

Report of the Board of Directors 2016

The economic operating environment

Global economic growth continued in 2016. Economic recovery in the US and eurozone continued, and Finland's economy finally took a cautious upward turn. The uncertain operating environment will make 2017 another challenging year. Earnings-related pensions are well secured also during economic turmoil. Varma has been preparing for the future changes in pension laws together with its customers.

Investment market sentiment changed many times during 2016. Political uncertainty increased as a result of several important votes, but their impacts were muted and short-lived or even contrary to expectations.

Early in 2016, the uncertainty concerning China's economy and capital markets and the situation in the Middle East shook up the markets. Prior to the Brexit vote market disturbance were expected, but the downswing was short-lived. The market reaction to the US presidential election result was positive. Interest rates were on a downward trend in the early months of the year but following the US elections the interest rates of government bonds picked up. The inflation rate started to rise in both the US and the eurozone towards the end of the year. Changes in monetary policy are also mirrored in the valuation of other asset classes.

The positive momentum in the US economy continued: the employment rate improved, the number of available jobs increased, as did salaries. Consumer confidence has been driving the increase in consumer consumption for a while now, and inflation expectations have been rising as a result of economic recovery and a stronger labour market situation. In December, the US central bank, the Fed, continued to normalise its monetary policy by hiking its benchmark rate and forecasting further hikes in 2017. The scale of the stimulus programme planned by the US administration and its progress are still uncertain, but intentions of increasing protectionism add to uncertainty relating to the direction and growth of the global economy.

As a result of stimulus measures, China's economy showed steady growth, but the growth rate is set to slow down due to structural changes relating to the efforts to increase the importance of the home market. On the other hand, China is burdened by overcapacity, increasing debt, market bubbles and other problems in the financial sector. Japan's economy showed signs of moderate recovery during the first three quarters of 2016. The Russian economy remained in deep trouble.

The eurozone economy progressed favourably and recovery was further boosted by the European Central Bank's (ECB) substantial monetary policy measures. Although there has been uncertainty in the eurozone concerning the situation of certain major banks, the financing conditions have relaxed. Both consumers' and companies' confidence in the economy has strengthened. The strengthening of the US dollar against the euro helps to boost exports, but the confusion relating to the final contents of Brexit is still a source of uncertainty.

The monetary policy framework continues to prop up growth in the eurozone. In December 2016, the ECB announced that it will extend its bond purchase programme until the end of 2017 but cut the value of its monthly purchases. Inflation rates have also started to pick up in the eurozone, and several crisis-stricken countries have been able to get their economies back on track, thanks to structural reforms. The easing of tight financial policy has promoted growth in demand.

Finnish economy finally resumes growth

Finland's economy grew faster than forecasted in 2016. The Ministry of Finance estimates a GDP growth of 1.6% over 2015. Growth was accelerated by the development of the domestic markets, which was more favourable than anticipated.

Consumer confidence in the Finnish economy strengthened. Combined with the low interest rates and increase in household indebtedness, the lower savings rate of households, increase in real income and subdued rise in consumer prices supported private consumption. The improved employment rate also supported this trend. Long-term unemployment has risen and the labour market continues to be burdened by structural inflexibility, which shows as discrepancy in demand and supply.

The outlook for Finnish companies remained very cautious. Private investments did, however, increase 2.8% in January-September 2016 in comparison to the previous year.

Towards the end of 2016 export demand picked up, and the worst was over. The volume of industrial output increased during the year in most months in comparison to both the corresponding period in 2015 and the previous month. According to Statistics Finland, industrial output increased 2.3% in January–November 2016 in comparison to the corresponding period in 2015.

In 2016, a tripartite labour market agreement, the competitiveness pact, was concluded, which strengthens exports' price competitiveness in relation to competitor countries. The improved competitiveness and recovery of exports are expected to strengthen employment and economic growth. In the short term, the competitiveness pact will weaken the growth potential of private consumption, as no pay increases will be implemented. The immediate impacts on public finances will be negative, when the impact of the increasing social security payments of employees will be compensated through tax reliefs.

