

Varma's interim report 1 January–30 September 2018

The comparison figures in parentheses are from 30 September 2017, unless otherwise indicated.

- Total result stood at EUR 108 (1,262) million.
- The nine-month return on investments was 3.5% (6.2%), and the market value of investments stood at EUR 46.9 (45.4) billion.
- Solvency capital was strong, at EUR 11,642 (11,444) million, i.e. 1.9 (1.9) times the solvency limit.

Economic operating environment

The recovering economy, improving employment, and the sustained strong trend in capital market valuations have supported the financing of pensions, the long-term sustainability of the earnings-related pension system and a moderate level of pension contributions. The outlook for the real economy remains bright, but geopolitical tensions and a shift in the direction of monetary policies have caused increased uncertainty.

The global economic outlook is still strong, although the growth rate is declining somewhat. The risks overshadowing economic growth increased in the third quarter of 2018. The differentiation of economic growth also continued. Backed by the accommodating financial policy, the US economy showed broad-based growth, but growth in the rest of the world was somewhat more moderate than expected. Business and consumer confidence were also clearly stronger in the US, where tax reliefs and favourable labour market development helped keep up optimism. In the rest of the world and especially in the economies dependent on international trade, concerns over import tariffs that the US government is pushing increased uncertainty and had a negative impact on export orders. Uncertainty in the eurozone is heightened due to the financial policy of Italy's new government and the country's debt sustainability. The markets in many emerging economies have challenged the governments' economic policies and the sustainability of the debt outlook.

Inflationary pressures have increased moderately due to the rapid rise in the crude oil price and the slight pay inflation pressures created by the tightening labour markets. The inflationary pressures in many emerging economies are related to weaker exchange rates.

Easy monetary policy and the unprecedented measures have continued for a long time in light of the business cycle, since the muted inflationary pressures have provided little leeway in terms of monetary policies. The success of monetary policy normalisation is a major risk factor related to the economy and market development. The change in the direction of the US monetary policy has already had an impact on emerging economies. China's economy continues to show steady growth, but there are concerns over its state. Both monetary and financial policy measures have been in use for a long time now to stimulate the economy.

The biggest risk is the expansion of the trade war which could weaken global economic growth and fuel large scale uncertainty. Increasing uncertainty is likely to reduce businesses' investment appetite, which in turn undermines the prerequisites for economic growth. In the globalised economy, the impacts of increasing protectionism on companies' business, their value chains and production as well as on the international distribution of work are also more difficult to forecast.

The strong global economic cycle has boosted Finland's economy. The GDP is showing strong and broad-based growth. For a small, open economy, the recovery of export demand has been vital. Employment has improved at a record-breaking speed, owing to faster economic growth and the improved cost competitiveness behind it. Considering the economic conditions, the unemployment rate remains very high – yet companies are reporting difficulties in finding employees. Solving the labour market mismatch between supply and demand, and measures to secure competence are essential so that labour availability does not become a bottleneck to economic growth.

The state of Finland's public finances has markedly improved thanks to faster economic growth and adjustment measures. Tackling the sustainability gap calls for better productivity, raising the employment rate to the Nordic level and longer careers.

Earnings-related pension system

Rapid improvement in employment and the sustained favourable trend on the capital market have improved the financing sustainability of the earnings-related pension system. Longer careers, higher employment rate and improved productivity are essential goals in terms of securing pensions. Varma has helped to respond to the challenge by improving its services' effectiveness through its pioneering work in vocational rehabilitation and workability management services for our customers.

The 2017 pension reform bolstered the sustainability of the earnings-related pension system. The biggest surprise that challenges the estimates is the rapidly declining birth rate.

Varma has been preparing together with its customers for the introduction of the Incomes Register at the beginning of 2019. The Incomes Register changes the earnings-related pension insurance processes both for our customers and for Varma. The goal is to reduce businesses' administrative workload and improve productivity in the provision of services.

Varma's financial trends

The total result at fair value for the nine-month period amounted to EUR 108 (1,262) million. The most important component of the total result is the investment result, which was 83 (1,223) million. The return on investments at fair value was EUR 1,592 (2,676) million. The interest credited on the technical provisions was EUR 1,509 (1,453) million. The estimated technical underwriting result was EUR -9 (14) million and the loading profit EUR 34 (25) million.

Varma's solvency remained at the same strong level as in the early part of the year. The solvency capital, which serves as a risk buffer for investment operations, was EUR 11,642 million at the end of September (11,534 mill on 1 Jan), and 132.8% in relation to the technical provisions (133.5% on 1 Jan).

