OPERATING AND FINANCIAL REVIEW

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"Our focus on continued profitability to the benefit of all stakeholders will remain our guiding force in the future."

Yassir Albaharna

Chief Executive Officer

OPERATING AND FINANCIAL REVIEW

REINSURANCE

The year 2017 will always be remembered as the year of natural catastrophe events, as much as years 2011 and 2001 conjure in the minds of professional reinsurers as most challenging. With estimated economic losses of US$ 330 billion[1], 2017 turned out to be the second costliest year behind 2011 for natural catastrophes ever recorded (2011: US$ 380 billion). Over US$ 135 billion (2011: US$ 105 billion) of the losses were insured with reinsurers carrying the major load, out of which 59% of the losses emanated from three Atlantic hurricanes in the third quarter (Harvey, Irma and Maria) which are estimated to have caused US$ 200 billion of economic losses and around US$ 80 billion of insured losses[2]. These events made 2017 as one of the worst years recorded for the global reinsurance market.

According to Aon Benfield, the high impact of catastrophe losses over the period has not significantly impacted traditional equity capital, which has remained stable. Of the most affected reinsurers, some reported modest capital erosion, primarily driven by depleted earnings resulting in inadequate coverage for capital management activities. In contrast, companies with low U.S. and Caribbean exposure generally grew in terms of capital, with the overall picture benefitting from a weakening U.S. dollar. To a large extent, underwriting profit in other areas, favourable development in prior year reserves and investment income have offset these catastrophic losses.

Capital dedicated to reinsurance saw growth despite the impact of catastrophe losses in 2017. The resilience of the market was further demonstrated as there were no significant capital withdrawals over the period. There has also been a strong and favourable response from reinsurance and capital markets to those insurers who demonstrated superior data quality and loss mitigation strategies. Such measures enhance a company's ability to provide customized risk transfer solutions and maximise protection for their risk profiles.

Global demand for reinsurance protection increased modestly during 2017, reflecting improved economics, the growing prevalence of risk-based capital regimes and emerging areas of risk transfer.

As regards the MENA region, despite a major fire loss in UAE which is one of the costliest claims in the region currently estimated at US$ 1.2 billion, it continues to remain attractive to global reinsurers, in view of the relatively low natural catastrophe exposure (except for Turkey, Iran, and Algeria). However, reinsurers remain concerned with the level of political instability as well as economic and social environment of the region. The main drivers for premium growth are, as in the previous years, stricter solvency requirements and growth in compulsory coverages such as motor and medical.

[1] Munich Re: Natural Catastrophe Events in 2017

[2] AON Benfield: "Reinsurance Market Outlook, Jan 2018"

[3] Willis Towers Watson: "Asia Insurance Market Report 2018"

In Asia, countries with limited natural disaster exposures, such as Korea and Singapore, has witnessed buyers who continued to increase retentions to control reinsurance costs; whereas for those with larger natural catastrophe exposures, namely China, Philippines, Japan, Thailand, Taiwan, Indonesia and Vietnam, there is growing evidence of tighter placements such as buyer options with future flexibility reducing, but not yet to the extent of the hard market[3].

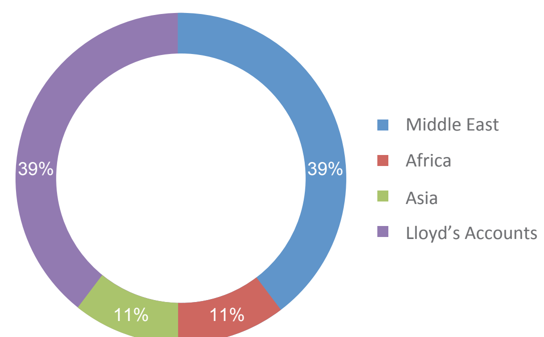
The increase in loss activity in recent years is expected to lead to more underwriting scrutiny and improved terms and conditions. Arig looks forward to benefit from these improved conditions, particularly with affirmation of A.M. Best A- rating and the possession of key ingredients which are necessary for riding the market cycle and benefiting from our financial stability, professional expertise and geographical reach.

BUSINESS REVIEW

Portfolio development

The Company's gross premiums written declined by 8.1% to US$ 225.6 million (2016: US$ 245.4 million) as a result of voluntary non-renewal of underperforming and inadequately priced accounts, in line with our prudent underwriting approach coupled with negative influence of exchange rate movements and downward premium adjustments of the Lloyd's portfolio. Additionally, premium income reduced following the run-off of our subsidiary - Takaful Re and our Branches in Singapore and Labuan.

