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 37th Annual Report and Consolidated Financial Statements for the 2017 Financial Year.

GROUP PERFORMANCE

Despite the high level of catastrophe losses experienced in 2017 and a major fire loss in UAE "ADNOC refinery", Arig continued to generate a positive result in 2017 of US$ 7.2 million attributable to shareholders (2016: US$ 9.2 million) backed by positive technical performance and higher investment earnings.

In addition, on 22 November 2017, A.M. Best affirmed Arig's Financial Strength Rating of 'A- (Excellent)', and its Long-Term Issuer Credit Rating of "a-". The outlook of both ratings remains stable. The rating agency highlighted in their related press release "the ratings reflect Arig's very strong balance sheet strength, its adequate operating performance, neutral business profile and appropriate enterprise risk management".

Arig's Gross written premiums declined to US$ 225.6 million (2016: US$ 245.4 million), reflecting strict price oriented underwriting approach, unwillingness to follow soft-market practices on the expense of top-line, negative influence of exchange rate movements and inadequately priced accounts coupled with downward premium adjustments to our Lloyd's portfolio.

The total investment income for the Company reached US$ 22.3 million (2016: US$ 19.3 million) reflecting strategic portfolio positioning.

THE MARKET

Economic Situation

After a year of political earthquakes, 2017 produced its share of significant world events. The most prominent ones were:

The world witnessed the inauguration of the 45th President of the United States of America heralding a drastic change in policy and a new vision at the White House. The paramount slogan of the new Administration is "America first" in the full sense of its meaning. The USA cancelled its participation in the Trans-Pacific Partnership and has withdrawn from the Paris Climate Agreement. Also, the approach of the Administration towards US "unfriendly" countries has become much stricter.

The presidential elections in France as well as the vote for the German Bundestag were, especially after the unexpected win of the Brexit-Supporters in the United Kingdom, the most important political events in Europe and anxiously awaited. The result of both turned out to be in favour of the European Union and diminished earlier fears fuelled by the rise of right-wing populism.

However, the United Kingdom continued its path towards an exit from the European Union by invoking Article 50 of the Lisbon Treaty. Britain has now until March 2019 to negotiate the terms of its departure and may endure a "hard Brexit", depending on how much disruption its divorce from the EU causes.

One of the most significant highlights in the Arab World was the promotion of Saudi Arabia's Royal Highness, Prince Mohammad bin Salman, as Crown Prince. His "Vision 2030" aims to modernize Saudi Arabia's economy and society and to prepare the country for a post-oil future, by transforming the Kingdom into an investment powerhouse and by empowering the private sector. Addressing corruption has also been a central topic on his ambitious agenda. Another development has been the growing tensions with neighbouring Qatar which is affecting trade, movement of capital and people.

The civil wars in Syria, Iraq, Libya, and Yemen remain. Besides being humanitarian disasters, they represent a significant challenge for the entire region, economically as well as socially.

The agreement of OPEC and non-OPEC producers led by Russia to extend oil output cuts until the end of 2018 and limit oil production, coupled with geopolitical tensions in the Middle East has supported crude oil prices. These have risen by about 20 percent between August 2017 and mid-December 2017 to over $60 per barrel. The increase in fuel prices raised headline inflation in advanced economies, but wage and core-price inflation remain weak. Among emerging market economies, headline and core inflation have ticked up slightly in recent months after declining earlier in 2017.

Ten years after the 2008 financial crisis, global economic growth is accelerating and stock markets around the world are hitting record highs. The International Monetary Fund (IMF) estimated in its latest World Economic Outlook (January 2018) an overall world output of 3.7% for 2017, 0.5% point higher than in 2016. About 120 economies representing three-quarters of the world GDP have seen a pick-up growth in year-on-year terms in 2017.

Growth in most emerging market and developing economies (EMDEs) with large numbers of commodity

REPORT OF THE BOARD OF DIRECTORS

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Saeed Mohammed AlBahhar

Chairman

exporters recovered in 2017, with the significant exception of the Middle East and North Africa, mainly due to oil production cuts. EMDEs are expected to grow by 4.7% in 2017 (2016: 4.4%) against a growth of 2.3% in 2017 (2016: 1.7%) in the advanced economies. China will remain at the top of the list with an expected growth of 6.8% (2016: 6.7%). A high growth of 6.7% is also expected in India; however, at a slightly lower level than 2016 growth of 7.1%.

