

13 February 2014

Report of the Board of Directors 2013

- The total result was EUR 1,558 (1,201) million, and the balance sheet total at fair value was EUR 38.3 billion (35.7 billion).
- Solvency remained the strongest in the sector, at EUR 9,140 (7,716) million or 31.6 (28.0) per cent of the technical provisions.
- The return on investment was 9.0 (7.7) per cent, and the market value of investments stood at EUR 37.7 (34.4) billion.
- The loading profit was EUR 32.0 (21.2) million.

Economic operating environment

Central banks' pro-active monetary policy supported the economy

The situation in the U.S. cast a brighter light on the 2013 economic year, and a clearer general picture of the global economy emerged. Economic problems in the eurozone also levelled out, but the crisis has not yet been overcome. The year was marked by the central banks' dynamic monetary policy interventions in the markets, and the consequent strong upswing, particularly in the stock markets of developed countries.

In the U.S., growth picked up towards the end of the year, bolstered especially by the increase in consumer spending, which was supported by the strengthening housing market and a decline in unemployment. The strengthening of the economy has increased the expectation that the Central Bank will begin to unwind its monetary policy stimulus. The U.S. Central Bank has announced it will continue with its measures: the monetary policy stimulus will continue for as long as is necessary. U.S. economic recovery has been slow compared to previous economic cycles.

Europe seeks balance and anticipates strengthened recovery

In the eurozone, progress has been made in balancing public finances in troubled countries, and growth expectations have slightly improved. The strong euro presents a challenge to the competitiveness of many eurozone countries. Although signs of a pick-up in industrial production began to emerge towards the end of the year, simultaneous savings measures and a wage freeze could curtail consumer spending and impede inflation in the entire eurozone. The European Central Bank has announced that it is technically ready also for negative interest rates.

13 February 2014

Capital markets showed strong development in 2013. The aggressive monetary policy in the U.S. propelled the securities markets to record figures. The financial markets are currently undergoing an unprecedented wave of regulation tightening and building. Increasing regulation will inevitably restrict lending and raise financing costs.

No growth in Finland's economy

Finland's economic development in 2013 was very sluggish. Finland lags behind its peer countries in economic growth. Our exports recover after a delay, and we face considerable challenges in our business and trade structures and in our public finances. Industrial production figures and export volumes shrank during the year. The added value of our exports has diminished. Although unemployment is higher, considering the economic situation, it is still at a reasonable level. This is because as the population ages, growth in potential workforce slows. Weak growth and the changing age structure of the population are widening the sustainability gap in Finland's public finances. The significance of the earnings-related pension system is highlighted in closing the gap, since earnings-related pension assets are considered a part of the national economic accounts and pension legislation is reflected in the supply of workforce.

Strong solvency is Varma's strategic choice

Varma's task is to invest pension assets profitably and securely. The financial crisis has hit pension systems and institutional investors worldwide. In the prevailing highly challenging and difficult-to-predict market situation, Varma's priority has been on fostering strong solvency. We strive for the best possible return on investments based on our chosen risk profile in order to secure the payment of pensions. Strong solvency and pro-active and prudent diversification of investments are especially important in a demanding market situation.

In the short-term, the goal of extending careers and companies' financial requirements do not necessarily match. A number of Varma's client companies are also experiencing difficult transformations. Varma's strategic goal is to offer effective pension insurance services. The ability to understand customers' needs is highlighted during major economic shifts. Varma is a strong expert in handling earnings-related pensions and a preferred specialist partner in workability management. Varma's goal is to be the most efficient pension insurance company and to offer its customers the best client bonuses in the sector.

13 February 2014

Financing of the earnings-related pension system is on a stable foundation and benefits are well-secured

The labour market organisations have committed to negotiating the pension system reform such that it takes effect at the start of 2017. The pension reform is expected to extend careers by at least 1.5 years, which will fulfil the tripartite commitments that were previously made. The main strength of Finland's private-sector earnings-related pension system is its stable financing balance. As part of the Pact for Employment and Growth, the main labour and employer confederations upheld the previously agreed pension contribution increases, which will raise the average pension contribution to 24.4 per cent in 2016.