Territorial split of Gross Written premium income



The regional premium distribution pattern changed comparing to last year, reflecting Arig's aim to balance its geographical split towards 1/3rd per main markets (MENA, Lloyds and other markets). In line with this strategy, our Lloyd's accounts' share reduced from 45% to 39%, while the Middle East increased from 35% to 39%. On the other hand, our income from Africa went up by 2% points to reach 11%.

Diversification within our book of business remains one of Arig's top priorities, while managing our risk exposures in a challenging market place. We are gradually shifting our portfolio away from regional treaty facilities towards lines where we have better control over our fortunes.

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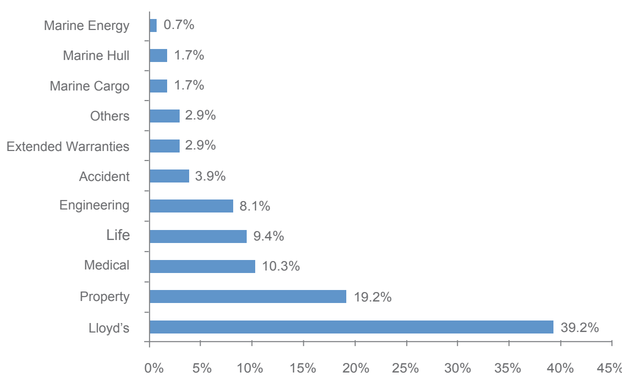
Our Facultative business increased in 2017 by US$ 9.5 million to reach US$ 32.4 million, representing a growth of 41.5% compared to the previous year.

Reflecting the current reinsurance demand in developing markets, Property still dominates as a major class in our portfolio with 37.3% share of the total non-life non-Lloyd's premium, followed by Medical and Engineering businesses with 20% and 15.9% respectively.

Life and Medical portfolio grew by 28.6% in 2017 to reach US$ 44.4 million. Personal lines will remain one of our major areas for development building on a customised solution approach with preferred insurance management partners in the region and by assisting our clients in exploring new sales channels.

Individual line contributions to Group's Gross Written premium income



Performance

Despite the challenging market conditions and the impact of major losses during 2017 on the Company's reinsurance portfolio, the overall technical result for the Group remained positive at US$ 5.5 million (2016: US$ 14.7 million). Our Lloyd's book reported a loss of US$ 19.6 million (2016: a loss of US$ 4.6 million) mainly due to significant losses reported by two syndicates. The major impact was attributable to US hurricane losses of US$ 14 million. The Company reviewed its Lloyd's portfolio during 2018 renewal and withdrew from the worst performing syndicate as a corrective measure.

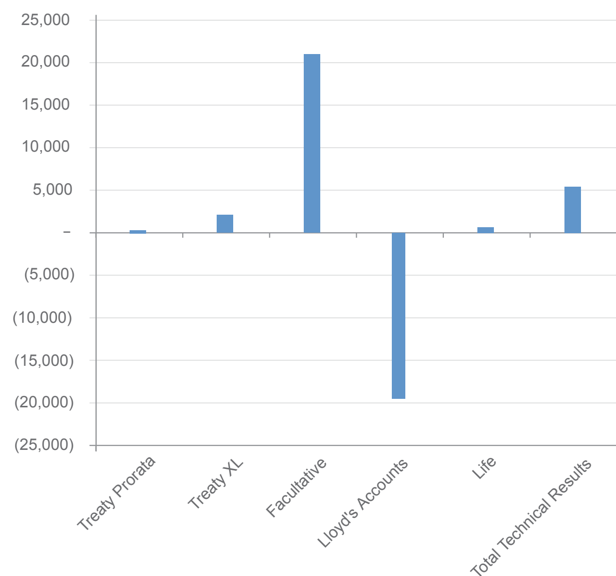
Same as in the previous years, the main profitability was driven by our facultative business which generated a technical result of US$ 21.2 million (2016: US$ 11.0 million).

Overall non-life treaties excluding Lloyd's business produced a profit of US$ 2.8 million for the year (2016: US$ 10.7 million) where both Engineering and Medical lines contributed a profit of US$ 1.7 million each and Marine Cargo US$ 0.8 million. Property business generated a loss of US$ 0.6 million (mainly as a result of a major fire loss in UAE).

