

3. Main Assumptions

The main assumptions used for measuring the value of insurance contracts and non-tradable financial assets are described below.

3.1 Parameters and assumptions in calculating life insurance provisions

3.1.1 Life and annuity insurance

For life and annuity insurance contract liabilities valuation, a modified prospective net premium method is applied by taking into account insurance acquisition costs, all of the contractual obligations and the previously allocated surplus. The insurance technical parameters used by the method are either the same as those used for calculating insurance premiums or corrected so as to reflect the subsequent circumstances which increase the value of liabilities. A correction to reflect the current circumstances applies to the annuity insurance products of Zavarovalnica Triglav, where the relevant liabilities are valued on the basis of rather conservative mortality tables and a prudently set lower interest rate of 3.8% p.a. for the contracts containing a fixed interest rate guarantee of 4% or 4.5% p.a. For the purpose of valuing annuity insurance contracts, instead of the legally allowed German mortality tables of 1987, Zavarovalnica Triglav applies the German mortality tables of 1994.

The guaranteed interest rate used for valuation at the Group level ranges between 2.75% p.a. and 3.8% p.a. The calculation takes into account insurance contract acquisition costs below the legally imposed level of 3.5% of the sum insured under life insurance policies.

3.1.2 Voluntary pension insurance

During the accumulation period, mathematical provisions are evaluated using the retrospective method. This method takes into account all of the premiums received up to the day of valuation, entrance charges, any sums paid out, the guaranteed interest rate and the additional allocated surplus made to individual accounts arising from profit sharing. During the pension annuity pay-out period, provisions are set aside on the basis of the current value of the expected future liabilities of the insurance company (the prospective net method).

Voluntary pension insurance belongs to the group of insurance contracts, as it includes the option of discretionary participation in the profits from the long-term business fund. Moreover, for the majority of voluntary pension insurance contracts the annuity factors are guaranteed and defined at the time of underwriting.

The insurance technical parameters used in the calculation are either the same as those used when underwriting a policy, or they are adapted to the circumstances expected in the pension annuity pay-out period in the

event these circumstances are worse than those taken into account in the premium calculation. The guaranteed technical interest rate used for the valuation of liabilities during the premium payment period ranges between 2% p.a. and 4.5% p.a. For the pension annuity pay-out period, a prudently set lower interest rate of 3.8% is applied to contracts containing a fixed interest rate guarantee of 4% or 4.5% p.a.

For the purpose of valuing its liabilities during the pay-out period of pension annuities bearing an interest rate from 2.75% p.a. to 3.80% p.a., instead of the legally allowed German mortality tables of 1987 the Group applies the German mortality tables of 1994, which are more conservative.

3.1.3 Supplementary voluntary pension insurance (SVPI)

During the accumulation period, mathematical provisions are evaluated using the retrospective method. The method takes into account all of the premiums received up to the day of valuation, entrance charges, any sums paid out, guaranteed interest rates and the additional allocated surplus made to individual accounts arising from extra returns on funds. During the pension annuity pay-out period, provisions are set aside on the basis of the current value of the expected future liabilities of the insurance company (the prospective net method).

The technical parameters used are either the same as those used when underwriting a policy or adjusted due to circumstances which will change later and increase the value of liabilities - primarily when valuing liabilities arising from pension annuity pay-outs. For valuation purposes, instead of the legally allowed German mortality tables of 1987, the Group applies the more conservative German mortality tables of 1994. During the accumulation period, the insurance companies of the Group guarantee a minimum annual return on net premiums paid, equalling 50% of the average annual interest rate on government securities with a maturity of over one year (figures published by the Ministry of Finance of the Republic of Slovenia). During the annuity pay-out period, the insurance companies value their liabilities at an interest rate ranging from 3.25% to 3.8%.

3.1.4 Unit-linked insurance

The liabilities for unit-linked insurance contracts are evaluated for each insurance policy as the fair value of assets in the investment account decreased by capitalised future management charges on initial units (actuarial funding). For certain insurance products additional provisions are formed to cover contractual risk payments under basic and additional policies.