At the start of 2013, international experts released their findings on the state and development needs of Finland's statutory earnings-related pension system. The pension scheme received a very positive evaluation. Among the particular strengths of the Finnish pension system are the cover provided by the statutory system, a consensual approach to decision-making, and a commitment to securing stable and long-term sufficiency of funding.

A strong earnings-related pension scheme creates stability for the economy and for society, since the responsibility for pensions extends well into the future. A sustainable pension system must be based on longer careers, general confidence in the pension scheme, fair division of resources between generations, and improving well-being at work. Remaining in working life longer and the funding of pensions will help the Finnish economy endure the change in the age structure.

Major projects are under way to renew the regulation of the pension sector. The preparation of proposals concerning the development of solvency regulations, defining the regulation concerning the governance of earnings-related pension companies, promoting competition in the pension sector, and regulation supporting workability management will continue in 2014.

Varma, for its part, strives to reinforce the pension system and secure pensions through highly successful investment operations, by improving the cost-effectiveness of its operations, and by offering effective earnings-related pension insurance services that support the insured and policyholders in extending careers.

In 2013, the average TyEL contribution was 22.8 (22.8) per cent of the salaries and wages. Employees below the age of 53 contributed 5.15 (5.15) per cent of their pay, while the rate for employees aged 53 and over was 6.50 (6.50) per cent. The YEL contribution was 22.50 (22.50)

13 February 2014

per cent of the confirmed earnings for those below the age of 53, and 23.85 (23.85) per cent for those aged 53 and over. Earnings-related pension contributions will increase in a frontloaded manner between 2012 and 2016 by a total of 2.0 percentage points to 24.4 per cent. The increase is divided equally between employer and employee.

The return requirement on technical provisions consisted of a 3.0 (3.0) per cent fund rate, a pension liability supplementary factor and the return on equity component. The value of the supplementary factor was 0.94 per cent on average in 2013. The return on equity component in 2013 was 19.92 per cent. The technical interest rate, used to determine the interest rate of the oldest premium loans, insurance contributions and other items, was 4.0 per cent until the end of June, and 4.75 thereafter.

Varma's financial trends

Varma's total result at fair value stood at EUR 1,558 (1,201) million. The total quarterly result varied during the financial year, such that the first-quarter result was the strongest and the second-quarter result the weakest. Varma's financial performance in the second half of the year was good.

Solvency regulations changed at the beginning of 2013. The change did not affect Varma's solvency position.

Varma's solvency strengthened during 2013 by EUR 1,424 million, and at the end of the year, solvency capital amounted to EUR 9,140 (7,716) million. Varma's solvency ratio, i.e. solvency capital in relation to technical provisions, is the highest among the main earnings-related pension companies, at 31.6 (28.0) per cent. Solvency capital was at a strong level: 2.2 (2.4) times higher than 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 was EUR 3,160 (2,492) million at fair value, which was 9.0 (7.7) per cent of the invested capital. The interest credited on the technical provisions was EUR 1,648 (1,303) million. Thus, the investment result for 2013 totalled EUR 1,512 (1,189) million. The average annual nominal return on Varma's investments over five years was 7.8 per cent, and over ten years 5.6 per cent. Operating expenses were 24 (16) per cent lower than the expense loading included in insurance contributions, and the loading profit stood at EUR 32 (21) million. The underwriting result was EUR 15 (-9) million.

13 February 2014

At the end of 2013, EUR 105 (78) million was transferred to the provision for current bonuses for client bonuses. The transfer represents roughly 0.6 (0.4) per cent of the estimated payroll of the insured.

The TyEL payroll of those insured by Varma totalled about EUR 17.8 (17.7) billion in 2013. The payroll is estimated to have stayed at the same level as the actual 2012 figure. Varma's premiums written totalled EUR 4,258 (4,230) million, of which TyEL insurance accounted for EUR 4,071 (4,041) million and YEL insurance for EUR 187 (190) million.