Varma's solvency capital was on a sustainable level, i.e. 1.9 (1.7 on 1 Jan) times the solvency limit.

Tables illustrating Varma's financial development are presented as attachments to this interim report.

Insurance business

Varma's pension recipients numbered 343,000 at the end of September (343,000 on 1 Jan). Claims paid in January–September totalled EUR 4,135 (3,955) million. As a result of the higher retirement age implemented in conjunction with the pension reform, 13% fewer new pension decisions were made by the end of September, totalling 16,964. A total of 38,499 pension decisions were made in January–September.

According to application data, EUR 17 million in premiums written have been transferred to Varma from other earnings-related pension companies during 2018. The account transfer result was especially good in small businesses.

At the end of September, Varma was providing insurance to 555,000 (537,000 on 1 Jan) employees and self-employed persons.

Investments

Varma's investment returns showed a reasonably favourable trend in January–September, as the markets continued to bounce back following the early-year turbulence. The return on investments stood at 3.5% (6.2%), and at the end of September the value of investments totalled EUR 46,936 (45,429) million. Varma's solvency remained at a high level of 132.8% (133.5% on Jan 1).

The more muted global economic outlook and increased political uncertainty have led the investment market to become differentiated. In the US, risk appetite has remained high due to companies' strong earnings development, but in both the emerging markets and Europe the investor mood has been cautious. Outside the US, the returns on higher risk asset classes have been typically weak during the current year. The rise in interest rates of long-term government bonds has been moderate, although the Fed's tightening monetary policy has caused especially short and mid-term interest rates to rise. In the eurozone the interest rate movements have been more moderate, and expectations concerning the ECB's interest rate hikes starting in the latter half of 2019 are very modest. An exception in the eurozone is Italy, whose government bond interests have risen sharply due to the new government's financial policies.

The imbalanced market development and occasional increase in volatility have made asset allocation challenging. Diversification across different asset classes and especially in unlisted investments has limited the risks resulting from volatility in the equity and fixed income markets. In Varma's investment allocation, the weight of listed equities was decreased further in the third quarter.

Varma's investments have yielded reasonable returns during the year. Returns have varied strongly between different asset classes and market areas. Equities and particularly private equity investments generated the strongest investment return in January–September. Hedge and real estate investments have also yielded consistent, relatively strong returns over the year. Fixed income investments have suffered from widened credit risk premiums, the steep slide of emerging market currencies and monetary policy normalisation, due to which the returns were negative in the nine-month period. At the end of September, the average nominal investment return over five years was 6.0%, and over ten years 5.9%. The corresponding real returns were 5.3% and 4.7%.

The fixed income investment return was negative at -1.2% (3.6%) in the nine-month period. The weak result is due to increased political uncertainty, gradual acceleration of inflation, and tightened dollar liquidity. These factors have weakened emerging market currencies and raised the risk premiums of the government and corporate bonds. The interest rate levels of eurozone government bonds have remained low, although the escalation of political uncertainty has caused especially Italy's government bond rates to rise. Eurozone money market interest rates have remained negative and the first interest rate hikes by the ECB are expected to take place in the second half of next year at the earliest. During the reporting period, the return on the loan portfolio was 2.7% (1.7%), on public sector bonds -4.5% (4.2%), on other corporate bonds -0.1% (5.5%), and on other money-market instruments 0.1% (-1.6%).

Equities generated a return of 6.6% (9.6%) in the reporting period. The global equity market development has been out of sync during the year. Returns are back on an upward trajectory following the heavy equity market turbulence early in the year, but there are extreme differences between geographical regions. The returns in the nine-month period are clearly in the black, and of listed equities, the US equities had the strongest returns. Finnish equities have also generated reasonably strong returns, but other regions' equities are in the red, mostly due to

weak returns from the emerging markets. Listed equities yielded a return of 5.5% (10.8%). Of all the asset classes, private equity investments generated the highest returns during the year at 12.2% (4.1%), while unlisted equity investments yielded 7.1% (8.1%).

The return on real estate investments grew to 4.0% (3.1%). Direct real-estate investments yielded a return of 3.2% (2.3%) and real-estate investment funds 6.6% (5.9%). In the third quarter, Varma acquired a development site in the Kivistö area of Vantaa's city centre. The construction work of the 129-flat building started in October. The project is due to be completed in 2020.

