

Varma's Interim Report 1 January–31 March 2017

The comparison figures in parentheses are from 31 March 2016, unless otherwise indicated.

- Total result amounted to EUR 584 (-754) million.
- The three-month return on investments was 2.7 (-1.4) per cent, and the market value of investments stood at EUR 44.4 (41.1) billion.
- Solvency capital was strong, at EUR 10,783 (9,110) million, which is 132.2 (128.6) per cent of the technical provisions and 1.5 (2.0) times the solvency limit.

Economic operating environment

The outlook for the Finnish economy has improved. Confidence and expectation indicators have been strengthening for some time, and the real economy has also improved.

Consumers' confidence in the economy is nearly at a record-high level, and their expectations of their personal situation are good. In the business sector, sentiment is not quite as high, but with the exception of construction, expectations strengthened in all main business sectors in March. Industrial production volumes grew in 2016.

Employment has improved, and the unemployment rate declined in the course of 2016. The improvement in the employment rate slowed down, however, during the first quarter of 2017. Finland's economic growth has been driven by the domestic market. Investments are beginning to recover, and exports are expected to be boosted by an increase in cost competitiveness and strengthening global economic growth. The pickup in exports looks promising for Finland's economy.

In the US, indicators suggest that growth will continue, although the pace slowed down at the end of last year. Expectations of the impacts of the new president's economic policy remained positive, despite both the lack of progress in the measures and lack of details in the plans. Uncertainty surrounding the contents of the economic policy and concerns over an increase in protectionism have not, however, stemmed growth or clouded confidence in the future of the markets.

In the light of economic growth, improved employment and strengthened leading indicators, the Fed continued with its previously announced normalisation of monetary policy. The monetary policy stimulus measures are being cautiously rolled back.

The stock exchanges continued to strengthen during the first quarter of the year. From a global perspective, interest rates bottomed out last year, rising slightly since then. Increased political risks were not mirrored in the valuations in the markets.

The Chinese economy has been steadily revived and is quite deeply in debt. The situation in the financing sector and real estate market, as well as potential market bubbles, are also raising concerns. The uncertainty appears to be under control at the moment, and the economy is growing along its predicted path.

The eurozone economy strengthened further, despite growth still being driven by domestic markets. Employment has improved, and the easing of tight financial policy has promoted growth in demand. The greatest concrete financial risk in Europe is the weak situation of Italy's banking sector. Political uncertainty in Europe continues, and the Brexit negotiations have officially begun. The French presidential elections in April are causing tensions. The strengthening economy appears to have at least temporarily tempered Euroscepticism.

Inflation has slightly increased, but the so-called core inflation rate remains quite muted in the eurozone. Also in Europe, the central bank has taken small steps to change the direction of monetary policy and has cut the value of its monthly purchases.

Earnings-related pension system

The reformed earnings-related pension legislation took effect at the start of 2017. The purpose of the pension reform is to lengthen careers and strengthen the financial and social sustainability of the earnings-related pension system. The pension reform will also help close the sustainability gap in public finances.

In the first stage of the pension reform, the new partial early old-age pension, which replaced part-time pension at the start of the year, raised the most interest among Varma's customers. The reformed legislation has increased the need for information, and Varma has especially focussed on developing its digital services for private customers. Effective means of lengthening careers are being sought by developing workability management services and through statutory vocational rehabilitation.

Varma's IT systems were updated in 2016 such that the renewed pension legislation has been applied since the start of 2017. System updates and modifications have been smooth and have not had an impact on the processing times of pension decisions.

As part of the pension reform, the equity-linked share of the return requirement on technical provisions was increased from 10 per cent to 15 per cent for the current year, and to 20 per cent as of the beginning of next year.

The Ministry of Social Affairs and Health approved the calculation bases concerning the distribution of customer bonuses for each earnings-related pension insurance company. The calculation bases will come into play for the first time for client bonuses that are to be distributed on the basis of surplus accrued in 2018 and which will lower insurance contributions in 2019. In Varma's criteria for distributing client bonuses, the investment and loading profit is distributed across five customer segments based on how the profit was made.