At the end of the year, 531,210 (539,740) individuals were insured by Varma. The number of valid insurance policies totalled 66,740 (68,900), covering 39,810 (41,280) self-employed persons and 491,400 (498,500) employees.

During the year, a total of 3,796 (3,881) new TyEL insurance policies and 5,340 (5,782) YEL insurance policies came into force at Varma.

Earnings and employment notifications received during the year totalled 1,483,634 (1,476,812), of which 92 (90) per cent were received electronically.

Varma observes good insurance principles. All business transactions with policyholders are on market terms. Particular attention is paid to transactions covering the financing of a policyholder's operations, real estate and other transactions, and leases. At Varma, business transactions related to pension insurance or investments are carried out independently. When acquiring new assets in connection with client transfers, Varma is mindful not to infringe on the previous insurance portfolio.

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

In 2013, a total of EUR 4,490 (4,222) million in pensions was paid out. The number of pension recipients increased, and at year-end, Varma was paying TyEL and YEL pensions to 333,762 (331,383) people.

13 February 2014

A total of 23,937 (22,031) new pension decisions were made during the year. The number of new pension decisions increased 8.7 percent and the total number of all pension decisions was 3.1 per cent higher than in 2012. Old-age pension decisions numbered 11,514 (10,229), and 5,461 (5,457) disability pension decisions were made. Part-time pension decisions increased and stood at 1,052 (842). Continuation decisions on temporary pensions totalled 5,871 (5,653), and other decisions numbered 13,131 (13,960). These were decisions required as a consequence of the changes in pension rights.

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 currently roughly 72 per cent of those who receive Varma's rehabilitation return to the job market either in full or partly. Varma has for years been a forerunner in vocational rehabilitation. Throughout 2013 Varma assisted its client companies in managing personnel risks through client-oriented co-ordination of well-being-at-work services, rehabilitation services and pension-decision services in order to support the management of pension costs and longer careers. Varma also contributed to the costs of customers' workability management projects in accordance with jointly agreed and often multi-year plans and contracts.

	31 Dec. 2012	31 Dec. 2011	Change
Number of insured			
TyEL ¹	491,400	498,460	-7,060
YEL	39,810	41,280	-1,470
Total	531,210	539,740	-8,530
1 of which covered by TEL registered supplementary pension insurance	4,928	5,545	-617
Number of insurance policies			
TyEL	26,930	27,620	-460
Number of pensioners			
Part-time pension	3,320	3,986	-666
Survivors' pension	51,427	51,487	-60
Disability pension	33,324	36,195	-2,871
Unemployment pension	38	408	-370
Old-age pension	230,249	223,999	6,250
Early old-age pension	15,404	15,308	96
Total ²	333,762	331,383	2,379
² Those receiving YEL pension	29,153	28,969	184
Those receiving TEL/YEL supplementary pension	43,286	42,797	489

13 February 2014

Varma's customer service has seen a considerable increase in the use of the company's online services. During the year under review, 74.5 per cent of all private customer contacts took place online. Pension recipients are able to update their address and account number information themselves by logging in using their Finnish personal banking codes. Through Varma's eServices, the insured can obtain the most recent estimate of their old-age and part-time pensions at various retirement ages, apply for a pension, and follow the progress of the application.

Varma sends a pension record to the insured once every three years. 235,287 (574,149) such pension records were sent out in 2013. The record shows information on earnings that apply to pension as well as the pension that has accrued until the end of the preceding year. The pension record is also available in electronic form via Varma's eServices.

Technical provisions

Varma's technical provisions grew 5.5 (2.7) per cent to EUR 31,399 (29,767) million. They contain a provision of EUR 106 (79) million for current bonuses reserved for client bonuses, a provision of EUR 1,301 (1,073) million for future bonuses contained in the solvency capital, and EUR 720 (190) million in an equity-linked provision for current and future bonuses, which transfers part of the equity returns of the earnings-related pension system to create a buffer. The equalisation provision amounted to EUR 1,118 (1,108) million.

