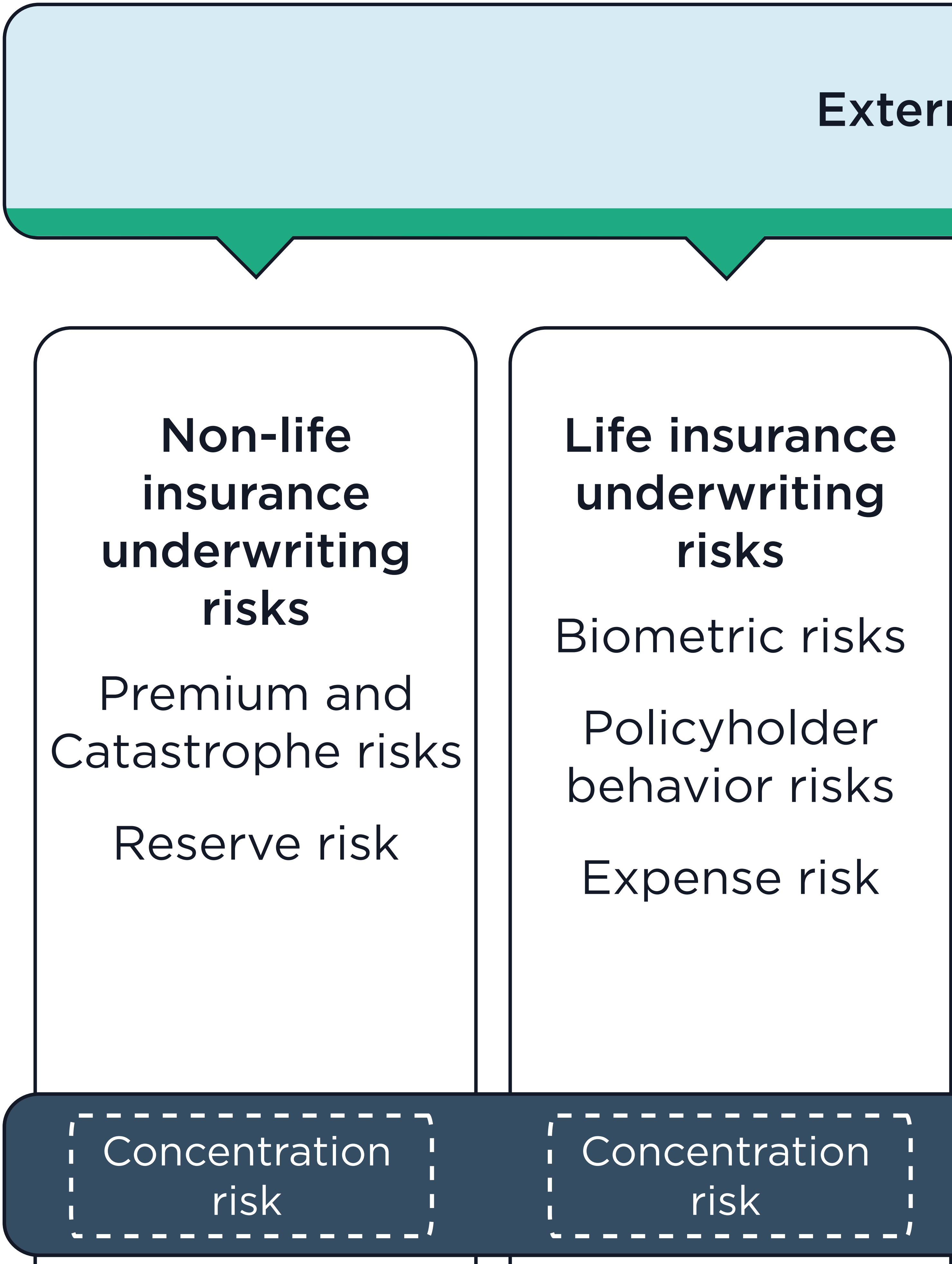
Sampo Group's **Annual Report 2013**

Risks Risks

Risks

In Sampo Group the risks associated with business activities fall by definition into two main categories: strategic risks associated with external drivers affecting the business environment and risks inherent in business operations.

Classification of Risks in Sampo Group


Exter
Non-life insurance underwriting risks
Premium and Catastrophe risks
Reserve risk
Life insurance underwriting risks
Biometric risks
Policyholder behavior risks
Expense risk
Concentration risk
Concentration risk

External Drivers and Strategic Risks

Strategic risk is the risk of losses due to changes in the competitive environment or lack of internal operational flexibility. Unexpected changes in general business environment can cause larger than expected fluctuations in financial results and in the long run they can endanger the existence of Sampo Group's business models. External drivers behind such changes are various, including for instance general economic development, development of the institutional environment and technological innovations. As a result of these external drivers, business models of the industry can change, new competitors may appear and customer demand and behavior can change.

