> • concluding a policy with non-eligible planholder; • using shares constituting a stakeholding of the pension fund's shareholders to secure the pension fund's liabilities;
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⁴⁹ Section 43 of the Act.

⁵⁰ Section 42 of the Act.

	<ul style="list-style-type: none"> • misreporting a current account with a bank other than the depository; • failing to acquaint planholders with the statute and the pension plan or failing to notify planholders in writing of changes to the pension plan which affect supplementary pension insurance benefits and entitlements; • failing to pay out supplementary pension insurance benefits to a planholder in the times and in the agreed manner; • failing to transfer a planholder's financial means to a different pension fund within the time limit; • failing some information duty; • failing to submit an application for a state contribution; • failing to return to the state budget wrongfully remitted state contributions; • administering its assets in a manner contravening planholders' interests; • failing to inform CNB without delay that it is not able to cover supplementary pension insurance benefit entitlements; • carrying on an activity that is not directly connected with supplementary pension insurance; • placing the pension fund's financial means in a manner contravening placement rules or investment limits or failing to notify CNB without delay that limits have been exceeded; • buying the shares of another pension fund or issuing bonds; • failing to publish a financial performance report; • failing to store or safeguard documents for the stipulated period; • providing information concerning an individual planholder without his or her authorization; • failing to submit to the CNB a list of shareholders pursuant to or failing to inform them of a change to the list; • failing fails to eliminate within the stipulated time limit irregularities found during state supervision or failing to inform the Office of the implementation of adopted measures; • failing to replace members of a pension fund's bodies within the specified time limit. <p>The same fine may be imposed on a depository which fails to eliminate irregularities found during state supervision or fails to inform ministry of the implementation of adopted measures.</p> <p>A further reconciliation check on the system is available through quarterly requests from for government subsidy payments as these contain full planholder details. MOF has retained the unit that handles government contributions and there will be a need to ensure that this control mechanism is replaced.</p>
Recommendations	<p>On-site supervision should be based on off-site risk analysis.</p> <p>The move to an integrated supervisor should afford an opportunity to rationalize responsibilities and prepare for a more sustainable system.</p>
<p>Principle 10. Internal controls & risk management</p> <p>There should be appropriate controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's bylaws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organizational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.</p> <p>The assets of pensioners and shareholders should be legally segregated with the appropriate levels of accounting, internal controls and governance mechanisms. The assets underlying pension liabilities should be sufficient to cover the nature of the liabilities in terms of amount, risk profile and maturity duration with a relatively high probability. In addition, the economic capital should be sufficient to provide sufficient time and financial cushion to enable an appropriate response to any unexpected deterioration in asset-liability matching (e.g. embedded options coming heavily into the money) and operational risk.</p>	

