

Report of the Board of Directors 2019

The economic operating environment

Sentiment varied in the course of the 2019 economic year, and monetary policies took a turn

Uncertainty in the economic operating environment continued, due to the economic cycle, trade war and geopolitical tensions. Despite slowing down, the economy continued to grow, and instead of escalating, the US–China trade war showed signs of easing. There is no quick or exhaustive solution in sight, as major strategic issues are at stake for both parties.

In spite of the slower economic growth, it was a strong year for investors. The normalisation of monetary policies was interrupted when uncertainty over economic growth and muted inflation expectations pushed central banks to make a switch in their monetary policies.

The US economy has had the longest economic expansion in history, and unemployment is at a very low level. Private consumption and consumer confidence are boosted by the good labour market situation and strong growth in asset values. Inflation expectations continue to be rather subdued. Uncertainty in China's economy was linked to the trade war with the US. China's economy has inefficiencies, for example, in the allocation of capital. Fiscal deficit and growing public debt leave less leeway for economic stimulus.

Growth in the eurozone is expected to remain at around one per cent. German industry, the driver of the European economy, has been vulnerable and has suffered from the trade war, uncertainty and challenges caused by a structural change. The difficulties of European industry are mirrored in the growth of the entire economic area.

The new commission has an ambitious work programme, but executing a common, persistent economic policy will be challenging, since member countries still have fundamentally different views on the means and leeway available. At the core of the commission's economic policy is the Green Deal, which would require a much stronger investment appetite in order to be realised. The UK general election finally delivered a clear political mandate for Brexit. The weak eurozone economy, moderate growth expectations and the inability to co-ordinate economic policy make up a difficult combination in a situation where there is also limited elbow room in monetary policy.

Slower improvement in employment in Finland

Finland's economic cycle has peaked out, but the economy continued to grow, and employment also improved. Total output has remained on a positive track, but corporate sector economic indicators weakened towards the end of the year and were mirrored in businesses' investment appetite. The investment rate is relatively low in Finland compared to the rest of Western Europe, and investments in production focus on replacement investments.

The employment rate has been improving for several years now, as a result of the accelerated economic growth and improved cost competitiveness. However, employment improved at a slower rate in 2019. The current employment rate is not sufficient to secure the sustainable financing of the welfare state's spending.

Earnings-related pension system

In 2019, the Finnish pension system ranked fourth in an annual international pension system comparison, the Mercer Global Pension Index. Finland was ranked number one in terms of the reliability and transparency of its pension system governance for the sixth time in a row. The comparison paid attention to efforts to improve the employment rate of older workers, the level of the smallest pensions, and increasing the level of funded contributions.

Prolonging careers is a key pension-policy target. The number of new commencing disability pensions has risen. There are many factors behind this trend, and according to the Finnish Centre for Pensions, the so-called activation model in the unemployment security system is one of them. A deeper understanding of the reasons behind occupational disability is essential. Varma has prepared for this by launching its own studies on the matter.

To help achieve longer careers, Varma offers its insured vocational rehabilitation when their work ability is threatened. Varma aims to manage the disability risk it insures by offering guidance and support to its customers. In its supervision release published in autumn 2019, the Finnish Financial Supervisory Authority (FIN-FSA) outlined the limits set forth in legislation for the quality and scope of disability risk management. According to FIN-FSA's earlier guidelines and the supervision release, earnings-related pension insurance companies are allowed to manage the disability risk they insure. They can do this by offering their customers guidance and advice in the disability risk management efforts that the customers carry out through their own work ability management work.

Labour market organisations proposed changes to survivors' pensions, and legislative amendments are currently being prepared. The organisations also agreed on changes to the continued unemployment allowance. The purpose of the change is to improve the employment rate and extend careers.

Preparatory work to merge Finland's private sector and municipal sector pension systems has been initiated in accordance with the Government Programme. The objective is for the pensions of municipal employees to be insured in future under TyEL, the private-sector pension system, and to create a new earnings-related pension insurance company based on part of the insurance portfolio of the current public sector pension provider Keva. The merger is in its initial stages, and it is a challenging and complex process.

Pension contributions and return requirement on technical provisions

In 2019, the average TyEL contribution was 24.4% of the salaries or wages. Employees under the age of 53 and over the age of 62 contributed 6.75% of their pay, while the rate for employees aged 53–62 was 8.25%. Entrepreneurs' YEL contribution was 24.1% of the confirmed earnings for those under the age of 53 and over the age of 62, and 25.6% for those aged 53–62.

The return requirement on technical provisions consisted of a 3.00% fund rate, a pension liability supplementary factor and the return on equity component. The value of the supplementary factor was 0.96% on average in 2019. The return on equity component in 2019 was 25.17%. The technical rate of interest, which is used to determine the interest rate of the oldest pension loans to Varma's customers and a number of other items, was 5.25% until the end of June and 5.00% thereafter. The insurance contribution interest rate, used to calculate pension contributions, stood at 2.00% throughout the year.

