Allianz Risk Transfer AG

Solvency and Financial Condition Report 2016

This document is an unofficial English translation of the SFCR.
Only the original German version of the SFCR is authoritative.

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Executive Summary

Basis of Report

The first uniform Europe-wide system of financial supervision for primary insurance companies and reinsurance companies entered into force on January 1, 2016 under the name "Solvency II".

Under the European legislative framework, in November 2009, the European Parliament and the Council of the European Union approved the proposal by the EU Commission and issued a framework directive (Directive 2009 / 138 / EC of the European Parliament and of the Council of November 25, 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II). The Solvency II Directive governs the taking-up and pursuit of the business of insurance and reinsurance in Europe. Since January 1, 2016, a fully revised Insurance Supervision Act (VersAG) has entered into force which transposes this European directive into Liechtenstein law. A European regulation (Commission Delegated Regulation (EU) 2015/35), which was passed by the EU Commission as a delegated act on October 10, 2014, is also directly applicable in the member states. It contains detailed rules on implementing the framework directive.

A prominent feature of the new supervisory system is the systematically risk-based focus of the company's reporting. This new focus has also resulted in a reform - and significant expansion - of reporting. In addition to obligations to report quarterly figures to the supervisory authority, including numerous electronic reporting forms, there is an annual report to the public in narrative format, extensive reports to the national supervisory authority and, not least, ad-hoc reporting whose purpose is to notify the regulator in a timely manner of significant events and decisions by management.

While the annual financial statements and the associated reporting requirements are largely unaffected by Liechtenstein's Law on Persons and Companies (PGR), the reporting requirements stipulated in the latest update of the VersAG require another report that is introduced here. It is called the "Solvency and Financial Condition Report" (also abbreviated as "SFCR") and is intended to provide an informative picture of the company's solvency and financial condition.

In line with the principles of the new supervisory system, this report is written from a risk-oriented viewpoint and identifies how the company addresses risks. Using a standardized procedure, the company evaluates and describes its main business processes. In addition, assets and liabilities valued in economic terms (at market value) are juxtaposed in the so-called Solvency Overview. The excess of assets over liabilities is shown here as the equity base.

The Allianz Group and Allianz Risk Transfer AG (ART AG) together made extensive preparations for the new supervisory rules which entered into force on January 1, 2016 and are fully in compliance with the stricter requirements. The Allianz Group has an approved, partial internal model for determining the Solvency Capital Requirements which it refines on an ongoing basis. ART AG uses the standard model.

Contents

The remarks in this report take into account the expert knowledge of the intended recipients. The report's structure follows the general recommendations of the European Insurance and Occupational Pensions Authority (EIOPA) and consists of five chapters, all of which are for the reporting period from January 1 to December 31, 2016.

The first section, "Business Activities and Performance", contains detailed data on the position of ART AG within the Allianz Group's legal structure and a description of the company's main business segments. It also provides qualitative and quantitative information about underwriting performance during the reporting period, both at the aggregate level and broken down into the main business segments. Finally, the first section provides information on investment results, both overall and broken down into asset classes, as well as on their composition.

The second section provides a description of corporate governance (also referred to as the governance system) at ART AG. This includes information on the organizational structure and workflows, in particular on the design and integration of so-called key functions into the new supervisory system. Additional elements of reporting include requirements for the professional qualifications and personal propriety of management ("Fit and Proper Requirements"), as well as information on the risk management system and the internal control system.

The third section deals with the company's risk profile. Information is provided regarding business risks, which are broken down into the following risk categories: underwriting risk, market risk, credit risk, liquidity risk, operational risk and other major risks. Along with a description of these risks, section three contains an assessment of their materiality and a discussion of risk concentrations and risk-mitigation techniques.

Section four of the report focuses on the valuation principles used to prepare the Solvency Overview in accordance with supervisory law, including an analysis of the differences in value to those used for financial reporting in accordance with commercial law. The rules for economic assessment under the new supervisory system were implemented for valuing assets, technical provisions and other obligations.