Due to the predominantly external nature of the drivers of and development in the competitive environment strategic risks are the responsibility of the executive level senior management. Proactive strategic decision-making is the central tool in managing strategic risks related to competitive advantage. Also, maintenance of internal operational flexibility to be able to adjust the business model and cost structure when needed is an efficient tool in managing strategic risks. Although strategic risks are not covered by the economic capital model in Sampo Group they may, however, have an effect on the amount of actual capital base, if deemed prudent in existing business environment.

Risks Inherent in Business Operations

In its underwriting and investment operations, Sampo Group is consciously taking certain risks in order to generate earnings. These earnings risks are selected carefully and managed actively. Underwriting risks are priced reflecting their inherent risk levels and the expected return of investments is compared to the related risks. Furthermore, risk exposures are adjusted continuously and their impact on the capital need is assessed regularly.

Successful management of underwriting and investment risks is the main source of earnings for Sampo Group companies. Day-to-day management of these risks, i.e. maintaining them within given limits and authorisations is the responsibility of the business areas and the investment unit.

Earnings Risks

Underwriting risk can be defined in general as a change in value caused by ultimate costs for full contractual obligations varying from those assumed when these obligations were estimated. Hence, underwriting risk realizes as a loss or adverse change in the value of insurance liabilities due to pricing and provisioning assumptions on claims payments being different than the actual ones.

Non-life Insurance Underwriting Risks

In non-life insurance underwriting risk is often divided in premium and reserve risk in order to distinguish between the risks related to unexpired and expired contracts.

Premium Risk relates to future claims and originates from claim sizes being greater than expected, differences in timing of claims payments from expected, and differences in claims frequency from those expected. As a result the claims cost for future claims exceeds the expected level and there is a loss or adverse changes in the value of insurance liabilities.

Catastrophe risk can be seen as an extreme case of premium risk. It is the risk of low frequency, high severity events, such as natural catastrophes. These events lead to significant deviations in actual claims from the total expected claims.

Reserve risk only relates to incurred claims, i.e. existing claims, and originates from claim sizes being greater than expected, differences in timing of claims payments from expected, and differences in claims frequency from those expected. As a result technical provisions are not sufficient to cover the cost for already incurred claims and there is a loss or adverse changes in the value of insurance liabilities.

Life Insurance Underwriting Risks

Biometric risks refer to the risk that the company has to pay more mortality, disability or morbidity benefits than expected, or the company has to keep paying pension payments to the pension policy holders for a longer time (longevity risk) than expected when pricing the policies. When a low frequency, high severity event leads to a significant deviation in actual benefits and payments from the total expected payments, catastrophe risk has realized.

Policyholder behaviour risks arise from the uncertainty related to behaviour of the policyholders. The policyholders have the right to cease paying premiums (lapse risk) and may have a possibility to interrupt their policies (surrender risk).

Expense risk arises from the fact that the timing and/or the amount of expenses incurred differs from those expected at the timing of pricing. As a result expense charges originally assumed may not be enough to cover the realized expenses.

Investment Portfolio Market Risks

Market risks refer to fluctuations in the financial results and capital base caused by changes in market values of financial assets and liabilities as well as by changes in the economic value of insurance liabilities. The changes in market values and economic values are caused by movements in underlying market variables such as interest rates, inflation, foreign exchange rates, credit spreads and share prices. Furthermore, market risks include also risk of worsening market liquidity in terms of widening bid-ask spreads and the risk of unexpected changes in repayment schedules of assets. In both cases the market values of financial instruments in investment portfolios may change.

Risks and returns in different markets are considered when Sampo Group companies enter into investments or sell investments from investment portfolios. The fundamental distinction between market risks and underwriting risks is that relating to market risks Sampo Group is in most cases a price taker and not a price giver.

Some risks, such as counterparty credit risks and operational risks are indirect consequences of Sampo’s business activities. They are one-sided risks, with no earnings potential related to them. Accordingly, the risk management objective is to mitigate these risks efficiently. Management of consequential risks is the responsibility of the business areas and the investment unit and the capital need for these risks is measured by independent risk management functions.

Consequential Risks

Counterparty Credit Risks

Counterparty risk is part of credit risk. In general credit risk refers to losses arising from occurred defaults of debtors (*issuer risk*) or other counterparties (*counterparty risk*) or from increases in assumed probability of defaults.

In the case of issuer risk the final loss depends on the investor's holding of the security at the time of default, mitigated by the recovery rate. In most cases issuer risk has already been fully priced as a lower market value before the event of default has occurred. In essence credit spread is the market price of credit risk. Similarly as other earnings risks, spread risk can be actively managed. Therefore, it is categorized in Sampo Group under investment portfolio market risks.

In the case of counterparty risk, the final loss depends on the positive mark-to-market value of derivatives or reinsurance recoverables at the time of default and on the recovery rate. Counterparty credit risk is mitigated by careful selection of counterparties, by diversification of counterparties to prevent risk concentrations and by using collateral techniques, e.g. ISDA Master Agreements backed by Credit Support Annexes.