Varma's financial trends

The national Incomes Register was introduced at the beginning of the 2019 financial year, and it had a major impact on insurance-related information flows. As an earnings-related pension insurer, Varma obtains the information it needs to calculate insurance contributions and pensions directly from the Incomes Register, where they are submitted by the policyholders, i.e. Varma's customers. The introduction of the Incomes Register entailed functional development requirements, which Varma, together with other operators in the sector, successfully resolved during the financial year. The Incomes Register brought the premium income accrual information closer to real time and made the monitoring of earnings reporting clearer. Pensions paid by Varma will be reported to the Incomes Register as of the beginning of 2021.

Varma's total result at fair value was EUR 2,197 (-1,741) million. The total result for each quarter of the year was positive. The first quarter of 2019, during which the major decline in share prices late in 2018 was corrected, was by far the strongest.

Varma's solvency strengthened during 2019 by EUR 2,027 million, and at the end of the year, solvency capital amounted to EUR 11,646 (9,619) million. Varma's pension assets in relation to technical provisions (solvency ratio) were 130.8% (127.5%). Solvency capital was at a secure level, i.e. at 1.8 (1.6) times the solvency limit. The solvency limit is changed in accordance with the risk level of the investments. Varma's strategic goal is to maintain the company's strong solvency through stable returns and operational efficiency.

The return on investments at fair value was EUR 5,241 (-902) million, which represents 12.0% (-2.0%) of the invested capital. The interest credited on the technical provisions was EUR 3,102 (913) million. Thus, the investment result for 2019 totalled EUR 2,139 (-1,816) million. Operating expenses were 38% (40%) lower than the expense loading included in insurance contributions, and the loading profit stood at EUR 53 (56) million. The underwriting result was EUR -2 (23) million and other result was EUR 8 (-4) million.

Varma pays out the entire loading profit as well as an additional 1% of the solvency capital as bonuses to its customers. Thereby, Varma's strong solvency and excellent operational efficiency benefit its clients in full. At the end of 2019, EUR 171 (153) million was transferred to the provision for current bonuses reserved for client bonuses. The transfer represents roughly 0.8% (0.8%) of the payroll of the insured.

The TyEL payroll of those insured by Varma totalled roughly EUR 21.1 (20.4) billion in 2019. The total payroll increased 3.4%. Varma's premiums written totalled EUR 5,286 (5,118) million, of which TyEL insurance accounted for EUR 5,099 (4,935) million and YEL insurance for EUR 187 (183) million.

At the end of the financial year, 541,926 (559,981) individuals were insured by Varma. At the end of 2019, the number of valid insurance policies totalled 65,381 (62,745), covering 37,795 (36,715) self-employed persons and 504,131 (523,266) employees.

During 2019, a total of 3,834 (2,832) new TyEL insurance policies and 6,147 (5,983) YEL insurance policies came into force at Varma.

During the 2019 account transfers, EUR 74 million in net TyEL income was transferred to Varma from other earnings-related pension companies, and EUR 70 million in new TyEL policies were sold. Varma succeeded well in all customer segments.

As a result of the Incomes Register implementation, the number of income and employment notifications received by Varma increased fourfold, totalling 9.7 (2.5) million. Income data is reported to the Incomes Register regularly after earnings are paid.

Varma provides policyholders with services through its own service channels and through the service networks of If P&C Insurance and the Nordea Group.

In 2019, a total gross amount of EUR 5,856 (5,668) million in pensions was paid out. The number of pension recipients remained at the same level as the previous year, and at year-end, Varma was paying pensions to 343,700 (343,400) people.

A total of 22,340 (22,476) new pension decisions were made during the year. The number of new pension decisions decreased 0.6% compared to 2018, and the total number of all pension decisions was 2.0% higher than in 2018. Old-age pension decisions numbered 10,519 (11,137), disability benefit decisions 5,959 (6,024) and partial early old-age pension decisions 2,351 (1,967). Continuation decisions on temporary pensions totalled 4,835 (4,488), and other decisions numbered 24,894 (24,093). Other decisions include decisions and preliminary decisions required as a consequence of the changes in pension rights. The share of rejected new disability pension applications was 34.6% (33.0%). Pension applications made online accounted for 54% (50%) of all pension applications.

The number of disability pension applications continued to grow in 2019, and were up 7.1% compared to 2018. The strongest growth, at 15.5%, was seen in continuation applications. The number of new disability pension applications increased by 4.6%. Musculoskeletal diseases (36.7%) and mental health disorders (33.8%) were most often cited as the main reasons for occupational disability. The proportion of mental health disorders has risen and musculoskeletal diseases have declined. Factors affecting the increase in disability pension applications include the rise in the employment rate, the higher retirement age, and the activation model, but also the transformation of work such that it no longer matches earlier competence and work ability. Vocational rehabilitation applications remained at the level of 2018.