At the start of the year, the calculation of the solvency limit for pension institutions also changed. The new calculation model takes the risks of investment operations and underwriting risks into account more broadly than before. In concept, however, the new solvency limit is not directly comparable with the previous limit. In the same connection, the method of presenting key figures related to solvency also changed.

Varma's financial trends

Varma's total result at fair value for the three-month period amounted to EUR 584 (-754) million. The most important component of the total result is the investment result, which was EUR 573 (-746) million. The return on investments at fair value was EUR 1,172 (-573) million. The interest credited on the technical provisions was EUR 600 (174) million. The estimated technical underwriting result was EUR 3 (-16) million and the loading profit was EUR 8 (9) million.

Legislation governing how earnings-related pension institutions' solvency is calculated changed as of the start of 2017. The change did not have a material impact on Varma's solvency position. Varma's solvency strengthened in comparison to the situation at the beginning of the year. The solvency capital, which serves as a risk buffer for investment operations, was EUR 10,783 million at the end of March (10,199 mill. on 1 Jan), and 132.2 per cent in relation to the technical provisions (130.9% on 1 Jan).

The solvency capital was on a sustainable level, i.e. 1.5 (2.0) times the solvency limit.¹ The solvency limits have been calculated in accordance with the regulations in force at the time.

Varma's balance sheet and income statement at fair value, solvency and its development, investments at fair values and total result are presented in the attachment.

Insurance business

At the end of March, Varma's pension recipients numbered 341,000 (340,000 on 1 Jan). Claims paid during January–March totalled EUR 1,260 (1,242) million. By the end of March, 6,778 new pension decisions were made, which is roughly 20.4% more than in the corresponding period last year. A total of close to 13,000 pension decisions were given in January–March. An especially popular type of pension was the partial early old-age pension, which took effect at the start of the year; a total of 870 people were granted the pension during the first quarter.

At the end of March, Varma provided insurance for 532,000 (530,000 at the start of the year) employees and self-employed persons.

Varma observes good insurance principles in its operations.

Investments

The strong return on Varma's investments during January–March was evenly distributed, due to the positive return development of all asset classes. The return on investments was 2.7 (-1.4) per cent, and the value of investments stood at EUR 44.4 (41.1) billion at the end of March. Thanks to the good return trend, Varma's solvency grew to the high level of 132.2 per cent in January–March (130.9% on Jan 1.).

During the first quarter of 2017, expectations of tax cuts and public investments promised by the newly elected US president upheld the positive return development in the equity markets. The realised economic growth figures have also been a positive surprise, and the nation's employment rate has remained strong. The Fed raised the interest rate in March for the third time. Short-term interest rates have increased steadily, but the increase in long-term interest rates is suppressed by concerns about weaker-than-expected inflation development.

Economic growth and inflation in Europe have also shown signs of an upswing. The positive financial development in the investment market has taken a back seat to several political events. In spring, the investment markets were nervous in anticipation of the impact of elections in the Netherlands and France and the impact of Brexit on the entire continent's economy and mutual trade. The European central bank has promised to continue its monetary policy stimulus measures at least until the end of the year, and if necessary, even longer.

Brighter growth expectations for the global economy combined with low return expectations for fixed-income investments continued to encourage allocation across internationally diversified equity investments. Effective diversification across asset classes will offset the risks resulting from the strong movements in the equity markets. Varma has increased its equity risk as the equity-linked share of the return requirement on technical provisions increased at the start of the year.

Equities generated the strongest return of Varma's investments, and listed equities in particular performed strongly. Other asset classes also yielded good returns in the first quarter. At the end of March, the average annual

¹ Under the new solvency legislation, Varma's solvency limit changed on 1 Jan. 2017. The amount of solvency capital remained at the same level, but with the higher solvency limit, the ratio of solvency capital to solvency limit decreased. The new solvency limit is not directly comparable with the previous limit.

nominal investment return over five years was 6.2 per cent, and over ten years 4.3 per cent. The corresponding real returns were 5.4 and 2.7 per cent.