The fifth and final section (Capital Management) presents a reconciliation of shareholders' equity under commercial law with regulatory capital ("own funds") and the amount of own funds eligible to meet the regulatory Solvency Capital Requirement.

ART AG currently uses the standard formula to determine the Solvency Capital Requirement; the introduction of an internal model is being investigated. As of December 31, 2016, eligible own funds totaled EUR 615.3 million. With EUR 429.6 million of risk capital, ART AG's solvency ratio stood at 143.2 %.

This Solvency and Financial Condition Report, published here for the first time, demonstrates ART AG's sound economic situation and enables the reader to reach his/her own conclusions in that regard.

Due to rounding, numbers added and percentages presented may differ slightly from the figures shown.

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A Business and Performance

A.1 Business

Introduction

Allianz Risk Transfer AG (ART AG) is a Liechtenstein-based joint-stock company and indirectly is a wholly owned subsidiary of Allianz Global Corporate & Specialty SE (AGCS SE), headquartered in Munich. 60 % of the shares of ART AG are held by AGCS International Holding B.V. in Amsterdam, in which AGCS SE in turn has a 100 % stake. ART AG was founded in Switzerland in 1997 as a global risk carrier for Allianz in the field of *Alternative Risk Transfer* for specialty and reinsurance businesses. ART AG offers companies with international operations a broad range of insurance and reinsurance, primarily in the General Liability, Asset Insurance, Property and Engineering Insurance divisions and in the specialty divisions of Transport, Marine and Aviation Insurance and Energy Supply. These services also include efficient claims processing, cross-border solutions as part of international insurance programs, captive and fronting services, risk consulting and structured risk transfer solutions. To provide these services,
ART AG and its branch offices and subsidiaries maintain teams in eight countries. Along with AGCS SE and a network of Allianz affiliates in more than 70 countries, as well as partner companies in other regions, it provides support for customers in 160 countries. ART AG maintains branch offices in Zurich, Switzerland, Hamilton, Bermuda and Dubai, United Arab Emirates.

As part of a realignment of the European business segment of ART AG, on October 3, 2016, the company's head office was relocated from Zurich, Switzerland to Schaan, Liechtenstein. The change in headquarters also meant that supervision of the company changed, from Switzerland's Financial Market Supervisory Authority (FINMA) to Liechtenstein's Financial Market Authority (FMA). The reporting currency also changed, from Swiss Francs to Euros.

In December 2016, as part of a financial restructuring of AGCS SE, AGCS SE sold 60% of the share capital of ART AG to its Dutch subsidiary, Allianz International Holding B.V.

KPMG (Liechtenstein) AG, Landstrasse 99, 9494 Schaan, Liechtenstein, was appointed as the auditor for fiscal year 2016.