Varma's total processing time for pension applications in 2019 was 25 days, which was 10 days shorter than the average processing time in the earnings-related pension sector.

Vocational rehabilitation is an alternative to disability pension, and the number of rehabilitation cases at Varma increased again. Rehabilitation has proven to be successful, as about 77% of those who received rehabilitation

through Varma returned to the job market either in full or partly. Varma has for years been a forerunner in vocational rehabilitation, and the company actively steers those with a work ability risk to rehabilitation. A larger share of Varma's customers use rehabilitation to return to working life than retire on disability pension. Throughout 2019, Varma assisted its client companies in managing personnel risks through client-oriented co-ordination of rehabilitation services and pension decision services, which also helps clients to manage their pension costs and support their employees' ability to continue at work.

Varma manages the disability risk of its insurance portfolio also by contributing to the costs of customers' work ability risk management efforts in accordance with jointly agreed and often multi-year plans and contracts. Varma has been publishing its new well-being at work contracts since April 2017.

	31 Dec 2019	31 Dec 2018	Change
Number of insured			
TyEL ¹	504,131	523,266	-19,135
YEL	37,795	36,715	1,080
Total	541,926	559,981	-18,055

¹ The method for calculating the number of insured changed in 2019, and the figures are not comparable. This is due to a change in the reporting method of income information.

Number of insurance policies			
TyEL	27,586	26,030	1,556
Number of pensioners			
Part-time pension	99	377	-278
Partial early old-age pension	4,632	3,585	1,047
Survivors' pension	50,065	50,350	-285
Disability pension	21,547	22,646	-1,099
Old-age pension	255,031	253,595	1,436
Early old-age pension	12,272	12,859	-587
Years-of-service pension	10	2	8
Total ²	343,656	343,414	242

² Those receiving YEL pension	29,251	29,431	-180
Those receiving TEL/YEL supplementary pension	43,102	43,442	-340

In terms of customer service, Varma's eServices are a key service channel. Through Varma's online services, the insured can obtain the most recent estimate of their pension amount at their planned retirement age. Of these

estimates, 96.6% (91.1%) were calculated online. Pensions can also be applied for, and the status of the application can be tracked, online. A total of 14,953 (14,135) applications were submitted electronically during the year.

The insured can see the development of their earnings-related pension in their pension record. As of 2019, information concerning any income paid by the employer is transferred directly from the Incomes Register to the pension record. Altogether 123,000 people checked their pension records online a total of 150,000 times. Varma sends a pension record to those insured who want to have their information on paper once every three years. In 2019, Varma sent a total of 204,000 (197,000) pension records.

Technical provisions

Varma's technical provisions increased 5.7% (-0.5%) to EUR 38,608 (36,521) million. They contain a provision of EUR 171 (154) million for current bonuses reserved for client bonuses, a provision of EUR 790 (1,486) million for future bonuses contained in the solvency capital, and EUR 1,424 (-255) million in an equity-linked provision for current and future bonuses.

Changes in the insurance portfolio

Varma received part of the insurance portfolio of a pension fund at the end of the financial year, and transferred part of its own insurance portfolio to another pension fund. The amount of pension liabilities transferred to Varma totalled EUR 25 million, and the pension liabilities transferred from Varma were EUR 16 million.

Investments

In 2019, Varma's investments showed strong returns as the markets rebounded, with central banks' help, from the turbulence of late 2018. The return on investments stood at 12.0% (-2.0%), and at the end of December, the value of investments amounted to EUR 48,709 (44,015) million. The good returns raised Varma's solvency ratio, which recovered to 130.8% (127.5% on Jan 1).

Varma's investments yielded very good returns while the markets enjoyed a strong upward trend. Listed and unlisted equity investments, infrastructure investments, and private equity investments yielded the best returns in 2019. Investments in unlisted investees diversified risks and generated strong returns. In Varma's investment allocation, the weight of listed equities was gradually raised as the year progressed. The returns on hedge funds, fixed-income investments and real estate investments were also relatively strong in the current interest rate environment. The U.S. dollar appreciated somewhat during the year. At the end of the year, the average nominal investment return over five years was 5.2%, and over ten years 5.8%. The corresponding real returns were 4.5% and 4.4%.

Considering the low interest rate level, the return on fixed-income investments was strong, at 4.5% (-1.8%). Behind the relatively good performance were central banks' accommodative monetary policy, more moderate inflationary expectations and a weaker growth outlook, which weighed down both risk-free interest rates and corporate bonds' risk premiums. The interest rates of government bonds hit bottom in the third quarter of the year, after which the

worst recession concerns subsided, and interest rates took a slight upward turn. The interest rates for eurozone government bonds showed rather congruent development, but the overall returns were the strongest in the higher risk countries, such as Greece and Italy. The long-term interest rates of Germany, which is seen as a safe haven, declined to as low as -0.7%, but recovered and approached zero towards year-end. The European Central Bank (ECB) cut its key deposit rate to -0.5%, which kept the money market interest rates negative. The return on the loan portfolio was 4.0% (3.7%), on public sector bonds a more moderate 2.6% (-4.2%), on other corporate bonds as much as 6.6% (-2.0%), and on other money-market instruments 0.4% (-0.1%).