Other investments also generated good returns, at 3.4% (5.7%), thanks to the positive development of hedge funds. Hedge funds have diversified the risk relating to equity and fixed income markets and compensated the moderate returns on fixed income investments.

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. During the first half of the year, the appreciation of the US dollar supported equity returns, but in the third quarter the impact was relatively limited. In terms of operations, foreign currency risks are managed as a single entity, and in financial reporting 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, broad diversification of investments, and sustainability, 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 1,357 (1,049) million.

Operating expenses and personnel

Varma's total operating expenses in the reporting period were EUR 101 (107) million. According to a full-year estimate, Varma will use 68% (75%) of the expense loading included in the insurance contributions for operating expenses. The loading profit for the period was EUR 34 (25) million. The total loading profit will be used for client bonuses.

Varma's parent company employed an average of 532 people in the reporting period (524 in 2017). At the end of September, Varma's personnel were distributed as follows: pension services 28%, insurance services 15%, customer service departments 12%, investment operations 13%, and other functions 32%.

Corporate Governance

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

Varma came in fifth place in an international comparison by the Asset Owners Disclosure Project (AODP), which assessed the world's 100 largest global pension funds' approach to climate-related risks and opportunities. In recent years, Varma has been developing the climate-friendliness of its investment portfolio.

Among the key measures of Varma's CSR programme this year are updating the CSR programme, promoting responsible customer work, and improving responsible investment in different asset classes.

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 significant 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 currency risk hedging. The diversification of the investment portfolio is based on allocation that takes into account the return correlations of asset classes.

Outlook

Global economic risks increased in the third quarter of the year. The cross-pressures are not expected to slacken in the coming months. We expect strong economic growth to continue for the time being in the US and to be stable in Europe, provided that the risk scenarios for the global economy do not materialise.

The duration and strength of the rise in asset values on the markets has been unprecedented. This, combined with the shift in the monetary policy and risks relating to the trade war escalating, is likely to boost market unrest. Varma's strong solvency is a key benefit that helps secure pensions in a challenging market situation.

Finland's economy will continue to grow, but the growth will be slower. New measures are required to improve employment and reduce structural unemployment. Achieving a higher employment rate is essential for the financing of both earnings-related pensions and the public sector. The time frame for preparing for rising age-related spending is about the close.

Helsinki, 18 October 2018

Risto Murto
President & CEO

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

Varma Mutual Pension Insurance Company is a responsible and solvent investor. The company is responsible for the statutory earnings-related pension cover of 900,000 people in the private sector. Premiums written totalled EUR 4.9 billion in 2017 and pension payments stood at EUR 5.5 billion. Varma's investment portfolio amounted to EUR 46.9 billion at the end of September 2018.

FURTHER INFORMATION:

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ATTACHMENT: Graphs and charts

www.varma.fi/en

www.varma.fi/annualreport

Balance sheet at fair values, Parent Company

| € million | 9/2018 | 9/2017 | 12/2017 |
|--|---------------|---------------|---------------|
| Assets | | | |
| Investments | 46,936 | 45,429 | 45,409 |
| Receivables | 494 | 436 | 747 |
| Furniture and fixtures | 4 | 5 | 5 |
| | 47,434 | 45,870 | 46,161 |
| Liabilities | | | |
| Capital and reserves | 128 | 123 | 124 |
| Valuation differences | 9,710 | 8,860 | 9,147 |
| Provision for future bonuses | 1,805 | 2,463 | 2,265 |
| Off-balance-sheet items | -1 | -1 | -1 |
| Solvency capital, total | 11,642 | 11,444 | 11,534 |
| Provision for current bonuses (for client bonuses) | 40 | 30 | 162 |
| Equity-linked provision for current and future bonuses | 1,165 | 722 | 769 |
| Actual technical provision | 34,328 | 33,344 | 33,501 |
| Total | 35,494 | 34,067 | 34,270 |
| Other liabilities | 258 | 328 | 195 |
| | 47,434 | 45,870 | 46,161 |

Income statement at fair values, Parent Company

| € million | 1-9/2018 | 1-9/2017 | 1-12/2017 |
|-----------------------------------|------------|--------------|--------------|
| Premiums written | 3,835 | 3,666 | 4,867 |
| Claims paid | -4,135 | -3,955 | -5,248 |
| Change in technical provisions | -1,102 | -1,037 | -1,324 |
| Net investment income | 1,618 | 2,701 | 3,373 |
| Total operating expenses | -101 | -107 | -129 |
| Other income/expenses | 0 | 0 | -8 |
| Taxes | -7 | -7 | -7 |
| Total result ¹⁾ | 108 | 1,262 | 1,524 |