In the rising interest rate environment, the return on fixed-income investments was good, at 1.4 (0.2) per cent. Growing inflation expectations and interest rate hikes by the Fed slightly increased the market's interest rate levels. In addition, political risks in the eurozone raised the credit risk premiums of government bonds especially in France and Italy. However, the credit margins of corporate bonds remained stable during the first quarter. In January–March, the return on the loan portfolio was 1.1 (0.8) per cent, on public-sector bonds 1.4 (1.1) per cent, on other corporate bonds 1.7 (-0.3) per cent and on other money-market instruments 0.1 (-0.1) per cent.

The US equity markets experienced a strong rise in the first quarter of 2017. The delaying of the nation's healthcare reform in March has somewhat weakened expectations. The equity markets rose strongly in Europe too, despite the concerns raised by possible political risks. Along with the strong rise of the equity markets, the return on Varma's listed equities rose to a high of 4.9 (-5.0) per cent. The return on Finnish equities was also good, at 4.7 per cent. The return on private equity investments was 1.9 (2.5) per cent, and the return on unlisted equities 1.3 (8.2) per cent.

The return on real estate investments rose to 1.5 (1.2) per cent, with real estate investment funds performing especially well. Direct real-estate investments yielded a return of 1.2 (1.2) percent and real-estate investment funds 3.1 (1.4) per cent. The sentiment in both the rental and real estate markets was positive during the first quarter. In March, Varma and SOK signed a new long-term lease agreement on the rental of 41,000 m² of office space in Ässäkeskus, SOK's head office located in Vallila.

Other investments also yielded good returns, at 1.9 (-2.1) per cent, as expectations of global economic growth improved. The return on hedge fund investments developed consistently during the first quarter, reaching a return of 1.6 (-2.0) per cent. Hedge fund investments effectively diversified the risk caused by market fluctuations in equity and fixed income investments over the long term.

Varma has US-dollar-denominated investments in hedge funds, equities, corporate bonds and private equity funds. In accordance with Varma's investment policy, part of the currency risk is hedged. The weakening of the US dollar early in the year decreased the result. In terms of operations, foreign currency risks are managed as a single entity, while in the performance indicators the exchange rate impact is included in the investment returns of various asset classes.

Varma's investment activities focussed on maintaining the company's strong solvency and broad diversification of investments, with a strong emphasis on risk management. In its investment risk management, the company used derivatives for hedging purposes and to control the risk level of the portfolio.

The market risk of investments is the greatest risk affecting the company's result and solvency. Equities constitute by far the greatest market risk. The VaR (Value-at-Risk) figure describing the total risk of Varma's investments stood at EUR 1,403 (1,807) million.

Operating expenses and personnel

Varma's total operating expenses in the reporting period were EUR 35 (36) million. According to a full-year estimate, Varma will use 75 (74) per cent of the expense loading included in the insurance contributions for operating expenses. The loading profit during the period was EUR 8 (9) million.

Varma's parent company employed an average of 558 (540 in 2016) people in the first quarter. At the end of March, the employees were distributed as follows: pension and customer service departments 56 per cent (56% at the end of 2016), investment operations 13 (13) per cent and other functions 31 (31) per cent.

Corporate Governance

Varma's Annual General Meeting was held on 15 March 2017. The Annual General Meeting approved the financial statements and discharged the Board of Directors, the Supervisory Board and the President & CEO from liability for the financial year 2016. The new members elected to the Supervisory Board are Olavi Huhtala, Juha Häkkinen, Jari Latvanen, Risto Penttinen and Saana Siekkinen.