The global equity markets showed very strong returns in 2019, and most of the major equity indices ended up rising more than 20%. The US equity market's performance was exceptionally good, in addition to which the strengthened dollar boosted US equities' euro-denominated returns. A couple of short-lived corrections were seen during the year, but the market tone remained positive as the central banks' actions improved the risk sentiment. Differences between geographical areas were rather large, but with a few exceptions, all of the major indices were on the rise. Finnish equities generated somewhat weaker returns than the rest of Europe, but as a whole, the returns on listed equities stood at 25.4% (-8.3%). Private equity investments also generated strong returns, at 15.1% (17.5%), while infrastructure and unlisted equity investments generated a return of 16.9% (3.8%).

The return on real estate investments was 4.1% (5.5%). Direct real-estate investments yielded a return of 3.9% (3.9%) and real-estate investment funds 4.7% (10.6%). Rental activity was at a high level, and the portfolio's occupancy rate was excellent. During the year, Varma sold the head office of SOK Corporation in Helsinki and invested in the OOPS office campus in Leppävaara, Espoo. The merger of the Jumbo Shopping Centre and Flamingo Entertainment Centre located in Vantaa to form the largest shopping and entertainment centre in the Nordics was carried out in the autumn. Property development was active, and projects initiated during the year include the planning of the Keilaniemen Portti office building in Espoo, Stora Enso's head office building in Katajanokka, Helsinki, and the hotel development on Annankatu street in Helsinki. The proportion of indirect investments grew, but the returns were weighed down especially by the negative value change in investments in the UK. At the end of the year, more than a third of sites in Varma's office premise portfolio had BREEAM environmental certification.

The return on other investments was 4.5% (-1.4%). Hedge funds were effective in diversifying the equity and fixed-income market risk, yielding a return of 5.0% (1.6%), while the return on alternative risk premium investments, included in other investments, was slightly negative.

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 year, the appreciation of the US dollar supported equity returns to some extent. 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 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 1,371 (1,777) million.

Varma's share ownership policy

The central principles in Varma's ownership policy are high-quality governance in the companies in which it has a holding, transparency of operations, active engagement, and the monitoring of incentive schemes for key personnel. The share ownership policy was updated in 2019, and the policy is available on Varma's website. In 2019, Varma participated in the Annual General Meetings of 65 companies and in the work of 28 companies' Shareholders' Nomination Boards. Varma's website contains a list of the company's memberships on the Nomination Boards of listed companies.

Operating expenses

Varma's operational efficiency is very good. Varma used 62% (60%) of the expense loading, included in the pension insurance contributions, to cover operating expenses. Controlling operating expenses is a key objective for Varma while simultaneously improving operational efficiency. Good operational efficiency benefits Varma's customers by means of client bonuses. Varma's goal is to manage the assets of both present and future pensioners as efficiently as possible.

Increasing operational efficiency also requires continuous control of human resources and, in particular, IT system expenses, as these account for most of Varma's operating expenses. Overall operating expenses decreased 0,6%, totalling EUR 124 (125) million.

Varma is actively involved in the development and administration of the pension sector's joint information systems, and expects from the joint systems transparency and efficiency in terms of costs.

Personnel

The average number of the parent company's personnel and the salaries paid during the financial year are shown in the table below.

	2019	2018	2017	2016	2015
Average number of personnel	537	532	524	540	549
Salaries and remunerations, EUR million	37.6	40.1	39.3	36.0	39.6

Tieto Esy, which is included in the Consolidated Financial Statements using the equity method, had an average of 38 (38) employees in 2019.

At year-end, Varma's personnel were distributed as follows: pension services 28% (28%), insurance and actuary services 18% (19%), customer service departments 13% (12%), investment operations 13% (13%), and other functions 28% (28%). After the end of the financial year, services related to disability risk management were re-organised into a separate function, into which 14% of Varma's personnel was transferred. These employees previously worked in pension services and customer services.

The PeoplePower Index, measuring employee satisfaction and engagement in Varma's employee survey, was 75.2 (72.2), and Varma was once again ranked as one of Finland's Most Inspiring Workplaces. Varma placed second in the Responsible Summer Job campaign's large employer category. Our personnel played a key role in the strategy work carried out during the financial year. Varma's personnel are also highly committed to executing strategic initiatives in the financial year 2020.