¹⁾ Result at fair value before the change in provision for current and future bonuses and equalisation provision

| € million | 1-9/2018 | 1-9/2017 | 1-12/2017 |
|--------------------------|------------|--------------|--------------|
| Underwriting profit/loss | -9 | 14 | 34 |
| Investment result | 83 | 1,223 | 1,453 |
| Loading profit | 34 | 25 | 45 |
| Other income/expenses | 0 | 0 | -8 |
| Total result | 108 | 1,262 | 1,524 |

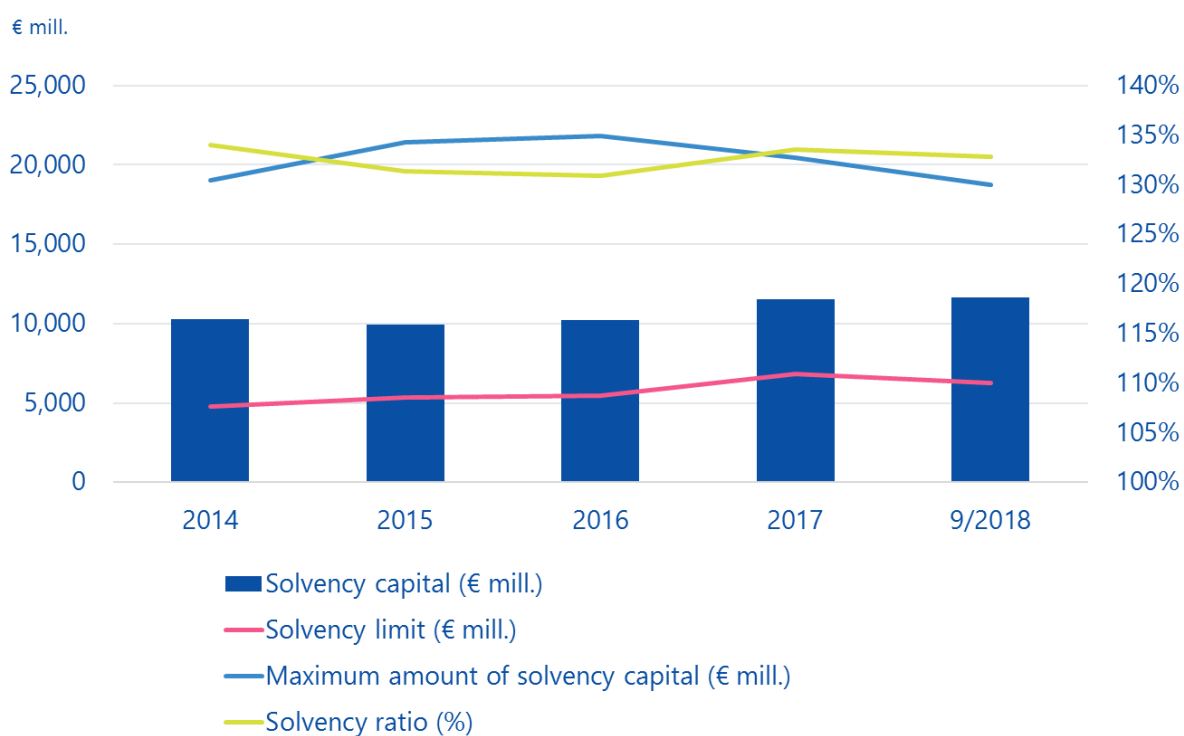
Solvency capital and limits

| | 30/09/2018 | 30/09/2017 | 31/12/2017 |
|--|------------|------------|------------|
| Solvency limit (€ mill.) | 6,238 | 5,955 | 6,820 |
| Maximum amount of solvency capital (€ mill.) | 18,715 | 17,866 | 20,459 |
| Solvency capital (€ mill.) | 11,642 | 11,444 | 11,534 |
| Solvency ratio (%) ¹ | 132.8 | 133.6 | 133.5 |
| Solvency capital/Solvency limit ² | 1.9 | 1.9 | 1.7 |

¹ Pension assets in relation to the technical provisions under §11 of the Ministry of Social Affairs and Health's decree governing pension institutions (614/2008).

