REPORT OF THE BOARD OF DIRECTORS

Dear Shareholders,

The Directors of the Arab insurance Group (B.S.C.) (Arig) are pleased to present the company's 34th Annual Report and Consolidated Financial Statements for the 2014 Financial Year.

FINANCIAL RESULT

Again, the global reinsurance industry was spared from catastrophic loss events, which supported further build-up of capital and added more pricing pressures to the market. Against this backdrop, the Arig Group achieved a net profit of US$ 15.6 million in 2014 (2013: US$ 18.6 million). The conventional business of the Group generated positive returns of US$ 20.5 million, whereas Takaful Re, the Group's Islamic reinsurance subsidiary, produced a loss of US$ 4.9 million for Arig's share. The difference in profitability is mostly the result of sharply different underwriting fortunes. Arig's combined ratio of 97.8%[1] stayed well within positive territory while Takaful Re disappointed with a ratio of 147%, leading the Group to an overall combined ratio of 101.7%.

Equally, business development varied between the two companies. While Arig's gross written premium expanded by 23% to US$ 296.9 million (2013: US$ 240.5 million) mostly on the back of its Lloyd's portfolio, Takaful Re's gross premiums reduced by 14% to US$ 18.4 million (2013: US$ 21.5 million). Combined, the Group wrote gross premiums of US$ 315.3 million, up by 20% from the previous year (2013: US$ 262 million).

Investment results were positive for both companies with Arig returning US$ 18.2 million on its investible assets (2013: US$ 17.8 million), and Takaful Re contributing US$ 1.9 million (2013: US$ 2.1 million).

The persisting difference in the performance between the companies is viewed by us with deep concern. Possible strategic solutions are being considered for implementation during 2015 in order to curtail the poor performance of Takaful Re.

THE MARKET

2014 will be remembered as a year that stirred mixed emotions with many. The digital revolution marched on and we are told that manufacturers are only five years away from mass-producing self-driving cars. Stem cell research is opening new cures for mankind, while a new generation of watches will watch over your health while staying in touch with a medical support network. While we seem to be advancing on technologies that guard over the well-being of the individual, less can be said about the ability of humans to resolve threats on a wider scale: intensifying regional conflicts in the Ukraine, Iraq and Syria, the resurgence of Ebola and a recent peak in aviation losses made world-wide headlines as did a slump in the economies of the Emerging Markets, new fears over the Euro zone and a dramatic decline in the price of crude oil. As individuals, we draw some relief from the progress made in research. But as shareholders in a reinsurer, we are predominantly concerned with the condition of our markets where economic, political, sociological and, increasingly, technological risks are determining our opportunities and our fortunes.

To illustrate the point, allow us to make a comparison between the state of the oil market and the condition of the reinsurance industry today.

- Supply and Demand
  Oil: for many years we believed that the world's demand for oil was insatiable and that in the long run, capacities would be outstripped by demand. However, prices for crude have dropped by over 50% since mid-2014, signalling that available supplies have outgrown buyer's demand.
  Reinsurance: quite similarly, a growing, more affluent population was assumed to drive economic growth world-wide that should result in an ever increasing demand for insurance and reinsurance capacities. However, after three years with below-average loss experience and an abundance of new capital entering into the industry, the available reinsurance capacity seems to have outgrown its customers' appetite.

- Technology
  Oil: rising oil prices eventually encouraged the application of technologies to either reduce the dependency on oil imports, or replace fossil fuels as a source of energy altogether. The U.S., being the world's largest economy, reduced oil imports by 35% over the last ten years and is expected to become a net producer. Germany, Europe's leading economy, has made renewable sources its #1 energy producer and is aiming for their 60% share of total. Bottom line: technology is taking a sizeable bite out of world oil demand, increasing downward pressure on prices.
  Reinsurance: the growing ability to model risks and to structure risk management has lead markets to greater confidence in managing their exposures. The

1 A ratio below 100% indicates that the company is making underwriting profit while a ratio above 100% means that it is paying out more money in claims that it is receiving from premiums.

The combined ratio is calculated as $\frac{\text{Incurred Losses}}{\text{Earned Premium}} + \frac{\text{Expenses}}{\text{Written Premium}}$

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“Arig has managed to carve out a niche that has enabled it to write business on a solid operating platform. Focused on diversification, strong risk management skills and operational efficiency we are confident to deliver consistently positive results across the market cycle.”