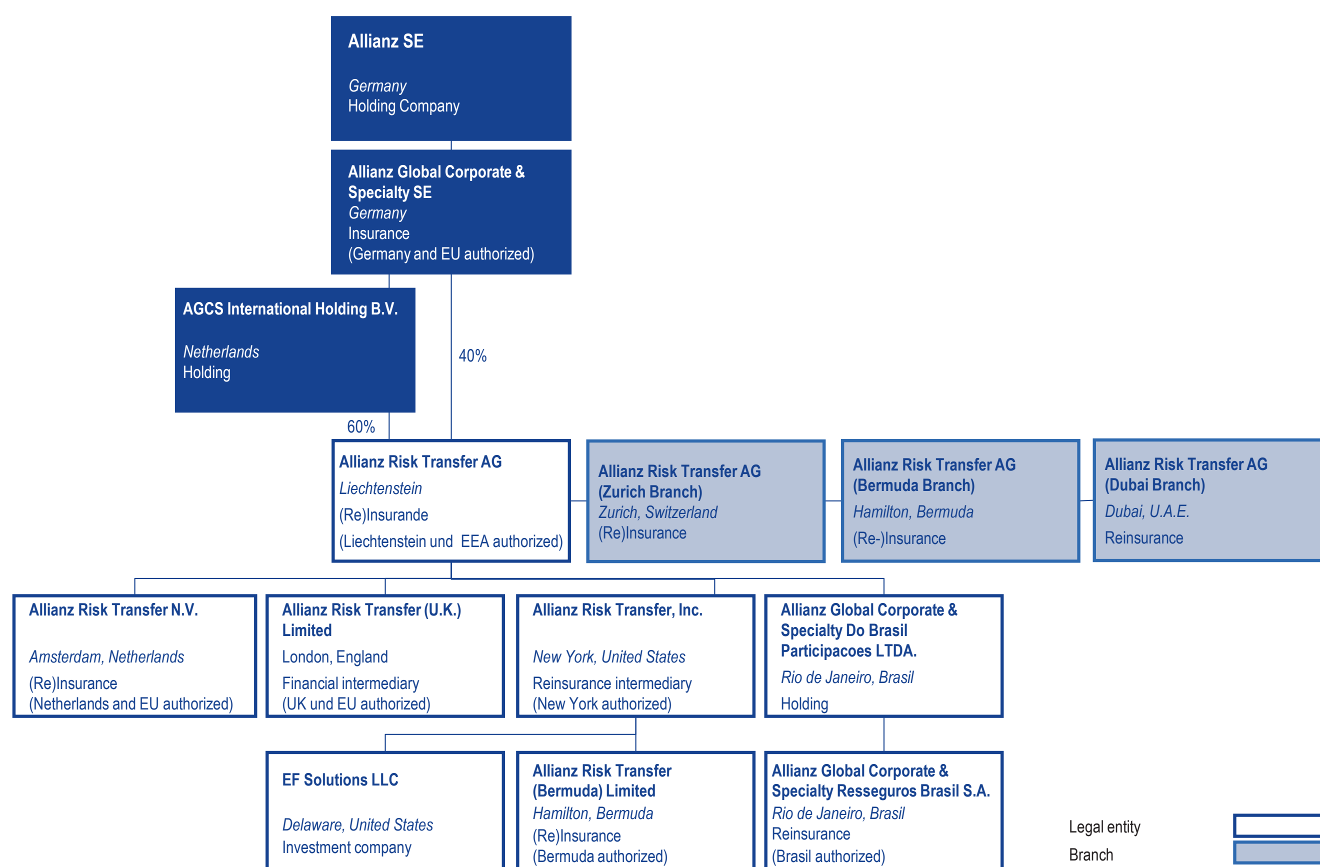
ART AG belongs to the Alliance Group under the management of Allianz SE, Munich, which is under the supervision of Germany's Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)), Graurheindorfer Str. 108, 53117 Bonn.

Allianz SE's Solvency II consolidated financial statements will be published on its website in May. The financial statements may be inspected there or requested from the company. ART AG is included in Allianz SE's Solvency II consolidated financial statements. You can find ART AG's Annual Report and other documents at www.art.allianz.com.

Affiliated Companies of ART AG

Company	Headquarters	Shareholding in %
Allianz Risk Transfer, Inc.	New York	100.0
Allianz Risk Transfer (U.K.) Limited	London	100.0
Allianz Risk Transfer N.V.	Amsterdam	100.0
Allianz Global Corporate & Specialty do Brasil Participações Ltda.	Rio de Janeiro	99.9

Corporate legal structure as of December 31, 2016



A.2 Underwriting Performance

Underwriting Performance according to Key Performance Indicators

Gross premium income decreased slightly during the fiscal year to EUR 1,090.3 million (previous year: EUR 1,247.6 million). The decrease of around EUR 157.0 million was primarily attributable to the fronting business for natural disaster risks underwritten by ART AG's branch office in Bermuda. Premiums written remained more or less the same as in the previous year in both Switzerland and Dubai. No business was underwritten via the new headquarters in Liechtenstein in 2016. Net earned premiums decreased by EUR 35.6 million to EUR 311.0 million year on year, mainly due to the business in the Bermuda branch office, where EUR 47.0 million of reinsurance contracts were not renewed.