² Solvency capital in relation to the solvency limit

Solvency development



Investments at fair value

| | 30 Sep 2018 | | | | 30 Sep 2017 | | | | 31 Dec 2017 | | | | 1-9/2018 | 1-9/2017 | 1-12/2017 | 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 | Vola- tility |
| Fixed-income investments¹ | 14,262 | 30 | 10,881 | 23 | 15,836 | 35 | 2,056 | 5 | 13,481 | 30 | 12,579 | 28 | -1.2 | 3.6 | 3.7 | |
| Loan receivables | 1,737 | 4 | 1,737 | 4 | 1,478 | 3 | 1,478 | 3 | 1,453 | 3 | 1,453 | 3 | 2.7 | 1.7 | 2.2 | |
| Bonds | 10,882 | 23 | 9,757 | 21 | 9,672 | 21 | 9,219 | 20 | 10,028 | 22 | 10,510 | 23 | -1.9 | 5.1 | 5.4 | 2.2 |
| Public bonds | 4,236 | 9 | 3,471 | 7 | 3,900 | 9 | 3,448 | 8 | 4,153 | 9 | 4,285 | 9 | -4.5 | 4.2 | 4.0 | |
| Other bonds | 6,646 | 14 | 6,285 | 13 | 5,772 | 13 | 5,772 | 13 | 5,874 | 13 | 6,224 | 14 | -0.1 | 5.5 | 6.2 | |
| Other money-market instruments and deposits | 1,643 | 4 | -613 | -1 | 4,687 | 10 | -8,641 | -19 | 2,001 | 4 | 617 | 1 | 0.1 | -1.6 | -1.9 | |
| Equity investments | 19,917 | 42 | 19,695 | 42 | 18,298 | 40 | 18,374 | 40 | 20,427 | 45 | 20,687 | 46 | 6.6 | 9.6 | 11.4 | |
| Listed equities | 15,715 | 33 | 15,493 | 33 | 14,304 | 31 | 14,380 | 32 | 16,492 | 36 | 16,753 | 37 | 5.5 | 10.8 | 11.6 | 5.9 |
| Private equity | 3,676 | 8 | 3,676 | 8 | 2,836 | 6 | 2,836 | 6 | 2,767 | 6 | 2,767 | 6 | 12.2 | 4.1 | 7.9 | |
| Unlisted equities | 527 | 1 | 527 | 1 | 1,157 | 3 | 1,157 | 3 | 1,167 | 3 | 1,167 | 3 | 7.1 | 8.1 | 18.5 | |
| Real estate investments | 3,854 | 8 | 3,854 | 8 | 3,556 | 8 | 3,556 | 8 | 3,602 | 8 | 3,602 | 8 | 4.0 | 3.1 | 4.9 | |
| Direct real estates | 2,851 | 6 | 2,851 | 6 | 2,741 | 6 | 2,741 | 6 | 2,797 | 6 | 2,797 | 6 | 3.2 | 2.3 | 2.9 | |
| Real estate funds | 1,002 | 2 | 1,002 | 2 | 815 | 2 | 815 | 2 | 805 | 2 | 805 | 2 | 6.6 | 5.9 | 12.0 | |
| Other investments | 8,903 | 19 | 10,236 | 22 | 7,739 | 17 | 8,683 | 19 | 7,900 | 17 | 8,907 | 20 | 3.4 | 5.7 | 9.3 | |
| Hedge funds | 8,916 | 19 | 8,916 | 19 | 7,771 | 17 | 7,771 | 17 | 7,886 | 17 | 7,886 | 17 | 4.9 | 5.3 | 8.5 | 1.4 |
| Commodities | 15 | 0 | 46 | 0 | 1 | 0 | 90 | 0 | 11 | 0 | 179 | 0 | | | | |
| Other investments | -28 | 0 | 1,274 | 3 | -33 | 0 | 822 | 2 | 3 | 0 | 842 | 2 | | | | |
| Total investments | 46,936 | 100 | 44,665 | 95 | 45,429 | 100 | 32,669 | 72 | 45,409 | 100 | 45,775 | 101 | 3.5 | 6.2 | 7.8 | 2.2 |
| Impact of derivatives | | | 2,271 | 5 | | | 12,760 | 28 | | | -365 | -1 | | | | |
| Investment allocation at fair value | 46,936 | 100 | 46,936 | 100 | 45,429 | 100 | 45,429 | 100 | 45,409 | 100 | 45,409 | 100 | | | | |

The modified duration for all the bonds is 2.4.

The open currency position is 25.5 % of the market value of the investments.

¹ Includes accrued interest

Total result