The deficit in public finances is still substantial and it will be highlighted in the coming years, as the ageing of the population will increase pension and care expenditure. Economic growth, although stronger, is not sufficient for balancing public finances. The recovery of exports is vital for strengthening the growth base, as the domestic markets alone are incapable of creating adequate economic growth.

Earnings-related pension system

The reformed pension legislation took effect at the start of 2017. The pension reform targets longer careers and stronger financial and social sustainability of the earnings-related pension system, and it helps close the sustainability gap of public finances. The age limits for old-age pension will gradually rise to 65 years, and thereafter will be linked to life expectancy. Part-time pension will be replaced by partial early old-age pension, and new part-time pensions will no longer be granted. Those who have been working in a strenuous job for a long time can apply for years-of-service pension.

The significance of employment is highlighted in the partly fund-based pension system. This makes it important to promote the achievement of the pension reform goals in the workplace. The goal of extending careers does not always necessarily coincide at workplaces and in people's lives when the economy is suffering and structural changes are shaking the business sector. We support our client companies and the insured in the midst of these changes: Varma is a strong expert in vocational rehabilitation and workability management.

The goal of the pension reform is to stabilise the pension contribution level. In conjunction with the pension reform and the competitiveness pact negotiations, it was agreed that the average level of pension contributions would be 24.4% until the end of 2021. According to the long-term calculations by the Finnish Centre for Pensions at the end of 2016, it seems that in the long term the 24.4% contribution level will not be sufficient for the funding of the pension benefits agreed on in the pension reform. Reasons for this are the weaker than anticipated economic growth and the fact that in the calculations, investment return assumptions for the earnings-related pension system were lowered. In the long term, the lower birth rate will also cause pressure to increase the contributions. In the pension reform it was agreed that the pension investors' opportunities for risk taking and targeting higher returns will be improved as of the beginning of 2017.

New laws concerning the calculation of the solvency limit took effect on 1 January 2017. The calculation is now more based on risk factors, and the separate regulations on technical provisions were abolished. As an indicator, the new solvency limit is not directly comparable with the current limit. Varma introduced calculation methods pursuant to the new solvency legislation from the start of the financial year 2017.

It was agreed in the competitiveness pact that the employees' pension contribution will be gradually increased by a total of 1.2% between 2017 and 2020, and employers' average contribution will be lowered by an equal amount. The labour market parties also agreed on changes to earnings-related pension companies' administration. In future, 1/3 of the members of the board of directors and supervisory board will be elected on the proposal of the major central organisations representing the employees, and 1/6 on the proposal of the major central organisations representing the employers. The changes will take effect in 2020 for the board of directors and in 2019 for the supervisory board.

Finland was ranked fourth in an international pension scheme comparison in 2016, improving on its previous ranking. According to the Melbourne Mercer Global Pension Index, Finland has the most reliable and transparent pension system in the world in terms of governance.

Pension contributions and return requirement on technical provisions

In 2016, the average TyEL contribution was 24.0% (24.0%) of the salaries or wages. Employees below the age of 53 contributed 5.70% (5.70%) of their pay, while the rate for employees aged 53 and over was 7.20% (7.20%). The YEL contribution was 23.6% (23.7%) of the confirmed earnings for those below the age of 53, and 25.1% (25.2%) for those aged 53 and over.

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 1.12% on average in 2016. The return on equity component in 2016 was 5.80. The technical rate of interest, which is used to determine the interest rate of the oldest premium loans and a number of other items, was 4.50% throughout the year. The insurance contribution interest rate, used to calculate pension contributions, stood at 2.00% throughout the year.

Varma's financial trends

Varma's total result at fair value stood at EUR 457 (-164) million. The total quarterly result varied during the financial year, such that the third-quarter result was the strongest and the first-quarter result the weakest.

Varma's solvency strengthened during 2016 by EUR 243 million, and at the end of the year, solvency capital amounted to EUR 10,199 (9,956) million. Varma's solvency ratio, i.e. solvency capital in relation to technical provisions, was at 30.9% (31.4%). Solvency capital was at a strong level: 1.9 (1.9) 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 at fair value was EUR 1,953 (1,679) million, which represents 4.7% (4.2%) of the invested capital. The interest credited on the technical provisions was EUR 1,511 (1,902) million. Thus, the investment result for 2016 totalled EUR 441 (-223) million. Operating expenses were 28% (26%) lower than the expense loading included in insurance contributions, and the loading profit stood at EUR 39 (36) million. The underwriting result was EUR -38 (23) million.