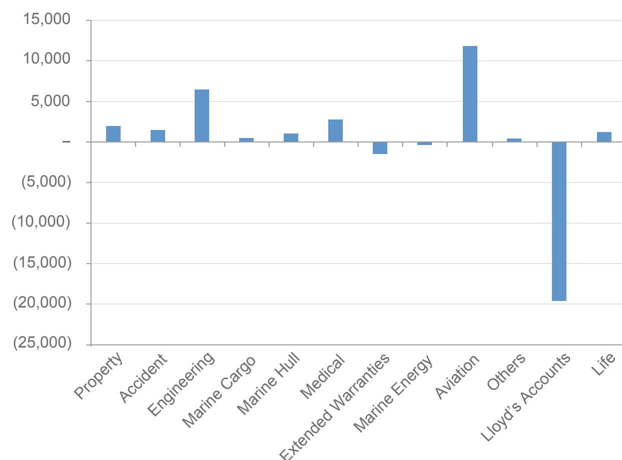
The life business performed well, comparing to the previous year, with technical results of US$ 1.1 million (2016: a negative result of US$ 2.5 million).

Run-off of our subsidiary Takaful Re's portfolio, which ceased operation in 2015, is in line with our exit strategy and this has additionally contributed to our bottom line by US$ 1.2 million (2016: US$ 1.2 million).

Group Technical Result by source (in US$ 000)



Group Technical Result by line (in US$ 000)



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Risk Capital Position

As has been the Company's practice, we commissioned independent external actuaries to provide an updated estimate of the amount of capital required to cater for risk events throughout the Group's operations at a 1:200 probability, or 99.5th percentile. Arig's Economic Capital shows significant redundancy against the Company's shareholders equity at this confidence level.

This demonstrates that the Group is offering substantial financial security to its clients, even in a stressed model scenario. Arig's reinsurance book has seen limited changes over the position one year ago. Key drivers for the Group's risk capital are underwriting risk and reserve risk, followed by market risk, operational risk and credit risk. During 2017, market risk has seen a notable decrease, while reserve risk decreased moderately. All movements combined resulted in a marginal decrease in the Group's Economic Capital requirement.

As it was endorsed through actuarial analysis, we remain highly confident that the diversity and the quality of the Group's portfolio provide solid protection to Arig's reinsured clients and shareholders' capital alike.

Outlook

The world economic performance is expected to improve, reflecting improved global manufacturing activities, a robust global trade, favourable financing conditions and firming commodity prices. The IMF's recent update estimated an overall projected world output of 3.9% for 2018. Emerging markets and developing economies are expected to grow by 4.9% in 2018, against a projected growth of 2.3% in the advanced economies.

Going forward, pricing conditions and underwriting profitability are predicted to improve after a challenging year affected by historically high natural catastrophe losses, as a result of recovering terms of trade in addition to stronger economic growth. There is now an increasing opportunity to benefit from the higher prices currently charged for natural catastrophe related covers, particularly in areas which were hit by recent claims. S&P reported that rate increases in response to the catastrophe events of 2017 were broadly in line with their expectations, with the highest rate increases achieved in the most loss-affected lines. Rate strengthening continues to be a hot topic in 2018 and S&P expect increases to continue through the remainder of the year especially with Florida and Puerto Rico up for renewal in the first half, with expectations of double-digit rate increases in these regions. Lloyd's insurers' outlook for 2018 is positive, as January renewals make for a favourable start after several years of falling prices especially in USA, which should provide reinsurers a chance to recover from 2017 major losses.

Similar as the previous years, Arig will continue to set prudent targets. Profitability and protection of our shareholders' capital will remain to be our top priority. Balancing bottom and top lines remains our main challenge, especially in a soft market. In this context, we will be reasonably 'technical' in our underwriting approach, while targeting business opportunities in opportunistic manner. We intend to maximise the increased prospects generated by the affirmation of our 'A-' rating by focusing more on facultative business. While willing to invest into our future, the Company continues to look for ways to reduce its expenses, without compromising its professional standards.

Our focus on continued profitability to the benefit of all stakeholders will remain our guiding force in the future.

INVESTMENTS

All major economic blocs recorded growth in 2017. Since the financial crisis of the last decade, this was the first synchronous global expansion.