Growth has been constrained in the MENA region with 2.5% estimate growth due to the impact of geopolitical tensions and on-going security concerns. One of the core markets that is expected to perform at a considerable lower level against 2016 is the Kingdom of Saudi Arabia -0.7% (2016: 1.7%).

The growth in Sub-Saharan Africa is expected to increase to 2.7% against 1.4% in 2016.

In the USA, the growth forecast has been revised upwards, given the stronger than expected activity in 2017, higher projected external demand and the expected macroeconomic impact of the tax reform; in particular, the tax cuts and the temporary allowance for full expensing of investment. The economic growth 2017 is estimated at 2.3% compared to 1.5% in 2016.

Post-Brexit, Britain's economy is underperforming. Sterling has depreciated, inflation has gone up. As a result, wages have been squeezed and investments have slowed down. The overall outlook for the UK in 2017 is 1.9% (2016: 1.9%).

Insurance and Reinsurance

The year 2017 will remain a prominent one in the reinsurance industry. According to Munich Re, natural catastrophe events in 2017 have caused record insurance and reinsurance market losses, with the total industry bill estimated at US$ 135 billion (representing 41% of economic loss for 2017 of US$ 330 billion). According to A.M. Best report published in early 2018, Lloyd's share in these losses is estimated to reach US$ 4.8 billion, topping by this the list of insurers and reinsurers covering these catastrophes. Swiss Re also recently put 2017 insured natural disaster losses at the same level of US$ 131 billion. In fact, 2017 is the second most costly natural catastrophe year on an economic basis behind 2011 when the Tohoku earthquake and tsunami pushed economic losses for the year to US$ 345 billion, in today's dollars.

The primary driver of the losses in 2017 was three Atlantic hurricanes in the third quarter. Harvey, Irma and Maria (HIM) which are estimated to have caused US$ 200 billion of economic losses and around US$ 80 billion of insured losses. In addition, other severe storms and wildfires in California are set to become the costliest wildfire loss in US history with estimated insured losses at around US$ 8 billion.

According to Swiss Re's data, the combined ratio of US Property & Casualty insurers is forecast to reach 109% in 2017, eight percentage points higher compared with 2016. The combined ratio for non-life reinsurer is estimated to hit 115%, mainly due to the hurricane losses, coupled with a number of other natural catastrophe events, including cyclone Debbie in Australia, earthquakes in Mexico and wildfires in California and Southern Europe. As a consequence, overall global industry profitability (ROE) for the full year is forecast to come in at around -4%.

Aon Benfield estimates that the global reinsurance capacity increased to US$ 600 billion at September 30, 2017. This figure includes conventional reinsurance as well as alternative capital. It is estimated that less than a third of 2017 losses fell into the private reinsurance market, representing a very manageable burden relative to the available capital base. 2017 losses have been absorbed without compromising the availability of reinsurance capacity, as more risk was being retained by primary insurers and more catastrophe exposure had been laid-off into the capital markets which confirm that the traditional reinsurers were well-capitalized. On the other hand, global reinsurance demand increased modestly during 2017 as a result of improved economics, the growing prevalence of risk-based capital regimes and emerging areas of risk transfer.

Capital availability and regulatory change are also resulting in new reinsurance company formations in rapidly developing and promising markets such as China and India.

According to the most recent report from PwC "US Insurance Deals Insights 1H2017", M&A activity in the insurance sector more than tripled to US$10 billion in the first half of 2017 compared to US$2.9 billion the same period last year.

The reinsurance market is continuously adapting to the ever-changing political risk environment, particularly during the current climate of increasing global political instability. When combined with the rapid emergence of new technologies, big data and predictive analytics, insurers will be presented with major challenges in the coming years in order to stay relevant and close gaps in existing coverage.