At the end of 2016, EUR 121 (115) million was transferred to the provision for current bonuses reserved for client bonuses. The transfer represents roughly 0.6% (0.6%) of the estimated payroll of the insured.

The TyEL payroll of those insured by Varma totalled about EUR 18.8 (18.4) billion in 2016. The payroll is estimated to have grown by 2.5%. Varma's premiums written totalled EUR 4,675 (4,576) million, of which TyEL insurance accounted for EUR 4,488 (4,380) million and YEL insurance for EUR 187 (196) million.

At the end of the year, 529,892 (524,340) individuals were insured by Varma. At year-end, the number of valid insurance policies totalled 62,116 (64,530), covering 35,998 (37,380) self-employed persons and 493,894 (486,960) employees.

During the year, a total of 2,616 (2,732) new TyEL insurance policies and 3,157 (4,330) YEL insurance policies came into force at Varma. Once again, Varma did well in the TyEL portfolio transfers. According to the TyEL client transfer statistics of the Finnish Pension Alliance TELA, Varma's net result was the best in the sector, at EUR 43 (52) million. This success in client acquisitions will promote a positive trend in premium income.

Earnings and employment notifications received during the year totalled 1,905,672 (1,744,332), of which 96% (95%) were received electronically.

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 2016, a total gross amount of EUR 5,345 (5,183) million in pensions was paid out. The number of pension recipients increased, and at year-end, Varma was paying pensions to 340,100 (337,100) people.

A total of 22,579 (23,113) new pension decisions were made during the year. The number of new pension decisions decreased 2.3% and the total number of all pension decisions was 4.7% higher than in 2015. Old-age pension decisions numbered 12,585 (13,175), disability pension decisions 5,577 (5,652), and part-time pension decisions 1,076 (694). Continuation decisions on temporary pensions totalled 4,432 (4,161), and other decisions numbered 19,233 (16,876). 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 31.7% (31.7%). Pension applications made online accounted for 47% (39%) of all new pension applications.

In 2016, the total processing time of pension applications at Varma was significantly shorter than the average processing time in the earnings-related pension sector. The new pension application processing system came into full use in 2015, which is why the processing times were markedly shorter in 2016. It will speed up the processing of pension applications and facilitate the automatization of the different stages of the process in the future.

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 Varma's rehabilitation 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 at workability risk to rehabilitation. A larger share of Varma's customers use rehabilitation to return to working life than retire on disability pension. Throughout 2016 Varma assisted its client companies in managing personnel risks through client-oriented co-ordination of workability management, 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. Early 2016, the Financial Supervisory Authority issued guidelines concerning support for workability management projects. Varma has implemented these guidelines in its business processes and will be publishing its new well-being at work contracts from April 2017.

	31 Dec 2016	31 Dec 2015	Change
Number of insured			
TyEL ¹	493,894	486,958	6,936
YEL	35,998	37,376	-1,378
Total	529,892	524,334	5,558
¹ of which covered by TEL registered supplementary pension insurance	3,427	3,867	-440
Number of insurance policies			
TyEL	26,118	27,151	-1,033
Number of pensioners			
Part-time pension	1,615	1,765	-150
Survivors' pension	50,702	51,156	-454
Disability pension	26,530	28,545	-2,015
Old-age pension	247,230	241,084	6,146
Early old-age pension	14,018	14,556	-538
Total ²	340,095	337,106	2,989
² Those receiving YEL pension	29,469	28,674	795
Those receiving TEL/YEL supplementary pension	43,913	43,643	270

In terms of Varma's customer service, online services have become a major service channel. During the year under review, 73% of all private customer contacts took place online. Through Varma's online services, the insured can obtain the most recent estimate of their old-age and part-time pensions at various retirement ages; 91% of these estimates were carried out online. You can also apply for pension and follow the progress of the application online. 54% of old-age pension applications were submitted online. A total of 11,359 applications were submitted electronically.

Varma sends a pension record to the insured once every three years. A total of 223,000 (208,000) pension records were sent out in 2016. 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 via Varma's eServices.