Short-term US interest rates rose in the year. However, this did not perturb the financial markets. Inflationary expectations continue to be low. A scenario of better economic growth, higher corporate earnings and benign inflation was a stimulus to the equity markets. The Morgan Stanley World Index rose 20.1%. In the US, the S&P 500 rose 19.4%. Most other developed and emerging equity markets registered gains.

The monetary policies of Central Banks continued to diverge. The ECB kept key interest rates unchanged and continued with its Asset Purchase program. The Bank of England joined the Federal Reserve in raising its Official Bank rate. The Bank of Japan maintained its short-term Policy Balance Rate at minus 0.1%. In spite of the better economic environment, Central Banks were very cautious in their actions.

The strategies of the Central banks impacted yields in the fixed income markets. European government bonds with a tenor of six years and less recorded negative yields. The Bank of Japan set a target yield of 0% on ten year Japanese Government Bonds. The benchmark ten year US Treasury Note closed marginally down for the year.

In this paradigm, there was a move into riskier assets such as High Yield bonds. There was also a move out of US dollar-denominated assets. Reflecting this, the Bloomberg Dollar Index weakened 8.5%.

A declining dollar and a well-executed production cut by OPEC buoyed crude oil. West Texas Intermediate futures closed the year above US$ 60 a barrel a level not breached since the middle of 2015.

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We continue to be conservative in our allocation and do not invest in strategies that are the flavour of the season. In line with the risk tolerance of the Group, our investment strategy remained unaltered. At the year-end, the Group's investments stood at US$ 665.1 million (2016: US$ 737.4 million) with 86.1% allocated to cash, short-term securities, and bonds. Group's investment income generated in 2017 was US$ 22.3 million (US$ 19.3 million in 2016).

At the time of this report, short-term US dollar money market rates such as six month LIBOR have increased. The dollar continues to weaken. Relatively riskier assets such as emerging markets are attracting sizeable inflows. The level of returns on investment grade short duration fixed income securities still continues to be low by historical standards. This phenomenon is a challenge to investors like Arig.

We will continue to manage a diversified low-risk portfolio within the Company's avowed investment risk appetite, carefully balancing market opportunities against our standing obligation to policyholders and shareholders. We still are at a low point in the interest rate cycle. Preservation and safety of capital at this juncture is paramount to exploit opportunities in the investment cycle later.

SUBSIDIARIES

Takaful Re Limited (TRL)

The Group's Islamic reinsurance subsidiary, TRL, which was placed in run-off in April 2016 reported a net profit of US$ 2.3 million (2016: US$ 2.2 million) for the year. Arig's share in the profit was US$ 1.2 million (2016: US$ 1.2 million).

TRL's investments yielded an average return of 1.5% (2016: 1.8%) with investment earnings of US$ 1.3 million (2016: US$ 1.9 million). The Company maintained its conservative investment strategy with a high degree of liquidity. About 52% (2016: 64%) of the US$ 71.0 million (2016: US$ 104.6 million) of invested assets were held in cash and short-term Islamic deposits.

The Shareholders' of TRL at their EGM on 17 October 2017, resolved to reduce the share capital from US$ 125 million to US$ 100 million. This reduction was effected after obtaining necessary approvals from TRL's regulator, Dubai Financial Services Authority.

Gulf Warranties (GW)

Gulf Warranties recorded a loss of US$ 0.1 million for the year (2016: profit US$ 0.1 million). Arig's share of this loss was US$ 0.1 million. Amidst challenging market conditions, the company recorded warranty revenues of US$ 2.3 million (2016: US$ 4.1 million) while non-warranty income contributed US$ 0.4 million (2016: US$ 0.7 million) for the year.

Arig Capital Limited (ACL)

ACL is a registered and fully owned corporate member at Lloyd's of London that allows Arig to share in business written by Lloyd's syndicates. In 2017, ACL wrote business through five syndicates namely Apollo, Argo, Barbican, Standard and Accapella, generating gross written premiums of US$ 88.6 million (2016: US$ 110.9 million). ACL retains limited risk for its net account and cedes most of its business to the parent company. ACL recorded a loss of US$ 2.7 million for the year (2016: net loss US$ 0.4 million) mainly impacted by US hurricane losses.

Arig Insurance Management (DIFC) Limited (AIM)

AIM will start active underwriting in the first half of 2018. The company is finalizing the Lloyds Cover Holder procedures. Capacity for 3 Special Lines products has been secured with a large Lloyd's Syndicate. Negotiations with several Reinsurers are in various stages of development (both Lloyd's and International capacities).