3.2 The liability adequacy test (LAT) for life insurance

The purpose of LAT is to verify the adequacy of provisioning for life insurance. The test consists of comparing the amount of provisions with the best estimate of provisions, arrived at on the basis of the present value of the best estimate of the future expected contractual and other cash flows. The calculation is performed for each separate contract while the results are aggregated on the level of homogenous groups. The test is based on a unified methodology that determines, among others, the grouping of policies into homogenous groups, the choice of risk-free discount rates and the type of cash flows being modelled. The portfolio balance is tested as at the last day of the business year.

3.2.1 Segmentation of life insurance products for the purpose of LAT test

Insurance contracts are segmented into homogenous groups which feature similar risks and are kept within the same portfolio. As a rule, insurance contracts are grouped according to their insurance classes:

- traditional life insurance,
- unit-linked life insurance and
- capital redemption insurance (supplementary voluntary pension insurance).

The adequacy of liabilities is measured on the level of a homogenous group. If the test shows that the liabilities are insufficient, the total amount of the difference is recognised as an increase in provisions and an expense in the income statement.

3.2.2 Parameters and assumptions applied to life insurance

Mortality, longevity and morbidity assumptions

Assumptions regarding mortality, longevity and morbidity rates are based on internal analysis of the company's life insurance portfolio, on the data of national statistical offices, the data of reinsurers and other sources.

Persistency

The model takes into account the lapse rates determined on the basis of analysis of past experience. The Group continuously monitors the persistency of insurance policies by duration and type of insurance, and adapts their assumptions accordingly.

Expenses

The calculation takes into account policy handling/maintenance expenses, claim handling expenses and asset management expenses, as defined on the basis of an analysis of the individual company's expenses in preceding years. Estimated future expenses are increased every year in line with the expected inflation rate.

Increasing insurance premiums

In the case of insurance policies for which the monthly premium directly or indirectly follows the increase in salaries, the increase is calculated in line with the expected inflation rate.

Expected returns and discount interest rates

The applied methodology determines that the discount rates used should reflect the yield of the local government bonds denominated in the currency of the contract being modelled. For the purpose of the LAT test, the yield curve of Slovene sovereign debt securities denominated in euros as at 30 December 2011 was applied. The reference value for a period of 10 years totalled 6.651%.

The best estimate of provisions was additionally determined on the basis of the yield curve of AAA-rated government bonds, published by the European Central Bank (ECB), which is used to verify the adequacy of the provisioning level as at 31 December 2011. The reference value of the curve for a 10-year period is 2.645%. Zavarovalnica Triglav also used the yield curves published by the ECB to test the adequacy of the provisioning level in the preceding years.

Profit participation

The determination of the profit participation rate is at the discretion of each Group member and regulated by internal rules. The estimated future allocation of surpluses are in line with the expected performance, the previous profit allocation rates and the policyholders' reasonable expectations.

In the model, profit is allocated in an excess of the technical interests for with-profit policies. The allocation is determined on the basis of the mathematical provisions as at the end of the financial year.

Annuity factor guarantee

The liability adequacy test allows for the possibility of a change in annuity factors by the insurer in the event of insurance policies for which the mortality forecasts indicate that life expectancy is likely to increase to such an extent that the contract conditions justify such a change. The calculation also assumes the probability that 80% of the policyholders will choose to receive a pension annuity, while the others will opt for a lump-sum payout.

3.2.3 Results of the liability adequacy test for life insurance

Liability adequacy tests based on available data show that provisions formed at the Group level are adequate.

3.2.4 Sensitivity analysis of LAT test to parameter changes

The valuation of liabilities depends on variables such as mortality, lapse rate, operating costs and the estimated percentage of policyholders deciding to opt for a pension annuity. Parameters are sensitivity tested in

order to assess the impact of changes to the above-mentioned variables on future liabilities, the level of provisions and net profit or loss for the year. The changes represent reasonable potential changes in the parameters which could significantly impact the performance of the company.

Individual sensitivity analyses always take into account the change of a selected parameter with all the remaining variables unchanged without accounting for the value of assets backing the liabilities.

The changes under consideration were:

- an increase in mortality rates by 10%,
- a decrease in longevity rates by 10%,
- an increase in lapse rates by 10%,
- an increase in expenses by 10%,
- an increase in the annuitisation rate by 10%.