Technical provisions

Varma's technical provisions grew 5.1% (decreased 0.6%) to EUR 33,501 (31,866) million. They contain a provision of EUR 122 (115) million for current bonuses reserved for client bonuses, a provision of EUR -578 (-1,083) million for future bonuses contained in the solvency capital, and EUR 324 (1,402) million in an equity-linked provision for current and future bonuses. The equalisation provision amounted to EUR 1,067 (1,203) million. On 1 January 2017, the equalisation provision was incorporated in the provision for future bonuses, and it will no longer be monitored as a separate item.

At the end of the year, the assets covering the technical provisions were 124.5% (130.6%) of the technical provisions.

Changes in insurance portfolio

During the financial year, no portfolio transfers from other pension companies or pension funds to Varma took place, nor did Varma make portfolio transfers to others.

Investments

In 2016, the return on Varma's investments was 4.7% (4.2%), and the fair value of Varma's investments increased to EUR 42.9 (41.3) billion.

The return on investments was slightly higher than the interest credited on the technical provisions, but solvency weakened to 30.9% (31.4%). Varma's solvency remained at a strong level.

The average ten-year nominal return on Varma's investments was 4.3% and the five-year return 6.5%. The real returns were 2.6% and 5.4% respectively.

In the first months of 2016, the investment markets were weighed down by concerns over the weakening of China's economic growth and the decline in the prices of raw materials. The low price of oil caused fear over the risk of bankruptcies within the oil industry and the state of oil-producing countries' economies. In the spring, the markets simmered down due to the ECB's announcement that it was expanding its monetary stimulus measures and especially by the postponement of the Fed's interest rate hike until the end of the year. As a result, interest rates continued to decline in both Europe and the U.S.

As other market sentiment improved, the investment markets started to become rattled by the Brexit vote and the US presidential election. The UK's likely exit from the EU weakened economic growth expectations in both Europe and the US immediately after the Brexit vote. Following the results of the US presidential election, the promised tax reliefs and public investments by the president-elect raised expectations for economic growth and pulled the equity markets up.

Despite the increased geopolitical risks, global economic growth seems to have picked up both in the US and Europe. The realised economic figures at the end of the year have proved to be better than expected on both continents. As expected, the Fed hiked its benchmark rate in December. Elevated expectations of inflation picking up and the Fed tightening its monetary policy at a faster rate drove interest rates up and strengthened the US dollar.

Generally speaking, the investment year was strong: share prices increased significantly and returns on corporate bonds were relatively high. Varma's investment result developed in line with the markets: the market development was negative in the first half, but the second half developed very strongly. Equities generated the strongest return, and unlisted equities and private equity in particular performed strongly. Corporate bonds also yielded a solid

return. The total return on investments was weighed down by the slightly negative return on real-estate investments, which was significantly influenced by EUR 218 million in write-downs.

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.

Varma has US-dollar-denominated investments in hedge funds, equities, corporate bonds and other bonds, and private equity funds. In accordance with our investment policy, most of the exchange rate risks have been hedged, but in the final quarter of the year, currency exposure was increased. In terms of operations, foreign currency risks are managed as a single entity, while in the performance indicators the exchange rate impact is included in the investment returns of various asset classes.

At the end of 2016, the fair value of Varma's investments totalled EUR 42,852 (41,293) million and the return at fair value was EUR 1,953 (1,679) million or 4.7% (4.2%). The value and returns of the investments are grouped according to risk in this report. The Notes show the breakdown of investments and investment returns by asset classes, grouped according to regulations and according to risk.

Fixed-income investments

Varma's fixed income investments stood at EUR 18,066 (12,268) million at the balance sheet date. The return on fixed-income investments was 4.2% (-0.4%). The return on the loan portfolio was 4.2% (2.4%), on public-sector bonds 1.8% (-2.5%), on other corporate bonds 7.8% (0.4%) and on other money-market instruments -0.4% (0.5%).

Fixed income investments consisted mainly of government and corporate bonds, money-market instruments and loans which include pension loans to Varma's customers.