Continuing as Supervisory Board members are Kari Jordan (Chairman), Satu Wrede (Deputy Chairman), Juri Aaltonen, Petri Castrén, Erkki Etola, Stig Gustavson, Erkki Järvinen, Jukka Jäämaa, Niina Koivuniemi, Ville Kopra, Tapio Korpeinen, Timo Koskinen, Päivi Kärkkäinen, Päivi Leiwo, Olli Luukkainen, Ilkka Nokelainen, Lauri Peltola, Jari Suominen, Leena Vainiomäki, Jorma Vehviläinen, Christoph Vitzthum, Anssi Vuorio and Göran Åberg.

Authorised Public Accountants Petri Kettunen and Paula Pasanen were elected as Varma's auditors. Authorised Public Accountant Marcus Tötterman and auditing firm KPMG Oy Ab were elected as deputy auditors.

As of the beginning of 2017, Varma's Board of Directors is composed of Jari Paasikivi (Chairman), Antti Palola (Deputy Chairman), Kai Telanne (Deputy Chairman), Riku Aalto, Mikael Aro, Johanna Ikäheimo, Ari Kaperi, Casimir Lindholm, Jyri Luomakoski, Petri Niemisvirta, Ilkka Oksala and Pekka Piispanen, and deputy members Eila Annala, Eija Hietanen, and Liisa Leino. Mikael Aro resigned from the Board of Directors on 2 March 2017, and in its meeting on 8 March 2017, the Supervisory Board elected Rolf Jansson as a member of the Board of Directors.

An up-to-date Corporate Governance Statement based on the recommendations of the Finnish Corporate Governance Code is presented on Varma's website. Varma publishes quarterly interim reports with the aim of ensuring transparent public financial reporting that conforms to best practices.

Responsibility

The carbon footprint of Varma's investments in 2016 was measured for the second time, and the result was published in February. The carbon footprint was reduced by 22 per cent in listed equities, and reductions were also seen in corporate bonds (-25%) and real estate (-8%). The results were achieved by, among other things, placing more weight on low-emission industries. The carbon footprint of Varma's own operations declined 23% in one year. The CO₂ reduction targets are part of Varma's climate policy for investments, which it published last year.

In a vote arranged by *Institutional Investor* magazine, Nordic investors selected among their peers Varma's sustainable equity portfolio as the best achievement in responsible investment in 2016. The sustainable equity portfolio invests in companies that benefit from climate change mitigation and is valued at approximately EUR 400 million.

In March, Varma published its first Annual Report and CSR Report in accordance with the Global Reporting Initiative (GRI) standards. The report takes into account the statutory requirements concerning the reporting of non-financial and diversity data.

Among the key measures of Varma's CSR programme this year are updating the share ownership policy, charting the supply chain, drawing up criteria for responsible procurements and promoting equality.

Risk management

Varma's risk position did not change significantly during the period under review.

Varma's greatest risks are related to investment operations and information processing. Financially the most important risks are those concerning investments. The risks of pension insurance operations are related to pension and insurance processing and to the effectiveness of the joint systems used in the sector. The Board of Directors has confirmed the principles for the company's internal control and risk management system. More information about insurance, investment, operative and other risks, the means for managing them, as well as related quantitative data, are provided in the notes to Varma's financial statements.

Varma's Board of Directors' investment plan lays down the general security goals for investments, diversification and liquidity goals, and the principles governing the company's foreign currency business. In calculating the solvency and assets covering the technical provisions, investment risks are taken into account according to the actual nature of the risk. The diversification of the investment portfolio is based on allocation that takes into account the return correlations of asset classes.

Outlook

Global economic growth will continue. The positive momentum in the economy will be sustained also in Europe. The Fed has indicated a further tightening of its monetary policy, and in the eurozone, too, monetary policy is being normalised in cautious steps, although at a clearly slower pace than in the US. Monetary policy will continue to support demand in the eurozone.

For now, expectations for Finland's economy have picked up more quickly than for the real economy. The economy is in need of an added boost – the recovery of exports is vital, as the domestic markets alone are incapable of creating adequate economic growth. The significance of public finances will be highlighted in the coming years, as the ageing of the population increases pension and care expenditure. Finland's economic growth, although stronger, is still not sufficient to balance public finances.