In our region, the most powerful driver of insurance and reinsurance demand remains to be medical insurance, which continues to be the fastest growing line of business. This trend is driven by the introduction of new compulsory

REPORT OF THE BOARD OF DIRECTORS

health insurance requirements which continue to evolve.

The region continues to remain attractive to global insurers and reinsurers, in view of the relatively low natural catastrophe exposure (except for Turkey, Iran, and Algeria).

Overall, reinsurance pricing has moved up in lines and territories most affected by recent losses, but not to the expected level given the amount of new capital entering the sector.

ARIG'S POSITION

Despite the challenging market conditions and a major market fire loss in UAE (ADNOC refinery) which is currently estimated at US$ 1.2 billion - making it one of the costliest claims in the MENA region - the overall technical return for the Group remained positive at US$ 5.5 million (2016: US$ 14.7 million). Our Lloyd's portfolio returned negative results of US$ 19.6 million (2016: loss of US$ 4.6 million) due to significant losses from most Lloyd's syndicates, who in return were affected by the 2017 US hurricane losses. While keeping in mind fast recovery potentials resulting from improved terms of trade, especially in the US insurance market, the Company revisited during the 2018 renewals, its Lloyd's portfolio and took corrective measures leading to the complete withdrawal from the worst performing syndicate.

Our non-life facultative portfolio showed, as in the previous years, a healthy performance of US$ 21.2 million (2016: US$ 11.0 million).

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

Our discontinued Takaful Re portfolio is also running off smoothly, and this has additionally benefited our bottom line by US$ 1.2 million (2016: US$ 1.2 million).

Gross written premiums were down by 8.1% for the year 2017, reflecting the negative influence of exchange rate movements, voluntary premium reductions in some under-performing accounts, mainly in the MENA region coupled with downward premium adjustments of our Lloyd's portfolio. Additionally, premium income reduced following the closure of our Takaful Re and our Branches in Singapore and Labuan.

The upgrade of Arig rating by A.M Best to 'A-' in late December 2016 was too late to have any effect on our 2017 treaty portfolio. The impact was more on our Facultative business where we managed to increase the premiums during 2017 by US$ 9.5 million, representing a growth of 41.4%

The Company also continued to manage its operating expenses. Operating expenses have been reduced by 12.7% compared with last year.

Under the current challenging market conditions, we continue to identify new products and opportunities to look for alternative solutions to the challenges at hand to maintain the Company's profitability.

The investment income increased by 15.5% in 2017 as compared to the previous year to reach US$ 22.3 million (2016: US$ 19.3 million) as a result of continuing positive equity returns. Our continued and well-executed investment strategy significantly contributed to the overall Group's profit.

OUTLOOK

The world economic performance is expected to strengthen. Improved global manufacturing activities, a robust global trade, broadly favourable financing conditions and firming commodity prices amid an investment-led recovery in advanced economies are reaffirming this prediction.

The IMF's recent update estimated an overall projected world output of 3.9% for 2018. Emerging Markets and developing countries are expected to grow by 4.9% in the same period. The WEO stated that broad-based cyclical global recovery is underway, aided by a rebound in investment and trade, against the backdrop of benign financing conditions, generally accommodative policies, improved confidence and the dissipating impact of the earlier commodity price collapse. Global growth is expected to be sustained over the next couple of years and even accelerate somewhat in emerging market and developing economies (EMDEs) thanks to a rebound in commodity exporters.

In 2018, the Kingdom of Saudi Arabia and the United Arab Emirates have introduced VAT and the expectation is that other GCC countries will follow suit during 2018/2019 which may have inflation implication in the region.

After a challenging year that caused historically high natural catastrophe losses to reinsurers who were already affected by low rates and investment yields, 2018 is expected to offer an improved operating environment as a result of recovering terms of trade in addition to stronger economic growth.

Lloyd's insurers' outlook for 2018 is positive, as January renewals make for a promising start after several years of falling prices. Direct and facultative property business saw the highest price increases. Most price improvement has been seen in loss affected US business where rates went up by a minimum of 10%, with some rate rises as much

REPORT OF THE BOARD OF DIRECTORS

as 25%. For the remainder of 2018, pricing is expected to be strong despite the high level of available capital in the industry. This is in part because much of the upcoming renewals will be related to US wind exposed business, which was affected by large losses in 2017[1].