Test results have proven mathematical provisions in all these scenarios of changing key technical parameters to be adequate.

3.3 Parameters and assumptions in calculating non-life insurance provisions

The unearned premium for most insurance policies is calculated pro-rata temporis, assuming a uniform distribution of claims frequency during the term of insurance contracts. Insurance policies with a variable sum insured are the exception to this rule. These policies include credit insurance, since the insurance cover in such cases gradually decreases, and construction and erection insurance, where the insurance cover rises. For such type of insurance, the calculation of unearned premiums is based on the assumption of a constant claim frequency throughout the duration of the insurance contract and variable insurance cover.

In general, the claims provisions are calculated in the Group as the sum of total claims reported but not settled (RBNS) and incurred but not reported (IBNR) claims. Provisions for incurred but not reported claims are calculated using the run-off triangles method.

Previous experience shows that claims from mass loss events, such as hail, floods and storms, are reported with considerable delay. None of the standard actuarial methods for determining the amount of IBNR claims after mass loss events is suitable for calculating these claims. Such claims can represent a significant part of the entire amount of incurred but not reported claims. In order to ensure an up-to-date calculation of the actual amount of claims after mass loss event, additional provisions for IBNR or insufficiently reported claims after mass loss events are formed, based on a joint assessment by actuaries and the department in charge of insurance claims.

Claims provisions also include provisions for annuities in the case of liability insurance. Provisions for these claims were calculated as a capitalised annuity value as at the cut-off date based on applicable mortality tables and an interest rate of 2.75%

3.4 Liability adequacy test (LAT) for non-life insurance

The insurance companies of the Group form reserves for unexpired risks for those lines of business where the expected loss ratio exceeds 100%. Additional reserves for unexpired risks are calculated as a product of unearned premiums and the difference between the value of the loss ratio and 100%.

Additional tests are performed to check the adequacy of the unearned premiums and unexpired risk reserves. The amounts of future gross claims and gross claim handling costs are applied in these tests and compared with the amount of established provisions for unearned premiums reduced by deferred insurance acquisition costs.

The results of tests show that the level of unearned premiums reserves, together with the level of unexpired risk reserves, is sufficient.

3.5 Parameters and assumptions applied in measuring non-quoted financial assets

In accordance with the internal rules on the valuation of equity investments relating to certain non-tradable assets, their fair value is established by arriving at a valuation (i.e. by making an appraisal) in compliance with IAS 39. The methods used include: the discounted cash flow method, the listed comparable companies method and the asset valuation method. The choice of method depends on the nature of the business of the company under appraisal. In order to obtain an impartial opinion, most of the value appraisals of other non-tradable assets have been provided by outsourced assessors.

Value appraisals of other non-tradable assets are based on the assumptions the assessor makes on the basis of public information and, where possible, on an interview with the management of the company under appraisal. The applied estimates and assumptions involve certain risks as to their future realisation. With the aim of reducing this risk, the assumptions and estimates applied are verified by different methods (by comparing assumptions and estimates against the industry average, individual traded companies, etc.). Moreover, a sensitivity analysis of the following value drivers is applied in order to estimate the value range of the company: the discount rate, net sales income, the EBITDA margin, and cash flow growth over a forecast period.

Sensitivity analyses for more detailed forecast periods (most commonly 5 to 10 year periods are taken into account) involve the following ranges for the above mentioned categories: income growth (2.5–5.5%), the EBITDA margin (3.0–8.2%), the discount rate (10.3–14.5%) and cash flow growth over a forecast period of (2.0–4.5%). The value, i.e. the range, of any of the given categories, depends on the character of the business and/or the risks associated with the analysed company and/or industry in which it operates.

Depending on the chosen assumptions, the process of value appraisal can result in differently appraised value ranges. A value within the calculated appraised value range is selected as the best assessment of an asset's fair value. In some cases, the appraised value range is rather wide. Due to the above mentioned uncertainty inherent to the process of appraising the value of non-tradable assets, which results in a relatively wide appraised value range, the Group aims to apply a consistent and prudent approach to best assessing an asset's fair value and thus minimising any subjective elements in this process.