Political uncertainty will continue to be a major factor influencing the operating environment in Europe and in the global economy. Finland's economy still faces risks stemming from political uncertainty and a potential increase in protectionism.

Helsinki, 20 April 2017

Risto Murto
President & CEO

The figures presented in this interim report are unaudited figures of the parent company.

Varma Mutual Pension Insurance Company is the largest earnings-related pension insurer and private investor in Finland. The company is responsible for the statutory earnings-related pension cover of some 873,000 people in the private sector. Premiums written totalled EUR 4.7 billion in 2016 and pension payments stood at EUR 5.3 billion. The company's investment portfolio amounted to EUR 44.4 billion at the end of March 2017.

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ATTACHMENT: Graphs and charts

www.varma.fi

<https://www.varma.fi/en/other/about-varma/financial-information-and-investments/>

Balance sheet at fair values, Parent Company

€ million	3/2017	3/2016	12/2016
Assets			
Investments	44,379	41,084	42,852
Receivables	205	187	604
Furniture and fixtures	4	9	4
	44,588	41,281	43,460
Liabilities			
Capital and reserves	119	114	118
Valuation differences	10,155	8,238	9,625
Equalisation provision		1,061	1,034
Provision for future bonuses	509	-303	-578
Solvency capital, total	10,783	9,110	10,199
Provision for current bonuses (for client bonuses)	91	87	122
Equity-linked provision for current and future bonuses	590	1,254	324
Actual technical provision	32,874	30,581	32,599
Total	33,463	31,836	32,923
Other liabilities	251	248	215
	44,588	41,281	43,460

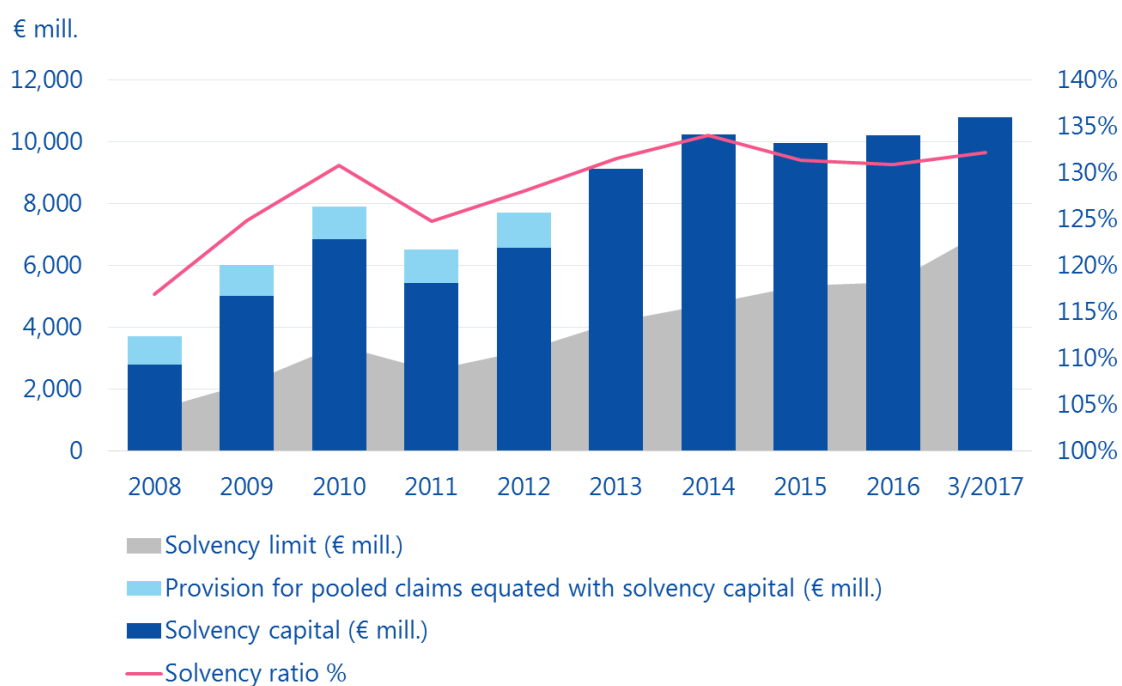
Income statement at fair values, Parent Company