Khalid Jassim Bin Kalban

Chairman

traditional risk transfer from customer to (re-)insurer is being superseded by a multitude of financial tools from service providers competing with each other over lucrative accounts. Today, 12% or US$ 62 billion out of an estimated US$ 575 billion of reinsurance capital are coming from outside investors[2] such as pension funds, endowments, sovereign wealth funds and asset managers. They have already taken over an estimated 40-50% of the lucrative catastrophe reinsurance segment and it is safe to say that "the influx of new capital into the reinsurance industry constitutes the largest change to the sector's capital structure in recent memory."[3] No surprise therefore that reinsurers, similar to the oil markets, have seen a constant decline in their prices and in profit margins: the Guy Carpenter Global Property Catastrophe Rate-on-Line Index fell yet again, in 2014 alone by 11% year-on-year.

- Market Dynamics
  So far, nothing has challenged market movements. For *oil producers*, general demand is down in line with a trimmed down economic projection in the global GDP of 3.3% for 2014 and 3.5% in 2015[4] . The slump in oil prices could well reflect underlying economic weakness and possibly be here to stay for some time to come. While this may spell good news for some producers, it reads trouble for those who have been depending on the sales of their natural resources. Their business model may be broken for now. *Reinsurers* may find themselves in a similar conundrum. Wedged between the demands from their shareholders and deteriorating market conditions, they will be looking for bold solutions to make better use of their capital as margins available from their bread-and-butter business keep declining. Traditional investment markets are not helping either as they are becoming increasingly volatile. Unsurprisingly, the reinsurance sector is currently on negative outlook by all major rating agencies. It seems that at least part of the business model needs to be reinvented but the question is: will shareholders be willing to support broad scale restructuring that may come with new risks attached?

In this daunting environment, opportunities for growth remain limited. At the same time we see governments turning increasingly protectionist towards an industry that is used to working globally. In Afro-Asia, China will be introducing a new regime that would sharply reduce access for foreign reinsurers to its growing market. Indonesia will be introducing yet another local reinsurer that will draw compulsory cessions from the local industry. Similarly, we are seeing more national reinsurance capacities spring up throughout our territories that will attempt to absorb simple risks that used to feed into international reinsurers' books.

Without doubt, it is a challenging market place yet also a chance to regroup and consider some changes that could take the industry and its services to the next level:

- Clearly, if reinsurers want to move out of the defensive, they need to add more value to their customer relationships by providing specialized products and services outside of the commodity segments. In that, they will either require their customers to think outside of the box, or they need to jump the queue and create their own new markets.
- Against the global industry backdrop, it will become increasingly difficult to satisfy shareholders' expectations from the proceeds of traditional reinsurance and investment options. Structured solutions, mergers & acquisitions, strategic alliances and the employment of third party capital need to be explored.
- While the reality of the digital revolution has changed lifestyles forever, insurance seems to have remained in a fetal position. The way products are designed, marketed and sold has essentially remained the same over the past 50 years whereas banks, for instance, have long since moved away from their branch based distribution and servicing system. This has not only saved cost, but also led to a completely different customer experience.

There is room for improvement on many fronts. Similar to what a dramatically reduced price of oil may signal to us, many of the past benefits may no longer be available in the future. It is time to roll up our sleeves and revisit the way we go about our businesses. This is not the time to be complacent resting on past laurels.

ARIG'S POSITION

Similar to the rest of the industry, Arig experienced mixed fortunes across its Group portfolio in 2014. Spared of large-scale catastrophe losses, there were a number of mid-size claims that affected the economics of our individual business segments. Strict risk selection in our acceptances has kept Arig from riding the market to its bottom, which clearly has yet to be reached. Yet we remain exposed to the pricing pressures of our markets, to local jurisdiction finding its own particular ways when disputes over claims occur, and the effects of political and military intervention, which have stopped us from writing business in markets that used to return healthy margins. Still, the Group managed to produce a respectable result under the difficult circumstances.