Description	<p>Pension fund assets are not segregated from shareholder funds. In addition, no mechanism exists which would allow pension holders or financial analysts to identify the specific assets supporting the pension funds' liabilities. An analysis of the risk characteristics of the liabilities is carried out by some fund managers but not by all—and is not required by law or regulation. Some fund managers use licensed actuaries to evaluate the policy liabilities.</p> <p>A minimum capital of CZK50 million is established by law but the law sets no minimum statutory solvency requirement. In addition there is no additional requirement to determine if economic capital levels are adequate. Pension funds are defined as "banks" for accounting purposes . Thus the specific provisions of IFRS related to insurance contracts (i.e. IFRS 4) are not applied to insurance. Even the pension (annuity) guarantee is not captured.</p> <p>External auditors are not required to examine internal control and risk management systems, although most international groups do ask their external auditors to review the systems of internal controls. Those financial groups with subsidiaries listed on US stock exchanges are obliged to apply the internal control audit provisions of Section 505 of the Sarbanes-Oxley Act.</p> <p>The Act on Pension Insurance is silent on the issue of internal auditors or their relationships with pension fund supervisory management or supervisory boards.</p> <p>The Commercial Code and the Act contain several provisions to prevent conflicts of interests (a clause prohibiting competitive conduct of employees is also in the Labor Code). The Act includes a provision that prevents a pension fund employee from serving two pension funds at the same time. The Act also provides supplementary controls over self-dealing in real estate and limits the quantum of self dealing to CZK5,000 per transaction. Under the Commercial Code, related party transactions need to be reported to the supervisory agency and published in the company's annual report. At the time of the mission the CNB was dealing with a situation where pension funds may have invested in the shares of their parent companies.</p> <p>Placements of the pension fund are subject to the following limits⁵¹:</p> <ol style="list-style-type: none"> 1. The value of securities issued by one issuer must not constitute more than 10 percent of a pension fund's assets. This restriction does not apply to bonds specified in G.12.1 and 2. 2. The total value of movables and real estate must not constitute more than 10 percent of a pension fund's assets. 3. A pension fund must not own more than 20 percent of the total nominal value of securities issued by one issuer. This restriction does not apply to bonds specified in G.12.1 and 2. 4. At least 70 percent of a pension fund's assets must be placed or invested in assets denominated in the currency in which the pension fund's liabilities in respect of planholders are denominated. 5. At most 70 percent of a pension fund's assets may be placed in assets described in G.12.3 to 6. 6. At most 5 percent of a pension fund's assets may be placed elsewhere than listed in G.12.1 to 7. 7. The financial means placed with one bank's deposit accounts, deposit books or deposits confirmed by a deposit certificate must not exceed 10 percent of the pension fund's assets or CZK 20,000,000, or the equivalent of such sum in foreign currency. 8. A pension fund is prohibited from purchasing the shares of another pension fund and from issuing bonds. <p>When exercising purchase or option rights attached to securities and in the event of changes in the price of securities or changes in the valuation of real estate and movables, the percentages stated in the previous subsections</p>
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⁵¹ Section 34 of the Act.

	<p>may be exceeded for a maximum period of six months, during which period the risk distribution must be restored in accordance with the previous subsections. A pension fund is obliged to notify the CNB without delay when the limits specified in subsections 1. through 6. are exceeded.</p> <p>A pension fund must manage its assets with due care and attention and with the aim of securing dependable revenues; it must not manage its assets in a manner contravening planholders' interests⁵². Pension funds may carry on activities other than supplementary pension insurance only if such other activities are directly related to supplementary pension insurance. Financial means accumulated by a pension fund must be placed with due care and attention in such a way as guarantees the safety, quality, liquidity and profitability of the composition of the financial portfolio as a whole. They may be placed in⁵³:</p> <ol style="list-style-type: none"> 1. bonds issued by a member state of the OECD or by the central bank of such state and bonds guaranteed by a member state of the OECD 2. bonds issued by the EIB, EBRD, IBRD or another international financial institution of which the Czech Republic is a member; 3. participation certificates of mutual funds; 4. securities traded on a authorized regulated market of an OECD country; 5. movables constituting a guaranteed safe deposit of financial means, with the exception of securities; 6. real estate providing a guarantee of a reliable placement of financial means and serving entirely or predominantly for commercial or residence purposes; 7. deposit accounts, deposit books and deposits confirmed by a deposit certificate at a bank or branch of a foreign bank in the territory of the Czech Republic or at a bank with registered office in the territory of OECD member states; 8. Hedging transactions, namely derivatives and options, can be concluded by a pension fund only under condition that they result in decreasing of the risks of rates of securities, interest rates and exchange rates of those assets forming a part of portfolio of pension funds⁵⁴. <p>A pension fund is obliged to buy securities at the lowest price made possible by proceeding with due care and attention and to sell them at the highest price made possible by proceeding with due care and attention. The pension fund shall be obliged to prove that these conditions were fulfilled.</p> <p>Only a bank being the depository of a pension fund can undertake financial settlement of any of the above transactions.</p>
Recommendations	<p>Even if pension fund assets are not segregated, the assets supporting the accrued policy liabilities should be clearly earmarked. The assets should not include any "intangible" assets such as deferred acquisition costs (DAC.) Furthermore, a full actuarial overview is needed of the fund's liabilities and matching assets (and underlying capital). A financial condition report (FCR) should be annually prepared by an actuary and submitted to the pension funds' governing bodies and the supervisory agency. Surplus distribution should allow for the recommendations contained in the FCR.</p> <p>Legislation should be amended to require that the external auditor also comment on the quality and robustness of the pension funds' systems of internal controls and risk management.</p> <p>Supervisory boards of pension fund companies should be required to review and approve the systems of internal controls of the pension funds, as in the case of collective investment funds under public notice 347/2004 Sb. Supervisory boards should also review the report of the actuary, as part of</p>

⁵² Section 31 of the Act.