Group companies and associates

At the end of 2019, the Varma Group comprised 123 (128) subsidiaries and 17 (17) associates. The most important subsidiaries and associates are Tieto Esy Ltd (50.1%), NV Kiinteistösjointus Oy (45.0%), Serena Properties AB (43.0%) and CMCV Kungens Kurva Holdco AB (45.0%). The Varma Group also owns 50% of the guarantee capital of Kaleva Mutual Insurance Company. Most of the subsidiaries and associate companies are real estate companies.

Governance

At Varma's Annual General Meeting, policyholders have about 78%, the insured about 20%, and the Sampo Group (the owner of the guarantee capital) about 2% of the votes.

Varma's Annual General Meeting was held on 14 March 2019. The General Meeting appointed eight new members to the Supervisory Board, raising the number of members from 28 to 32. Kari Ahola, Lasse Heinonen, Mika Joukio, Risto Kalliorinne, Mari Keturi, Johanna Moisio, Panu Routila and Sauli Vääntti were elected as new members to the Supervisory Board. The Annual General Meeting approved the financial statements and discharged the Board of Directors, the Supervisory Board and the President and CEO from liability for the financial year 2018.

Kari Jordan (Chairman), Saana Siekkinen (Deputy Chairman), Satu Wrede (Deputy Chairman), Juri Aaltonen, Eero Broman, Petri Castrén, Jukka Erlund, Erkki Etola, Olavi Huhtala, Juha Häkkinen, Jukka Jäämaa, Kari Kauniskangas, Ville Kopra, Tapio Korpeinen, Timo Koskinen, Pekka Kuusniemi, Päivi Leiwo, Olli Luukkainen, Jari Suominen, Leena Vainiomäki, Petri Vanhala, Jorma Vehviläinen, Christoph Vitzthum and Anssi Vuorio continued as Supervisory Board members.

The Chairman of Varma's Supervisory Board, Kari Jordan, resigned from the Supervisory Board on 28 March 2019, following his election as a member of Nordea's Board of Directors. According to the Act on Earnings-Related Pension Insurance Companies, the chairman of a supervisory board cannot be a member of a bank's board of directors. Varma's Supervisory Board held its constitutive meeting on 16 May 2019. The Supervisory Board elected Christoph Vitzthum as its Chairman. Saana Siekkinen and Satu Wrede were re-elected as deputy chairmen. Saana

Siekkinen resigned from the Supervisory Board on 31 December 2019 after having been elected as a new member to Varma's Board of Directors.

Authorised Public Accountants Antti Suominen and Jenni Smedberg have served as Varma's auditors. Authorised Public Accountant Robert Söderlund and Ernst & Young Oy have served as the deputy auditors.

As of the beginning of 2019, Varma's Board of Directors is composed of Jari Paasikivi (Chairman), Antti Palola (Deputy Chairman), Kai Telanne (Deputy Chairman), Riku Aalto, Eila Annala, Johanna Ikäheimo, Rolf Jansson, Ari Kaperi, Jyri Luomakoski, Petri Niemisvirta, Ilkka Oksala and Pekka Piispanen, and deputy members Eija Hietanen, Liisa Leino, and Risto Penttinen.

In its meeting on 27 November 2019, Varma's Supervisory Board selected Saana Siekkinen and Mari Walls as new members, and Timo Saranpää as a deputy member of the Board of Directors, effective 1 January 2020. Ilkka Oksala was also chosen as a deputy member. He served as a member of the Board of Directors until 31 December 2019. Board of Directors member Johanna Ikäheimo and deputy members Eija Hietanen and Liisa Leino resigned from the Board on 31 December 2019.

An up-to-date Corporate Governance Statement based on the recommendations of the Finnish Corporate Governance Code is presented on Varma's website.

Capital and reserves

Varma has 71 guarantee capital shares, which are held by Sampo Plc and Mandatum Life Insurance Company Limited. Under the Articles of Association, interest approved by the Annual General Meeting is paid on the guarantee capital of EUR 11.9 million each year. The maximum rate is the technical interest rate applied to the insurance provided in accordance with the legislation on employee pensions plus one percentage point.

Risk management

The goal of Varma's risk management is to identify and manage, in accordance with the defined risk appetite, risks that the company is subjected to, arising from and centrally linked to its business activities, and to secure continuity of operations. As a responsible operator, Varma considers it vital that the execution of the company's core task as a provider of statutory pension insurance is guaranteed and adequately efficient under all circumstances.

Varma's risk management activities are guided by the principles for the risk management system, which are annually approved by the Board of Directors. Company-level risk management is an element of the finance and actuary functions in order to ensure that risk reporting and risk management is independent of the risk-taking function. As of 2017, the company has drawn up a risk and solvency estimate for the Board of Directors, pursuant to the act on earnings-related pension companies.