Premium growth and underwriting profitability are expected to pick up in 2018 and 2019, driven by an increase in the demand for non-life insurance. This growth will come predominantly from emerging markets, with premium growth forecast at 6% and 7% in 2018 and 2019 respectively in real terms. For advanced markets, modest improvements in macro conditions and accelerating inflation are expected to subdue real growth. In nominal terms, premium growth momentum is expected to accelerate marginally, driven by economic activity and moderate price increases[2].

Rate increases during 2018 will be contingent on catastrophe loss experience during 2017. Insurers subjected to heavy catastrophe losses can expect significant rate increases, particularly those exposed to the most hard-hit areas such as the USA and Caribbean. There is a general consensus that these insurers will see rate rises as high as 20-30%. Conversely, rates are expected to remain flat for those insurers who have not been affected by such losses[3].

The main sensitivities going forward are further large losses, unexpected movements in interest rates and developments that drive changes in market structure. Issues to watch for include the unwinding of quantitative easing, the progress of ‘Brexit’ negotiations, the impacts of US tax reform, the prospect of further sector consolidation and the creep of protectionism[4].

At Arig, our focus will remain on maintaining a well-balanced portfolio, while benefitting from market opportunities in a controlled and opportunistic manner. At the same time we continue applying capital modelling techniques to ensure that our risk-adjusted capital remains at appropriate levels.

After the establishment of Arig Insurance Management (DIFC) (AIM) in Dubai during 2017, we intend to transform it into an “off balance-sheet” and purely fee-based operation. The aim is to further diversify and balance our income stream by adding a third column to our current operation, besides our primary activity as risk-carrier and investor.

We are, in line with the mentioned intention, entering into cover-holder agreements with a number of Lloyd’s syndicates. The objective is to write for, and on their behalf, niche products which are currently not offered by Arig or which could create synergy effects for both parties.

[1] *Sources: RBC Capital Markets analysts*

[2] *Swiss Re: “Global insurance review 2017 and outlook 2018 /19”*

[3] *Source: Guy Carpenter / Willis Re*

[4] *AON Benfield: “Reinsurance Market Outlook, Jan 2018”*

The fact that AIM is located at the DIFC surely adds value in this regard.

DIFC has positioned itself not only as an important reinsurance hub for the region, but also for business emanating from Africa. The majority of the leading reinsurance brokers are represented, in one way or another, at the DIFC. These brokers are controlling the placement of largely better performing corporate accounts, which should improve AIM’s access to such business.

The affirmation of Arig’s rating by A.M. Best allows us further access to business, where “A” rating is either a prerequisite, due to risk-based solvency regimes or where restrictions were previously placed due to management directives. For example, this applies to our engagement in facultative business, which is a targeted growth area or in many Far-Eastern markets.

In 2017, Arig expanded its development into Personal Lines business as a diversification tool, enjoying double digit reinsurance premium growth. Through its partnership with a pioneering Personal Lines technology company, it has been able to deliver a complete ‘front to back’ solution to one of its customers, enabling them in turn to deliver e-commerce insurance. Using these platforms, it is easier to launch and if necessary re-engineer product portfolios, as well as promote more effective cross selling as buyers establish online insurance profiles which can be interrogated intelligently for marketing. Furthermore, by using these digital developments, Arig is already in discussion with potential partners to expand its presence into more diverse markets.

Despite the current industry environment, Arig remains highly confident that we are well equipped to deal with the challenges at hand. Our reinsurance and investment portfolios are sufficiently diversified and our risk management is vigilant. We believe we can turn volatility into a profitable business across the business cycles by using our financial strength, market presence and third party relationships.

Our prime focus will remain on the protection of our policyholders and our shareholders’ capital, while providing reasonable returns on our equity.

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 the Central Bank of Bahrain for their support and cooperation throughout the year. The Directors also thank the Management team and the staff of Arig Group for their commitment, professionalism and sincere efforts.

On behalf of the Board of Directors

Saeed Mohammed AlBahhar
Chairman
13 February 2018