At the end of the year, the assets covering the technical provisions were 121 (118) per cent of the technical provisions.

Investments

At the end of 2013, the value of Varma's investments totalled EUR 37,718 (34,406) million and the return at fair value was EUR 3,160 (2,492) million or 9.0 (7.7) per cent. All asset classes yielded a positive return. The average nominal return over the last five years was 7.8 per cent. The value and returns of the investments are grouped according to risk in this report. The Notes show the breakdown of investments and their returns by investment category, grouped according to regulations and according to risk.

13 February 2014

The focus of Varma's investment activities was on active risk management, and the security of investments was emphasised. The key target was to secure a strong solvency position. During the year, Varma reduced the share of its fixed-income investments and increased the share of equities and other investments in its portfolio. In its investment risk management, the company used derivatives for hedging purposes and in controlling the risk level of the portfolio.

Varma's fixed income investments stood at EUR 10,624 (10,666) million at the balance sheet date and were distributed as follows:

- loan receivables EUR 2,026 (2,441) million
- public-sector bonds EUR 3,869 (4,052) million
- other corporate bonds EUR 5,363 (5,347) million
- other money-market instruments -635 (-1,175) million; the impact of derivatives, EUR 1,878 (1,910) million, is presented separately.

The return on fixed-income investments was 1.2 (4.4) per cent. The return on the loan portfolio was 3.3 (3.2), public-sector bonds -1.8 (3.6), other corporate bonds 3.0 (8.1) and other money-market instruments -0.4 (0.7) per cent.

In a low interest rate environment, the return on Varma's fixed-income investments was divided. Considering the prevailing interest rate level, the return on the loan portfolio and on corporate bonds was good. The returns on government bonds were burdened by sticking to bonds with the best credit rating and by the increase in long-term interest rates during the year.

At the balance sheet date, the value of Varma's equity investments was EUR 14,756 (11,727) million. Listed equities stood at EUR 11,579 (8,567) million, private equities at 2,175 (2,394) million and unlisted equities at EUR 1,002 (766) million. The return on Varma's equity investments was 21.8 (14.5) per cent. Listed equities yielded a return of 23.7 (14.9) per cent, private equities 12.1 (13.0) per cent, and unlisted equities 26.7 (15.5) per cent.

Equity investments performed the best of all asset classes. The return trend of listed equities was very good, with companies distributing high dividends and share prices rising substantially during the year. Finnish equities had the highest returns in Varma's portfolio, and U.S. equities showed a similar increase in value.

13 February 2014

Private equities and unlisted equities also generated good returns. Of Varma's private equity investments, close to half are invested in the U.S., and the rest mainly in Europe and the Nordic countries. Private equity and unlisted equities represent a long-term asset class in Varma's portfolio, and their long-term return has been very good.

Real-estate investments stood at EUR 4,304 (4,463) million at the balance sheet date, with direct real estate investments accounting for EUR 3,739 (3,961) and real estate investment funds for EUR 565 (503) million of the total. The return on real estate investments was 3.1 (4.5) per cent. Direct real-estate investments yielded a return of 2.0 (4.6) per cent and real-estate investment funds 11.6 (3.1) per cent.

The volume of Finland's real estate trade remained at a low level in the first half of 2013. However, new real estate funds specialised in residential and care properties actively added to their portfolios. The markets picked up towards the end of the year, however, and the volume of real estate trade grew significantly as a result of several commercial real estate transactions. Varma made EUR 84 million worth of new real estate investments, and had 230 new rental flats under construction in the Helsinki area in 2013. In terms of business premises, Varma shifted its focus from new construction to developing office premises and to maintenance construction and renovations. The change in fair value of Varma's directly owned real-estate holdings totalled EUR -131 million.