As a provider of statutory earnings-related pension insurance, Varma's main risk is related to solvency management. The single largest risk factor in terms of solvency management is related to investment

performance. When investment returns exceed the return requirement on technical provisions, the company's solvency improves, and if they fall short of the return requirement, solvency declines. The principles for investment risk management are determined in the company's investment plan. The plan documents the general security goals set for investments, the diversification and liquidity goals of investments, and the principles for organising currency risk hedging. The Board of Directors assesses the investment risks in terms of changes in value, expected returns, security and the principles of foreign currency policy, the company's risk-bearing capacity in terms of investments, and the development of the company's solvency.

Other major risks in 2019 focussed on developing the business in a changing operating environment, and external services, such as the first operating year of the Incomes Register. More information about strategic, financial, investment and operative risks, as well as related quantitative data, is provided in the notes to Varma's financial statements.

Sustainability

Varma's most essential sustainability impacts are defined in the company's Sustainability Programme. The programme was revised in 2018, and its focal areas are promoting work ability and good working life, mitigating climate change, ethical business, open communication and responsibility for Varma employees.

Varma has assessed its sustainability risks relating to operations and business relations and has put in place comprehensive management systems and sufficient and appropriate processes, which ensure duty of care as regards these risks.

Varma's sustainability targets and measures are explained more broadly in a separate report conforming to the Global Reporting Initiative (GRI) guidelines. The report is integrated in Varma's online annual report, which will be published in February.

Report on non-financial information

Business model description

Varma has a responsible core task – to secure pensions. Taking care of personnel and responsibility for the environment hold the greatest importance in Varma's operations and in the supply chain. The biggest impacts of Varma's investments operations relate to environmental responsibility, social responsibility, responsibility for Varma's employees, respecting human rights and fighting corruption and bribery.

The key policies guiding Varma's sustainable business operations are the Sustainability Programme, Code of Conduct, Principles for Responsible Investment, Climate Policy for Investments, and Supplier Code of Conduct.

Social responsibility and employee-related responsibility

For Varma, social responsibility means high-quality and smooth implementation of pension provision, promoting our customers' work ability and responsibility for our employees.

Varma has been improving its pension application processing to provide faster pension decisions to its customers. The average processing time of all pension applications shortened from 31 days in 2018 to 25 days in 2019. That is 10 days shorter than the average for the sector. Varma's goal is to ensure that pensioners receive uninterrupted income and that pension is paid to their bank account during the first month. In 2019, the first pension was paid within the target period to 86.5% of new pensioners.

Varma's goal is to lengthen the careers of its client companies' employees and reduce disability pensions by developing work ability management and offering effective rehabilitation. In 2019, the average disability pension contribution category of Varma's client companies was 3.6 (3.7). Of Varma's vocational rehabilitation customers, 77%, i.e. 1,580 people, returned to working life during the year.

During the financial year, Varma rejected 34.6% (33.0%) of new disability pension applications. The rejection rate for all earnings-related pension companies was 33.7% (31.5%). The Pension Appeal Board changed Varma's disability pension decisions in 14.2% (13.9%) of the cases it handled. The corresponding rate for the entire private earnings-related pension sector was 13.0% (13.2%).

Varma takes care of the well-being at work, competence, and equal and non-discriminative treatment of its personnel. The achievement of goals in the different areas is monitored through an annual employee survey, among other means. The PeoplePower Index, measuring Varma employees' satisfaction and engagement, was 75.2 (72.2), which equals a good rating. Varma was included for the second time on the list of Finland's Most Inspiring Workplaces and placed second in the Responsible Summer Job campaign's large employer category.

The realisation and experience of equality and non-discrimination are measured through a separate survey, which is conducted once every two years to identify any areas needing improvement. In 2019, Varma focused on developing self-directed work teams and diversity. In order to increase the transparency of the remuneration system, Varma for example carried out a market salaries comparison, where the total salaries were compared to the finance sector's market salaries, taking into account job requirements and performance. The goal has been to increase both personnel's understanding of how their pay is formed and the transparency of compensation through open job grading and performance assessment based on common criteria.

Environmental responsibility and mitigating and adapting to climate change

Varma's opportunities to influence the environment can be examined in terms of its operations (Varma's office building and the environmental impact of the work performed in it), its supply chain and its investments. The biggest opportunities for influencing are through Varma's investment operations.

Mitigating climate change is one of Varma's key sustainability targets. Climate change also requires investors to prepare for the change and manage the related risks, as climate change is shaping the business opportunities of different sectors and influencing future investment valuations.

Varma's goal is to develop its investment portfolio so that it is aligned with the Paris Agreement's target of reducing emissions to limit global warming to 1.5 degrees Celsius in comparison to the pre-industrial level. Varma published its revised climate targets in 2019. The company commits itself to developing its portfolio towards carbon neutrality in 2020–2035.

Climate change also presents investors with return opportunities. Varma composes from the investments in different asset classes a climate-friendly investment allocation, which includes investees benefiting from and/or offering solutions to climate change. The target is for the allocation to represent 20% of the investment portfolio by 2025.