In the fixed income markets, the year was characterised by the ECB's sizable public sector bond purchase programme, increase in US interest rates and deposit fees charged by banks. In Europe, interest rates fell during the year to a record-low level, whereupon investors reported positive interest rate returns. The narrowing risk margins on corporate bonds improved returns on bonds.

The return on government bonds was 1.8% (-2.5%) and on corporate bonds 7.8% (0.4%). The duration of the loan portfolio was kept fairly short, at around 3.4 years, which dampened the impact of the interest rate movements on the result.

The return on loan receivables, 4.2% (2.4%), was strong in the low interest-rate environment. The amount of pension loans continued to decrease during the year.

The return on money market investments, -0.4% (0.5%) was negative due to the interest charged on cash deposits by banks. Interest rates in Europe have dropped to a very low level. In future, it will be challenging to achieve a positive real return on fixed-income investments in future. Interest income may also easily turn negative, should interest rates start to rise.

Equity investments

At the balance sheet date, the value of Varma's equity investments was EUR 18,527 (18,465) million. The return on equities totalled 6.4% (8.8%), of which listed equities yielded 4.5% (8.0%), private equities 11.2% (7.8%), and unlisted equities 23.7% (21.2%).

Share prices fell sharply in the first months of 2016. The valuation of shares was affected by several risk factors during the year. Preparing for these factors was challenging, but, in the end, they turned out to be positive. These included assessments concerning the financial standing of European banks, the Brexit vote in the UK, and the US presidential election. The impact of all of these on share prices was smaller than expected.

Towards the end of the year, share prices rose, and the equity year as a whole turned out to be strong as the low interest rate level steered capital to higher-risk investments. The general economic development has not had a direct impact on the development of the equity markets.

Real estate investments

Varma continued to increase the international diversification of its real estate investments in 2016. Real-estate investments stood at EUR 3,643 (3,906) million at the balance sheet date, with direct real estate investments accounting for EUR 2,897 (3,313) and international and Finnish real estate investment funds for EUR 746 (593) million of the total.

The return on real estate investments was -0.9% (3.3%). Direct real estate investments yielded a return of -2.6% (2.3%) and real estate investment funds 6.8% (9.9%). The return on direct real estate investments remained negative owing to the fair value write-downs during the financial year. In 2016, the impact of the impairment of the fair value of the real estate under Varma's direct ownership totalled EUR -218 (-88) million. The value of and total return on the portfolio were influenced by fair valuations, the divestment of properties and investments carried out.

The weighting of domestic, directly-owned real estate investments was decreased. Varma divested a total of EUR 301 million in direct real estate investments. At year-end, the vacancy rate for the business premises owned directly by Varma stood at 6.2%.

Investments in 2016 totalled EUR 116 million, and they were focussed on development, maintenance construction and renovations of existing properties, and housing construction. During 2016, the construction of 128 new flats owned by Varma was completed, and at the end of the year, Varma had 103 new rental flats under construction in the Helsinki area. Several other housing construction and development projects are also under planning. In Finland, investments are focussed on the Helsinki Metropolitan area and the largest growth centres.

Other investments

Other investments amounted to EUR 7,320 (6,991) million. These consisted of hedge funds EUR 7,184 (6,663) million, commodities EUR 137 (352) million, and other investments EUR -2 (-24) million. The return on other investments was 5.3% (3.5%).

The return on hedge fund investments was 5.6% (3.9%). The return on hedge fund investments picked up significantly towards the end of the year, improving Varma's total result. Within the portfolio, different types of funds containing credit risk yielded the strongest returns.

Total portfolio risk

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 1,633 (1,842) 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%.

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. In 2016, Varma actively participated in the Annual General Meetings of the domestic companies in which it owned shares and in the work of the 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 72% (74%) of the expense loading, included in the pension insurance contributions, to cover operating expenses. Controlling operating expenses is a key objective 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 5%, totalling EUR 138 (145) 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.

	2016	2015	2014	2013	2012
Average number of personnel	540	549	552	565	572
Salaries and remunerations, EUR million	36.0	39.6	40.1	37.9	37.0

Tieto Esy, which is included in the Consolidated Financial Statements using the equity method, had an average of 64 employees in 2016.

At year-end, Varma's personnel were distributed as follows: pension services and customer service departments 56%, investment operations 13%, and other functions 31%.