Operational Risks

Operational risk refers to the risk of loss resulting from inadequate or failed processes or systems, from personnel or from external events. This definition includes legal risk but excludes risks resulting from strategic decisions. The risks may realize for instance as a consequence of:

- internal misconduct;
- external misconduct;
- insufficient human resources management;
- insufficiencies in operating policies as far as customers, products or business activities are concerned;
- damage to physical property;
- interruption of activities and system failures; and
- defects in the operating process.

Materialized operational risks can cause immediate negative impact on financial results due to additional costs or loss of earnings. In longer term materialized operational risks can lead to loss of reputation and, eventually, loss of customers which endangers the company's ability to conduct business activities in accordance with the strategy.

Compliance risk is the risk of legal or regulatory sanctions, material financial losses or loss of reputation resulting from a company's failure to comply with laws, regulations and administrative orders as applicable to its activities. A compliance risk is usually the consequence of internal misconduct and hence it can be seen as a part of operational risk.

Some risks such as interest rate, currency and liquidity risks are by their nature linked to various activities simultaneously. In order to manage these risks efficiently Sampo Group companies have to have a detailed understanding of expected cash flows and their variance within companies' all activities. In addition, a thorough understanding of how expected cash flows and the market consistent values of assets and liabilities may fluctuate at the total balance sheet level under different scenarios is needed. These balance sheet level risks are commonly defined as Asset and Liability Management (ALM) risks.

The ALM risks are one of the focus areas of the senior management because of their complexity and relevance to risks and earnings in the long run.

ALM Risks

When changes in different market risk variables (interest rates, inflation, foreign exchange rates) cause a change in the fair values of investment assets and derivatives that is of different size than the respective change in the economic value of insurance liabilities, the company is exposed to *ALM risk.* It is crucial to remember that the cash flows of insurance liabilities are modelled estimates and therefore uncertain in relation to both their timing and amount. This uncertainty is a central component of ALM risk as well.

On balance sheet level, ALM risks contribute considerably to economic values, risks and capital need. Sampo Group companies analyse ALM risks and monitor ALM exposures actively and the risks are taken into account when managing investments and developing insurance products.

In addition to the risks relating to fluctuations in market values and economic values, ALM risks include liquidity risk. *Liquidity risk* is the risk that group companies are, due to lack of available liquid funds and/or access to relevant markets, unable to conduct their regular business activities in accordance with the strategy, or in extreme cases, are unable to settle their financial obligations when they fall due. Liquidity risk includes potential illiquidity of investments and unexpected non-renewal of insurance policies. Moreover, the availability and cost of refinancing and prices of financial derivatives affect the Group companies' ability to carry out normal business activities.

The sources of liquidity risk are either internal or external. If the company's rating declines or if the company's solvency otherwise appears jeopardised, its ability to raise funding, sign reinsurance contracts or enter into financial derivatives at a reasonable price is endangered. Moreover, policyholders may also not be willing to renew their policies. These effects may realize in a general market turmoil situation simultaneously with difficulties to sell investment assets.

Sampo Group manages the liquidity risk by maintaining both parent company's and the subsidiaries' creditworthiness and reputation on appropriate level. Also, diversification within business operations exposed to liquidity risks is sought. In particular the maturity diversification of expected cash flows generated from different business activities is under constant scrutiny. Since there is no unambiguous technique to quantify the capital need for liquidity risk, it is not directly taken into account in capital need estimates. Thus only the interest rate risk part of ALM risks is accounted for in the economic capital framework.

Concentration risks arise when the company's risk exposures are not diversified enough and as a result of this for instance an individual claim or financial market event could threaten the solvency or the financial position of the company. Risk concentrations may evolve within one risk class or across the risk classes defined above, with the exception of operational risks. Concentration can be at the single-name level or at the level of homogenous group like a geographical area or an industry sector. Within operational risks concentration risks are of different nature and realize due to for example reliance on a single IT system or a single vendor. Another risk that can be realized over any activity is the reputational risk.

Concentration Risks at Different Levels

Direct concentrations can evolve within separate activities – large single name or industry specific insurance or investment exposures – or across the activities when a single name or an industry is contributing widely on profitability and risks of the company through both insurance and investment activities.

Concentration risk may materialize also when profitability and capital position react similarly to general economic development or to structural changes in institutional environment in different areas of business. In that case concentration risk can be seen as part of strategic risk.

Reputational Risk

Reputational risk refers to the risk that adverse publicity regarding the company's business practices or associations, whether accurate or not, causes a loss of confidence in the integrity of the institution. Reputational risk is often a consequence of a materialized operational or compliance risk and realizes often as a deterioration of reputation amongst customers and other stakeholders.

In Sampo Group corporate culture, which is based on core values ethicality, loyalty, openness and entrepreneurship, is seen as a major tool in preventing reputational risk. These core values are reflected in Sampo Group's Corporate Governance system and how Sampo deals with core stakeholders (i.e. customers, personnel, investors, other co-operation partners, tax authorities and supervising authorities) and other parties, who may have interest in Sampo's business.