When it comes to mitigating climate change, it is critical for global index investors to shift their focus towards lower-carbon investments. In 2019, Varma developed, in collaboration with other parties, two sustainable exchange-traded funds (ETF), and invested a total of EUR 700 million in them.

Climate risk management and reporting

Varma constantly analyses the financial risks and opportunities and the business impacts brought by climate change. As part of the Sustainability Report, Varma reports on business impacts caused by climate change in accordance with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).

One tool for monitoring the management of climate-related risks is the carbon footprint, which is measured for direct equity investments, listed corporate bonds and direct real estate investments. In comparison to the baseline of 2015, the carbon footprint of Varma's listed equity investments in relation to net sales declined 16% and that of listed corporate bonds 20%. The CO₂ footprint of real estate investment was 27% lower per gross square metre than in 2015.

Varma requires its investees to have a plan for reducing their emissions and encourages companies to disclose, in accordance with TCFD, information about how climate change is included in the company's governance, strategy and risk management, especially in emissions-intensive industries.

Varma also does not invest in coal mining operations, and direct shareholdings in oil exploration are negligible, at 0.02%. Of Varma's direct equity investments, 13% were in companies that use fossil fuels in their production to a major extent, while the corresponding figure for the benchmark index was 12%. Varma is committed to exiting from investments in thermal coal by 2025, and to exclude oil exploration from its investments by 2030.

Varma has also identified industries with a need for enhanced ESG screening, i.e. with higher environmental, social and governance risks. Enhanced ESG monitoring and analysis concerns, for example, so-called transition industries that have a high exposure to climate risks.

Varma has defined industries that, in terms of climate change, both offer the greatest opportunities for emission reductions through their business and are also clearly exposed to risks caused by climate change mitigation, such as regulation and market risks. The transition industries comprise the oil & gas industry, electricity & heat production, and the automotive, mining, concrete, chemical and transport industries.

Varma has looked into the proportion of the transition industries in listed equity and fixed-income investments. At the end of 2019, the total share of these industries in the analysed asset classes was smaller than in the global benchmark index. Varma also analysed the contribution of different transition industries to the carbon intensity of Varma's direct equity investments at the end of 2019. The results show that electricity generation accounted for half of the carbon intensity.

Varma also follows the transition industries' proportion in private equity and infrastructure funds. In future, the goal is to raise the share of renewable energy in electricity generation to 50% in our investments by 2030.

Scenario analysis

Varma has carried out scenario analyses based on global climate models in order to determine how well its investments are aligned with the targets of the Paris Agreement.

The development of Varma's real property portfolio was examined in an analysis which included the carbon dioxide emissions from the heating and electricity of business and residential properties owned by Varma. The analysis shows that the future emissions from Varma's real property are, using the baseline scenario, in line with Science Based Targets' 1.5 degrees Celsius, but in order to reach the targets, the emissions from real property should decline 92% by 2050. The biggest emission reductions can be achieved by purchasing green electricity for business premises – residential properties owned by Varma already use green real estate electricity. Additional emission reductions can be achieved with solar electricity and heat pumps. The development of the real property portfolio's emissions is also closely linked to the fact that district heating in Helsinki, Espoo and Tampere has become greener, i.e. it is increasingly based on renewable energy sources.

Of the real property directly owned by Varma, 70% is located in the Helsinki metropolitan area. Practically all the buildings are located within a radius of approximately 10 kilometres from the seashore, and thus their climate burden is higher than average. In addition to the risk of a sea flood, slanted rain and strong winds may cause problems in controlling moisture levels in the buildings. At Varma, this is taken into account in building condition surveys and facade solutions for new buildings.

A sea flood analysis was also performed on Varma's real estate portfolio, according to which the risk is low. Varma takes the sea flood risk into account especially in new development projects and when purchasing new buildings.

Varma examined the development of direct equity and fixed-income investments' carbon footprint during 2016–2019 in comparison to the reduction targets set out in the new climate policy. For Varma to meet the new climate targets, the emissions of investees with high emissions must decline annually or, alternatively, Varma needs to reduce its positions in these investees.

Environmental impacts of Varma's operations and the supply chain

The environmental impacts of Varma's operations are controlled using WWF's Green Office system. The Salmisaari office building was audited in 2019, and Varma was granted Green Office certification. In order to reduce the carbon footprint of its own operations, Varma has shifted to using green electricity and had a solar power system installed on the roof of its office building. The carbon footprint of the company's own operations was 44% lower compared to the 2015 baseline. At the beginning of 2020, Varma introduced green district heat, which is produced using waste heat and further lowers the operational carbon footprint.

The environmental aspects of the supply chain are taken into account in the Supplier Code of Conduct, in which our suppliers are encouraged to use a certified environmental system or a documented operating method for managing their environmental matters.

Respecting human rights and fighting corruption and bribery

In the Code of Conduct, Varma commits to combating the grey economy and bribery, and following responsible investment principles, among other things. Varma is also committed to operating in accordance with the UN's principles concerning business and human rights and expects the same from its supply chain.