Group companies and associates

At the end of 2016, the Varma Group comprised 152 (186) subsidiaries and 22 (20) associates. The most important subsidiaries and associates are Tieto Esy Ltd (50.1%), Technopolis Plc (24.0%) and NV Kiinteistösjointus Oy (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 17 March 2016. 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 2015. The new members elected to the Supervisory Board are Jukka Jäämaa, Timo Karttinen, Niina Koivuniemi, Ville Kopra, Timo Koskinen and Jari Suominen.

Kari Jordan (Chairman), Martti Alakoski (Deputy Chairman), Satu Wrede (Deputy Chairman), Juri Aaltonen, Petri Castrén, Erkki Etola, Stig Gustavson, Tauno Heinola, Jarmo Hyvärinen, Erkki Järvinen, Tapio Korpeinen, Päivi Kärkkäinen, Päivi Leiwo, Olli Luukkainen, Ilkka Nokelainen, Lauri Peltola, Matti Rihko, Leena Vainiomäki, Jorma Vehviläinen, Christoph Vitzthum, Anssi Vuorio and Göran Åberg continued as Supervisory Board members. Tauno Heinola resigned from the Supervisory Board on 1 October 2016 and Martti Alakoski on 2 December 2016.

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

In 2016, Varma's Board of Directors was composed of Berndt Brunow (Chairman), Jari Paasikivi (Deputy Chairman), Antti Palola (Deputy Chairman), Riku Aalto, Mikael Aro, Johanna Ikäheimo, Ari Kaperi, Jyri Luomakoski, Petri Niemisvirta, Ilkka Oksala, Kai Telanne and Veli-Matti Töyrylä, and deputy members Eija Hietanen, Mikko Ketonen and Liisa Leino.

In its meeting on 1 December 2016, Varma's Supervisory Board elected to the Board of Directors Casimir Lindholm and Pekka Piispanen as new members and Eila Annala as a new deputy member, effective 1 January 2017. The terms of Berndt Brunow, Veli-Matti Töyrylä and Mikko Ketonen expired on 31 December 2016.

At its meeting on 15 December 2016, Varma's Board of Directors elected Jari Paasikivi as Chairman, and Kai Telanne and Antti Palola as Deputy Chairmen of the Board, effective 1 January 2017.

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 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.

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.

In the earnings-related pension system, the liquidity risk is manageable, as 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% 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.

Varma has been increasing its currency exposure towards the end of the financial year, and this trend has been continued in 2017. The opening of the currency risk involves normal investment risks.

The pension reform that took effect at the beginning of 2017 will contribute to the structural adjustment of the Finnish economy. The main risk of the pension reform, from the point of view of implementing pension provision, relates to the application of the new legislation, especially in terms of the new pension benefits, years-of-service pension and partial early old-age pension.

The defined-benefit nature of earnings-related pension provides security and financial predictability. Securing the pension benefits of the young and future generations strengthens the future of the earnings-related pension system. Agreeing on the contribution level until the end of this decade is an important stabilising factor for companies in the current challenging economic situation. Owing to the agreed benefit adjustments, balancing the financing of pensions with a reasonable cost burden appears to be possible. The increase in the retirement age will facilitate financing in the longer term.

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.

Responsibility

Since autumn 2015, Varma has been building a Corporate Social Responsibility (CSR) programme, including targets and measures. The programme defines the most essential impacts of Varma's CSR. Varma has assessed its CSR risks relating to operations and business relations and has put in place sufficient and appropriate processes, which ensure duty of care as regards these risks.

Varma's CSR targets and measures are explained in a separate report conforming to the GRI guidelines.

Report on non-financial information

Business model description

Varma has a responsible core task – to secure pensions. The greatest impacts in terms of matters relating to environmental and social responsibility and employees, respecting human rights, and fighting corruption and bribery are linked to Varma's investment operations. Taking care of personnel and responsibility for the environment bear the greatest importance in Varma's own operations.