⁵³ Section 33 of the Act.

⁵⁴ If such transactions can be concluded on public market, the pension fund is obliged to conclude them only on public market, and furthermore on authorized regulated markets of OECD, provided they are valuated on daily basis by reliable and transparent method and the respective fund is able to turn them any time in financial means and conclude such transactions at their market value.

	<p>its discussions with the external auditor</p> <p>All pension funds should be required to maintain an internal audit function report directly to the pension funds' supervisory board.</p> <p>While some pension funds already discuss risk management in their annual reports this should be mandatory.</p>
<p>Principle 11. Reporting Reporting channels between all the persons and entities involved in the administration of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.</p>	
Description	<p>There are no specific requirements that pension funds establish internal reporting channels to ensure that all persons and entities involved in the administration sufficient relevant and accurate information. Assets remain in the name of the pension fund at all times and are held and independently valued by an unrelated bank depository: the Act on Collective Investment assigns the depository bank to perform extensive oversight duties (including settlement, monitoring of compliance, holding paper based securities and record keeping), which require effective and timely transmission of relevant and accurate information.</p> <p>Typically there are 5 parties (not including the 2 supervisors with oversight responsibility) involved in pension fund reporting and information flows, namely the pension fund, the asset-management companies, the broker dealer, the bank depository and the planholder. The World Bank team noted that the system in practice works on a "multiple eyes" basis with daily monitoring of cash movements by the pension fund and depository and at least monthly reconciliations of the accounts of the pension funds and asset-management companies. The pension fund is also usually able to monitor commission levels paid to brokers on a real time basis.</p> <p>The standard reporting requirements to the planholders include annual report on their account and the returns to the planholder account. In addition pension funds must publish their key financials in the national press. Moreover, the pension fund's articles of association, statute, pension plan, annual report, overview of deposits and placement, number of planholders, list of the members of a pension fund's bodies and a list of the pension fund's shareholders have to be made available to the public⁵⁵.</p> <p>The Act requires pension fund to specify methods of publishing reports, including financial reports, regulatory reports, reports to planholders and changes to its governing documents. Pension funds also comply with regulatory requirement on regular submission of electronic information⁵⁶.</p> <p>Rules of calculations of the value of securities in the portfolio of a collective investment fund stipulated by the Act on Collective investments apply mutatis mutandis to pension funds.⁵⁷ Appraisal of assets and liabilities follow these rules: (i) the securities and derivatives must be regularly appraised within the deadlines specified in the statute, at least once every 2 weeks; (ii) real properties, movable things, rights, and other values must be regularly appraised within the deadlines specified in the statute, at least once annually (by qualified estimate or by an appraiser); (iii) during an accounting period, a fund shall appraise the assets and liabilities as of the date of determining the current value of a share or unit certificate without compiling a financial statement; and (iv) assets and liabilities of a fund shall be appraised pursuant to a special regulation governing accounting or further implementing regulation.⁵⁸</p>
Recommendations	A mechanism should be available to show the half yearly and yearly

⁵⁵ Section 26 of the Act. In addition the Commercial Code stipulates that these documents are also available in the company's file at the Commercial Court' Register.

⁵⁶ Section 11 of the Act.

⁵⁷ Section 33 (5) of the Act.