Varma's own operations have not been found to entail major human rights risks. Varma's Code of Conduct provides anti-bribery and anti-corruption guidelines concerning, for example, offering and accepting gifts and hospitality and avoiding conflicts of interest. An online course helps raise awareness of the Code of Conduct, and in 2018, the course was completed by 91% of Varma's employees. The course is taken every two years and is due next in 2020. The Code of Conduct is complemented by other internal guidelines and instructions relating to, for example, data security and data protection, and the identification of money laundering.

Sustainable supply chain management

Varma has analysed its supply chain in order to identify sustainability matters, and determined the sustainability requirements which are contained in the Supplier Code of Conduct. Varma expects its direct service providers to commit to the sustainability requirements. A direct service provider is responsible for its own supply chain.

The Supplier Code of Conduct covers, among other things, good business practices, human rights, occupational safety and health, and respect for the environment. It also includes a notification requirement and a permission for audits.

Varma will update its real property purchase criteria in 2020 in order to promote low-carbon circular economy solutions.

Varma expects its partners and suppliers to sign an agreement on complying with sustainability requirements. The first tier of Varma's supply chain mainly covers Finland alone: of all purchases made in 2019, Finnish service and goods providers accounted for 98.7% (98.8%). Main purchases relate to construction activities, the real estate business, and IT services.

Evaluation of investees' sustainability

Varma expects the listed companies that it invests in to comply with local legislation and international standards and agreements, typically the principles of the UN Global Compact initiative on social responsibility, and to respect human rights. Varma reviews the compliance with the standards with the help of an external service provider, which examines Varma's direct listed equity investments, listed corporate bond investments and equity funds twice a year. In September 2019, the norms-based screening covered 25% of all of Varma's investments. At the end of the year, listed equity investments and listed corporate bond investments included three companies with a confirmed environmental violation and an ongoing engagement process.

A typical channel for engagement is decision-making portfolio managers' meetings with investees. In 2019, Varma had around 300 corporate meetings, in which the integration of sustainability in the strategy and business of the

investees was discussed. In 2019, Varma was represented in 28 companies' Shareholders' Nomination Boards and participated in the Annual General Meetings of 65 companies.

For ethical reasons, Varma excludes from its direct investments companies that concentrate on the manufacture of tobacco and companies that manufacture controversial weapons, such as nuclear weapons, anti-personnel mines, cluster bombs, and chemical and biological weapons.

In the name of climate change mitigation, Varma has excluded investments in companies that rely on coal- or lignite-based operations for more than 30% of their net sales. In direct investments, Varma strives to engage with companies with the aim of having them decommission coal power plants by 2030.

Varma signed the UN-supported Principles for Responsible Investment (PRI) in 2011. Varma reports on its responsible investment annually in accordance with the PRI framework. PRI included Varma in the PRI Leaders' Group in an assessment carried out in 2019, which rated investors according to the responsibility of their practices when selecting and assessing external asset managers.

Environmental ratings are a concrete way to develop the sustainability of real estate. Varma's goal is to have its most important buildings certified according to the BREEAM environmental rating system by 2025. The quality system is particularly aimed at improving how energy efficiency is monitored and verified. The goal is to achieve a rating of at least "Good" or "Very Good". In 2019, eleven buildings owned by Varma were granted BREEAM In-Use environmental certification. At year-end 2019, a total of 48 of Varma's real properties had environmental certification, making up 39% of the real estate base under our direct ownership.

Varma's goal is to make use of circular economy models in its real estate business. The principles of circularity will be integrated in all the processes of new construction and renovation projects as well as maintenance.

Outlook

The risks related to the economic operating environment levelled off towards the end of 2019. The biggest risks are connected to the escalation of trade policy and geopolitical tensions. On the other hand, the decline of the tensions could be a major contributor to a stronger economy.

Finland is a small, open economy whose success and possibilities to finance current transfers and well-being services – including pensions – depend on how well we manage to sell our production to larger markets. There is plenty of uncertainty relating to the economic development of export markets, especially in Europe. At the same time, there is very little monetary policy leeway in the eurozone, and the co-ordination of financial policy has not been successful.

The employment rate will improve at a slower rate, and the muted investment appetite in terms of both production capacity and research and development undermines the economy's growing conditions in Finland. The increase in age-related spending will allow less latitude in public finances, and the window for preparing for the increased spending is closing. In addition to economic challenges, the low birth rate contributes to major uncertainties regarding the sustainable financing of the pension system in the long term.

The zero-interest-rate environment is causing problems for pensions systems all over the world. Low interest rates and muted inflationary expectations have steered institutional investors' assets to higher-risk and lower-liquidity investees. Strong corrections cannot be ruled out, but Varma's strong solvency will secure pensions even in possible sharp market corrections.

Varma continues to effectively implement the earnings-related pension system.