Environmental responsibility

In 2016, Varma determined the carbon footprint of its investments and drew up an environmental policy, which sets targets for CO₂ reduction in direct investments by asset class. In 2016, the carbon footprint of Varma's listed equity investments in relation to net sales declined 22% from the previous year and was 36% lower than Varma's benchmark index. The carbon footprint of Varma's listed corporate bond investments in relation to net sales was 50% lower than Varma's benchmark index. The calculation method for the carbon footprint of listed corporate bond investments was improved in 2016, which is why the results are not fully comparable to the previous year. The CO₂ footprint of real estate investment was 8% lower per gross square metre than in 2015.

The environmental impacts of Varma's own operations are monitored using WWF's Green Office system. In 2016, Varma received a Green Office certification following an office audit. The carbon footprint from Varma's own operations declined 23% in 2016; switching to green electricity had the greatest impact.

Social responsibility and employee-related factors

For Varma, social responsibility means disruption-free implementation of pension provision and promoting our customers' workability. Our operational target is to make sure that pension and rehabilitation customers receive their decisions without delay and that pension decisions are fair. In 2016, the average processing times of pension applications at Varma were shortened from 60 days in 2015 to 43.9, and applications were processed 8.8 days faster than on average in the earnings-related pension sector. Pensions were paid to customers' accounts within four days of the pension decision.

Varma's goal is to reduce disability pensions by developing workability management and offering effective rehabilitation. The average disability pension contribution category of Varma's client companies was 3.4 (3.5) in 2016. Varma's clients are happy with our workability management services, and the willingness to recommend is at a high level (in 2016, NPS was 54.2). 77%, or around 1,230, of Varma's vocational rehabilitation customers returned to working life in 2016.

Varma's goal is to take care of our employees' well-being at work and competence, and guarantee a high and consistent level of supervisory work for our employees. The achievement of these goals is monitored through a regular employee survey. In 2016, employees' overall satisfaction was at a good level with a rating of 3.90 (previous survey: 3.83) on a scale of 1 to 5.

Varma's supervisors are continuously coached, and feedback on how performance is managed is monitored in the employee survey. In 2016, performance management was given a good rating of 3.7, which is at the same level as in the previous survey.

Respecting human rights and fighting corruption and bribery

Varma expects listed companies that it invests in to comply with local legislation and international norms and agreements, typically the principles of the UN Global Compact initiative on social responsibility. 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.

The review of compliance with agreements, performed in October 2016, covered entirely Varma's direct investments in listed companies, direct listed corporate bonds and active equity funds. The review covered 32% of Varma's investment portfolio.

At the end of the year, Varma's listed equity investments or listed corporate bond investments did not include companies with long-term violations. For ethical reasons Varma excludes companies that concentrate on the manufacture of tobacco and nuclear weapons from its direct listed investments. Varma signed the UN-supported Principles for Responsible Investment (PRI) in 2011. We report on responsible investments annually in accordance with the PRI framework.

Varma own operations do not entail major human rights risks. Our supply chain only covers Finland, for the most part. 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. Every Varma employee is expected to complete an online Code of Conduct course every two years. In 2016, the course was completed by 88% of all Varma employees.

Outlook

Economic growth continues globally, and economic recovery is also expected to continue in the eurozone, supported by monetary policies. US growth is sustained, and the Fed has indicated a further tightening of its monetary policy. The economic policy of the new US administration will likely begin to take form early in 2017. The fiscal stimulus of the economy is expected to strengthen inflation. The heightened inflation expectations and changes in monetary policy point to a positive economic shift of some kind.

Although valuation levels in the capital markets held their ground in the political turmoil of 2016, we anticipate further uncertainty in 2017. For pension investors, the operating environment in the investment markets remains challenging in the current year.

In terms of Finland's economy, employment and exports are expected to pick up with a delay, thanks to the competitiveness pact, provided that pay rises remain moderate in the following pay agreements, too. The strengthening of investments is expected to continue. A slowdown in global economic growth, potential increase in protectionism in the US and a general build-up in political uncertainty could pose a risk to Finland's economic recovery.

In Finland, the pension reform has brought about changes to both pension benefits and pension financing as of the beginning of 2017. Changing pension legislation increases the need for information among customers, and we have prepared for this through measures in customer service and increased communication. Varma is, together with its customers, well prepared for changes in pension legislation, and the company has improved the effectiveness and efficiency of its services, especially in the well-being at work and pension adjudication activities.