⁵⁸ Section 82 of the Act on Collective Investments.

	performances (expense rates, return against benchmark etc) and financial strength of the pension funds in a manner that is digestible to the average citizen.
Principle 12. Disclosure The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, supervisory authorities, etc.) in a clear, accurate, and timely fashion.	
Description	<p>All major decisions with possible effect on future benefits must be specified some way in the governing documents of the pension fund (articles, statute or pension plan). These have to date been approved by the financial supervisory agency and made available to public.</p> <p>The supplementary pension insurance is established by the signing of a policy between an individual who is eligible to be a planholder and a pension fund. The contract must not contain any clauses that could be misused to the planholder's disadvantage⁵⁹. Prior to the signing of a policy the future planholder must be familiarized with the statute and the pension plan⁶⁰. The pension plan to which a policy refers and which is attached to the policy shall be part of the policy.</p> <p>By signing a policy the pension fund is bound to provide the planholder with benefits in the amount and manner stipulated by the pension plan and given policy, and the planholder is bound to remit contributions to the pension fund on the conditions, in the amount and in the manner defined in the pension plan and given policy. Each policy must settle the provision of old-age pension⁶¹.</p> <p>A pension fund is obliged to notify planholders in writing of any changes to the pension plan that affect supplementary pension insurance entitlements and benefits. There is no provision regarding timeliness.</p> <p>All governing documents, financial reports, information legal changes, minutes of the general meetings, and some other documents are available in the Collection of Documents at the relevant court (the list of these documents is available on the internet). They can be obtained from court at a photocopying charge. Annual reports, status and pension plan are available for download at the pension fund website, which may be accessed directly or through the APF website. At the time of the mission no pension fund made its articles of association available on the web.</p> <p>Information on investment returns and administrative costs are included in the annual report. The Act stipulates that the pension fund's annual report and the pension fund's articles of association must be accessible to all planholders, including pension recipients.</p> <p>A list of the members of a pension fund's bodies and a list of the pension fund's shareholders, has to be available to the public at the pension fund's registered office and all branches⁶².</p> <p>Planholders must be informed by the pension fund at least once a year of the surplus distribution which the pension fund registers in favor of their supplementary pension insurance entitlements. It needs to send this information within one month from the date of a general meeting which decided on surplus distribution. The information must include the pension fund's report on economic performance, including an overview of deposits and placement of the pension fund's assets and the amounts thereof, as well as the number of planholders.</p> <p>The pension fund is also obliged to send the above information any time at the planholder's request. The pension fund is authorized to demand from the</p>

⁵⁹ Section 12 of the Act.

⁶⁰ Section 13 of the Act.

⁶¹ Section 14 and 15 of the Act.

⁶² Section 26 of the Act.

	<p>planholder reimbursement of reasonable costs incurred in respect of the sending of information on a second and further occasion⁶³.</p> <p>There is no disclosure requirement regarding managerial decisions unless the decision affects entitlements and benefits.</p> <p>There is no requirement to disclose corporate governance or risk management policies and procedures. Some information may be included in the annual report and other documents available in a public domain.</p> <p>While assets need only be valued annually under the provisions of the Act they are valued at least quarterly for the purposes of the APF we site disclosure. Some pension funds value assets as frequently as weekly.</p>
Recommendations	See Reporting above.
Principle 13. Redress	
Pension plan members and beneficiaries should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts that assure prompt redress.	
Description	<p>There are no statutory redress channels except for the court. Complaints have typically been sent to financial supervisory agency, which usually passed them onto the pension fund concerned. In these situations the pension fund has been required to copy financial supervisory agency in on the response supplied to the planholder. Some planholders also contact the APF.</p> <p>In case of bankruptcies courts are not particularly effective. Out of 9 cases only one was settled at the time of the mission and the rest had been in process on for over 4 years.</p> <p>The MOF does have a longer term strategy to improve consumer education on financial matters and to strengthen redress mechanisms.</p>
Recommendations	A fully fledged financial services ombudsman or equivalent could be created in the Czech Republic, possibly building on the current rather narrowly defined role. The proposed MOF program should be encouraged and provided with adequate resources.
Principle 14. Exercise of voting power	
Description	<p>There is no requirement to consider voting. However, pension funds, that are limited to not more than 20 percent of one issuer's shares, are in a position to exercise some power by coordinating the voting with the rest of their financial group or through concerted action organized through the APF. In practice there is no evidence of shareholder activism in the Czech Republic.</p> <p>Pension funds have no obligation to disclose their vote at an annual or special meeting but an interested party may, at least theoretically, get such information from the minutes of the general meeting that are filed with the respective Commercial Registry Court.</p> <p>As with all shareholders, pension funds have a choice to exercise voting rights, but not an obligation. In practice decisions to use a pension fund's vote are made by the asset manager of the pension fund or the asset management company that is contracted by the pension fund.</p>
Recommendations	The APF should carry out policy research regarding voting by pension funds at the shareholders' meetings of the companies they hold investments.