€ million	1-3/2017	1-3/2016	1-12/2016
Underwriting profit/loss	3	-16	-38
Investment result	573	-746	441
Loading profit	8	9	39
Other income/expenses	0		14
Total result	584	-754	457

Solvency capital and limits

	31/03/2017	31/03/2016	31/12/2016
Solvency limit (€ mill.)	7,125	4,586	5,455
Maximum amount of solvency capital (€ mill.)	21,375	18,345	21,819
Solvency capital (€ mill.)	10,783	9,110	10,199
Solvency ratio %	132.2	128.6	130.9
Solvency capital/Solvency limit	1.5	2.0	1.9

Solvency development



Investments at fair value

	31-March-2017				31-March-2016				31-December-2016				1-3/2017	1-3/2016	1-12/2016	24 m
	Market value		Risk position		Market Value		Risk position		Market Value		Risk position		Return	Return	Return	
	€ mill.	%	€ mill.	%	€ mill.	%	€ mill.	%	€ mill.	%	€ mill.	%	MWR	MWR	MWR	Volatility
Fixed-income investments¹	14,321	32	3,071	7	15,496	38	14,553	35	13,695	32	18,066	42	1.4	0.2	4.2	
Loan receivables	1,432	3	1,432	3	1,353	3	1,353	3	1,432	3	1,432	3	1.1	0.8	4.2	
Bonds	11,815	27	12,250	28	10,334	25	10,327	25	11,435	27	12,780	30	1.6	0.3	5.3	3.4
Public bonds	4,092	9	4,433	10	4,030	10	3,805	9	4,092	10	5,374	13	1.4	1.1	1.8	
Other bonds	7,724	17	7,817	18	6,303	15	6,522	16	7,343	17	7,406	17	1.7	-0.3	7.8	
Other money-market instruments and deposits	1,074	2	-10,611	-24	3,809	9	2,873	7	828	2	3,854	9	0.1	-0.1	-0.4	
Equity investments	19,490	44	19,683	44	15,614	38	15,757	38	18,333	43	18,527	43	4.3	-3.1	6.4	
Listed equities	15,555	35	15,748	35	12,278	30	12,420	30	14,599	34	14,793	35	4.9	-5.0	4.5	12.5
Private equity	2,898	7	2,898	7	2,569	6	2,569	6	2,794	7	2,794	7	1.9	2.5	11.2	
Unlisted equities	1,037	2	1,037	2	767	2	767	2	940	2	940	2	1.3	8.2	23.7	
Real estate investments	3,721	8	3,721	8	3,775	9	3,775	9	3,643	9	3,643	9	1.5	1.2	-0.9	
Direct real estates	2,906	7	2,906	7	3,143	8	3,143	8	2,897	7	2,897	7	1.2	1.2	-2.6	
Real estate funds	815	2	815	2	631	2	631	2	746	2	746	2	3.1	1.4	6.8	
Other investments	6,846	15	7,886	18	6,199	15	6,460	16	7,182	17	7,320	17	1.9	-2.1	5.3	
Hedge funds	6,859	15	6,859	15	6,243	15	6,243	15	7,184	17	7,184	17	1.6	-2.0	5.6	3.1
Commodities	-5	0	197	0	-30	0	230	1	-1	0	137	0				
Other investments	-7	0	830	2	-13	0	-13	0	-2	0	-2	0				
Total investments	44,379	100	34,361	77	41,084	100	40,544	99	42,852	100	47,555	111	2.7	-1.4	4.7	5.1
Impact of derivatives			10,018	23	0	0	540	1			-4,703	-11				
Investment allocation at fair value	44,379	100	44,379	100	41,084	100	41,084	100	42,852	100	42,852	100				

The modified duration for all the bonds is 3.0.

The open currency position is 23.9% of the market value of the investments.

¹ Includes accrued interest

Total result