2 Aon Benfield: Reinsurance Market Outlook, January 2015
3 Guy Carpenter: Capital Markets Report, September 2014
4 IMF World Economic Outlook, January 2015

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Owing to Arig's widely diversified book of business, different segments of our portfolio could be employed to balance any under-performance of others. Our Specialty book, which includes Engineering, Casualty, Motor Extended Warranties, Marine and Energy lines, continued to perform strongly even if its largest class, construction, was affected by some sizeable losses. Facultative Property business remained profitable as did niche and run-off business from earlier years.

The Treaty block, which includes delegated underwriting arrangements with clients, performed strongly in the Middle East and Turkey, and poorly on the Indian Sub-continent while results from the Far East and Africa largely broke even. Our partnerships in the Lloyd's market returned a healthy margin to testament that our venture into this very different business environment is adding real value to our book.

Equally, the results from the Personal Lines of Life and Medical continued to thrive while we continue to enhance the products and services our team is capable of offering to our clients.

Unfortunately the Re-Takaful sector continued to disappoint. After restructuring the portfolio that is exclusively written from insurers operating on Islamic principles, following the introduction of new management and subsequent to analyzing our peers' fortunes in the Takaful marketplace we see limited chances for our subsidiary to achieve economical mass and to become profitable in the foreseeable future, unless its current business model is reformed.

All in all, we have reached most of our targets in 2014 even if the result from the company's underwriting and investment activities is reflective of the industry's compressed earnings margins. Nevertheless, the Board is pleased to propose a dividend of 5% that remains subject to approval of the Central Bank of Bahrain.

OUTLOOK

For the current year, the general expectation is that "Declining rates, broader terms and conditions, an unsustainable flow of net favorable loss reserve development, low investment yields and continued pressure from convergence capital are all negative factors that will adversely impact risk-adjusted returns over the longer term."[5] A.M. Best, our rating agency, further believes that "Given where rate adequacy is, it will continue to take optimal conditions – including benign or near-benign catastrophe years, a continued flow of net favorable loss reserve development and stable financial markets – to produce even low double digit returns. Such return measures would have been considered average or perhaps mediocre just a few years ago."[6]

There is little to add to these global statements, other than perhaps the fact that obviously we cannot expect catastrophe experience or financial markets to remain stable at ideal levels. Insurance is about managing volatility so naturally we will see results fluctuate. Using some degree of caution and realism, we would expect ROE figures of between 7-10% to apply globally. This goes hand-in-hand with a world economic outlook that reflects a reduction from previous highs. It includes the Emerging Markets and the GCC. While prices for crude oil around US$ 50 per barrel will spell good news to manufacturing economies, they could have a mid-term impact on the oil producers. At this time, we would not expect major market corrections for the GCC members just yet as the need for infrastructure investments remains unabated and the development of the Personal Lines segment largely under-exploited. But it just has become even more difficult to generate profitable growth from a market that is already experiencing extreme pricing pressure.

Arig has worked within a free market since the day of its inception 34 years ago. We welcome competition provided all is done on a level playing field. In practice, this is not always the case especially in some Emerging Markets where we see some governments are using a stronger hand. Yet, between the global leaders who are driving the reinsurance industry and many regional contenders, Arig has managed to carve out a niche that has enabled it to write business on a solid operating platform. Focused on diversification, strong risk management skills and operational efficiency, we are confident to deliver consistently positive results across the market cycle. We expect industry results to remain under pressure as there is little doubt that the market is currently at a low due to an imbalance between supply and demand. Yet, we would like shareholders to know that their capital is in good hands. The Board of Directors and the Management of Arig are doing their very best to ensure continuous returns on the company's capital.

5 Best's Briefing by A.M. Best, January 5, 2015

6 ditto

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ACKNOWLEDGEMENTS

The Board takes this opportunity to express its gratitude to His Majesty the King, His Royal Highness the Prime Minister and His Royal Highness the Crown Prince for their wise leadership and encouragement for the insurance sector of the Kingdom of Bahrain. The Directors further extend their thanks to our business partners, clients, shareholders and regulators for their support and cooperation throughout the year. The Directors also thank the management and the staff of the Arig Group for their commitment, professionalism and sincere efforts.

On behalf of the Board of Directors

Khalid Jassim Bin Kalban
Chairman
12 February 2015