⁶³ Section 26 of the Act.

Annex III: Tax Structure of Contributions and Withdrawals

Contributions

- The State contribution is tax exempted. The State contributes as follows:

Planholder's Contribution (CZK)	State Contribution (CZK)
100 - 199	50 + 40% of the amount over CZK 100
200 - 299	90 + 30% of the amount over CZK 200
300 - 399	120 + 20% of the amount over CZK 300
400 - 499	140 + 10% of the amount over CZK 400
500 and more	150

- Planholders contributions up to CZK 6,000 per year are not tax exempted, but contributions over CZK 6,000 per year can be deducted from the personal income tax base up to the total deduction limit of CZK 12,0000 per year.
- Employers contributions up to five percent of wage are not considered as a part of the employee income, for income and social security tax purposes. Therefore, it is cheaper for the employer to raise total compensation of its employees by paying contributions to a supplementary pension fund than increasing wages, because they do not have to pay the social security tax form the respective amount. Moreover, employers can deduct from their tax base the contributions they make to a voluntary pension plan of their employees up to three percent of employee's annual wages.

Withdrawals

- If the benefit is taken as lump-sum (one-off payment) then a 15 percent tax is due over the difference between the lump-sum and the sum of planholders contributions and the State contribution.
- If the benefit is taken as a pension (flow of benefits), a withholding tax equal to 15 percent is paid over the amount of the benefit exceeding the sum of contributions made by both the employer and the planholder and State contributions.
- If the plan is terminated before there is limited right to receive benefits from it, a 25 percent tax is paid on the difference between the surrender payment and the sum of planholders contributions and State contributions.

Annex IV: Annuitization

The APF submitted the following comments on annuitization:

- 1) The relevance of the mortality rates was never set by law. Nevertheless, they were submitted to supervisory agencies. With the first pension plans ever in our history, the pension funds gave priority to pensions paid out during life and until exhaustion of the amount saved, which posed no problems, either, from the standpoint of liquidity, for the pension funds or for the interests of the planholders. State regulators however gradually increased their objections that this form of payment does not guarantee the same level of payments because they decline as the age increases.
- 2) Next the law dispensed with pensions for a fixed period, leaving only pensions for life. By order of the regulator, pension plans that did not use the mortality rates of the Czech Office of Statistics were not approved.
- 3) After that, however, based on calculations by pension fund actuaries, we started being informed that the mortality rates given by the Czech Office of Statistics are based on the total population of the Czech Republic and do not correspond to the specific base of pension fund planholders and that in case of massive exhaustion of the pensions, the mortality rates of the Czech Office of Statistics could lead to pension funds not being able to meet their customers' claims.
- 4) As early as 2004, the APF called on certain organs of public administration—the Ministry of Finance, the Ministry of Labor and Social Affairs, and the Czech Office of Statistics—to create with the special involvement of the Czech Office of Statistics special mortality rates intended for the use of pension funds. The result was the establishment of a task force at the Ministry of Labor and Social Affairs, which is currently calculating the degree of difference in mortality for the over-all mortality rates of the Czech Office of Statistics and for the base of pension fund planholders.
- 5) To date no special mortality rates for pension funds have been published, and the funds have since 2004 been allowed to use the mortality rates of the Czech Office of Statistics in calculating the development of the base of pension fund planholders. Calculating death rates for the purposes of insurance has been left entirely up to the insurance companies.



THE WORLD BANK
Private and Financial Sector
Development Department
Europe and Central Asia Region
Washington, DC