Other investments amounted to EUR 6,157 (5,640) million. These consisted of hedge funds EUR 4,850 (3,779) million, commodities EUR 201 (289) million, and other investments EUR 1,106 (1,571) million. The return on other investments was 4.5 (6.0) per cent.

It was a successful year for hedge funds, and Varma's hedge-fund investments generated a return of 8.8 per cent. They performed consistently, with only minor fluctuations during the financial period. The return on inflation-linked investments was affected by the rise in real interest rates and by the slow-down in the inflation rate. The other investments asset class provided, on the whole, return and diversification benefits at a low risk level during the year.

The market risk of investments constitutes the greatest risk affecting the company's result and solvency. Equities constituted by far the greatest market risk. The VaR (Value-at-Risk) figure describing the total risk of Varma's investments stood at EUR 1,118 (1,076) million. The figure represents the maximum fall in the market value of the company's investment portfolio in normal conditions over a period of one month with a probability of 97.5 per cent.

13 February 2014

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. In 2013, Varma actively participated in the Annual General Meetings of the domestic companies in which it owned shares and in the work of 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 used 76 (84) per cent of the expense loading, included in the insurance contributions, to cover operating expenses. Control of IT system expenses, in particular, improved Varma's operating expense efficiency compared to the previous year. 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.

In addition to economies of scale, increasing 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 on the previous year, totalling EUR 143 (149) million.

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

Personnel

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

	2013	2012	2011	2010	2009
Average number of personnel					
Parent Company	565	572	588	601	615
Salaries and remunerations, EUR million ¹					
Parent Company	37,9	37.0	39.5	36.9	34.3

¹ Do not include the salaries paid by Tieto Esy Ltd., as the figures for the company have been consolidated using the equity method.

Tieto Esy, which is included in the Consolidated Financial Statements using the equity method, had an average of 88 employees in 2013.

13 February 2014

At the end of the year, Varma's personnel were distributed as follows: pension insurance and customer service departments 63 per cent, investment operations 12 per cent, and other functions 25 per cent.

Group companies and associates

At the end of 2013, the Varma Group comprised 205 (226) subsidiaries and 22 (21) associates. The most important subsidiaries and associates are Tieto Esy Ltd (50.1 per cent), Garantia Insurance Company Ltd (30.5 per cent), SATO Corporation (45.7 per cent), Technopolis Plc (24.0 per cent) and NV Kiinteistösijoitus Oy (45 per cent). The Varma Group also owns 50 per cent of the guarantee capital of Kaleva Mutual Insurance Company. Most of the subsidiaries and associate companies are real estate companies.

Corporate Governance

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

The Annual General Meeting held on 21 March 2013 elected Petri Castrén, Lauri Peltola, Juhani Pitkääkoski, Arja Talma, Leena Vainiomäki and Satu Wrede as new members of Varma's Supervisory Board. Continuing as Supervisory Board members were: Juri Aaltonen, Martti Alakoski, Berndt Brunow, Erkki Etola, Stig Gustavson, Tauno Heinola, Tapio Korpeinen, Tapio Kuula, Päivi Kärkkäinen, Olli Luukkainen, Ilkka Nokelainen, Jari Paasikivi, Hannu Penttilä, Pertti Saarela, Kari Sairo, Mika Seitovirta, Saana Siekkinen, Antti Sippola, Jorma J. Takanen, Kari Virta, Anssi Vuorio and Göran Åberg.

At the Supervisory Board Meeting, Tapio Kuula was elected Chairman and Martti Alakoski was elected Vice-Chairman.

At the Annual General Meeting, Raija-Leena Hankonen, Authorised Public Accountant, and Petri Kettunen, Authorised Public Accountant, were elected as Varma's auditors, and Paula Pasanen, Authorised Public Accountant, and KPMG Oy Ab as deputy auditors.

13 February 2014

In its meeting on 3 December 2013, the Supervisory Board re-elected to the Board of Directors the following members, whose terms were expiring: Johanna Ikäheimo, Kari Jordan and Veli-Matti Töyrylä. The new members elected were Petri Niemisvirta, Jari Paasikivi and Antti Palola. The Board of Directors was chaired by Sakari Tamminen, with Kari Jordan and Mikko Mäenpää acting as Deputy Chairmen.

On 22 August 2013, Varma's Board of Directors appointed Risto Murto (PhD Econ.) President and CEO, effective 1 January 2014. On 9 October 2013, the Board named Reima Rytsölä (M.Soc.Sci) as the company's Chief Investment Officer, effective 1 January 2014.

At its organising meeting on 31 January 2014, Varma's Board of Directors elected Kari Jordan as Chairman, and Jari Paasikivi and Antti Palola as Vice-Chairmen of the Board.

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. Varma aims at transparent financial reporting that conforms to best practices.

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, an interest approved by the Annual General Meeting is paid to the guarantee capital of EUR 11,941,342.78 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. A guarantee capital share gives the holder 420 votes in the Annual General Meeting.

Risk management

The risks related to Varma's result and solvency are primarily affected by the result of investment activities. The most important operative risk concerns IT systems, which have a key role particularly in the processing of pensions and insurances within a mainframe environment and in the networked operating environment of the pension system.

13 February 2014

In the earnings-related pension system, the liquidity risk is manageable, as the pension expenditure can be accurately forecast and investments are strongly focussed on liquid instruments. Varma's insurance business risks, which are minor, are linked to the sufficiency of the insurance contributions collected and the technical provisions accumulated from them in relation to the pensions that are the company's responsibility.

Varma's investment plan determines, among other things, the general security goals set for investments, the diversification and liquidity goals of investments, and the principles for organising foreign currency business. The Board of Directors assesses the risks in Varma's investments with respect to changes in value, expected returns, security, and the foreign currency business, and the company's risk-bearing capacity in the area of investments, including the development of the company's solvency position. The basic allocation laid down in the investment plan also lays down the basic level for the total portfolio risk. Deviations from the basic allocation are allowed within defined limits. The maximum risk level is measured so that even after a 25 per cent drop in the value of listed equity investments and certain hedge fund investments, the solvency capital still exceeds the minimum solvency capital by at least the amount of the VaR and is, in any case, always at least at the solvency limit. The diversification of the investment portfolio is based on allocation that takes into account the return correlations of asset classes. Risks are managed by, for example, diversifying investments by asset class and item, by analysing the investment portfolio and items, by avoiding risk concentrations, by securing guarantee policy, through careful valuation practice, by using derivatives, and by applying a supervision and follow-up system.

More information about insurance, investment, operative and other risks, the means for managing them, as well as related quantitative data, is provided in the notes to Varma's financial statements.

Outlook

The global economy has begun to recover. The balancing of economic problems in the eurozone will create room for growth. Industrial production began to show increasing signs of improved growth in the eurozone towards the end of the year. For many countries, however, the strong euro will put pressure on the price competitiveness for some time to come.

There are many challenges to be solved in Finland's economy, despite the positive effect the upswing in global demand is expected to have on our economy in 2014. Economic forecasts covering the next few months remain sluggish. As a result of long-term developments, our

13 February 2014

business and trade structures have changed, and the added value of our exports has diminished. Finland needs new sources of growth.

The capital markets have enjoyed strong growth in Finland, particularly when considered in relation to the situation in the real economy. This is indicative of investors' confidence in the solid future profitability of Finnish companies. Changes in central banks' monetary policy could upset the markets. Assessments of the effects stricter monetary policy would have on capital markets are partly contradictory; success in the timing and scope of actions will, however, be crucial.

The private sector earnings-related pension system is on a stable financial footing, and it offers the insured consistent defined-benefit pensions. Varma aims to be a forerunner in earnings-related pensions as well as a reliable partner to its clients in earnings-related pension insurance. Varma highlights pension companies' responsibility for professionally handling investment risk management and supports the sector's efficiency and transparency and the prerequisites for competition. Earnings-related pension insurance companies must handle the task set out for them as efficiently as possible for current and future pension recipients.