Because of major loss events in the non-proportional reinsurance segment, the net loss burden increased slightly from EUR 199.2 million to EUR 205.6 million. As a result, the loss ratio rose from 57 % in 2015 to 66 % in 2016. Although commission income from ceded reinsurance decreased during the fiscal year, the overall expense ratio was maintained at the same level. The positive results benefited from income from non-performance-related profit-sharing.

The net combined ratio rose from 64.3 % to 78.8 % during the year under review. However, the previous year benefited from the reversal of equalization provisions. Adjusted for the reversal of equalization provisions, the ratio increased from 72.2 % to 78.8 %, primarily due to the aforementioned decline in net premiums earned.

Underwriting Result

€ thousand		2016
Gross premiums written		**1,090,285**
Net premiums earned		**311,009**
Other net underwriting income		3,662
Net claims incurred		-196,280
Net expenses for premium refunds		9,995
Total net operating expenses		**-62,368**
thereof	Operating expenses, in the narrower sense	-53,076
thereof	Loss adjustment expenses	-9,292
Other net underwriting expenses		-63
Net underwriting result		**65,956**
Net loss ratio		63.1 %
Net expenses ratio		15.7 %
Net combined ratio		78.8 %

Net Underwriting Results by Business Segment

	Gross Premiums Written	Net Premiums Earned	Net Claims Incurred	Net Operating Expenses	Expenses for Profit-Sharing and Premium Refunds	Net Under-writing Result before Equalization Provision 2016
€ thousand	2016	2016	2016	2016	2016	2016
Direct business and proportional reinsurance business assumed						
Fire and other property insurance	131,740	68,377	-38,269	-62,030	6,325	-25,598
General liability insurance	102,169	32,366	-9,171	-10,029	0	13,166
Marine, aviation and transport insurance	30,962	13,646	-15,099	875	0	-578
Various financial losses	29,202	10,949	7,319	-1,984	230	16,514
Motor vehicle liability insurance	10,844	12,779	-9,476	-3,438	18	-117
Credit and surety	2,323	203	-3,861	-223	0	-3,881
Other motor vehicle insurance	4,148	4,756	-3,513	-463	0	781
Health insurance	5,280	999	-59	-463	0	476
Other insurance segments	409	230	125	43	0	398
Subtotal 1	317,076	144,305	-72,004	-77,713	6,573	1,161

€ thousand	Gross Premiums Written 2016	Net Premiums Earned 2016	Net Claims Incurred 2016	Net Operating Expenses 2016	Expenses for Profit-Sharing and Premium Refunds 2016	Net Under-writing Result before Equalization Provision* 2016
Non-proportional reinsurance business assumed						
Non-proportional property reinsurance	565,430	116,032	-74,207	11,798	-13,690	39,933
Non-proportional marine, aviation and transport reinsurance	22,649	13,673	-12,332	-1,219	3,662	3,785
Non-proportional liability reinsurance	185,096	35,399	-37,785	4,869	18,589	21,073
Non-proportional health insurance	34	1,600	47	-103	-1,540	4
Subtotal 2	773,209	166,704	-124,276	15,345	7,021	64,795
Total	1,090,285	311,009	-196,280	-62,367	13,594	65,956

The total net underwriting result cannot be calculated from the income statement items listed above, as immaterial items are not listed.

In this table, EUR 9.3 million of claims processing expenses are reported under net operating expenses, while these expenses are shown under net expenses for claims in the income statement prepared in accordance with commercial law.

Under the PGR, investment expenses are not part of the underwriting result and therefore are not included in the table.

The above presentation by insurance line of business is not completely comparable to the table in the 2016 Annual Report, as the prior-year figures for some insurance lines of business had to be reclassified.

Direct Insurance and Reinsurance

In 2016, the direct insurance business and proportional reinsurance business assumed continued to face a very tough competitive environment characterized by persistent premium erosion. Total net premiums earned decreased by EUR 98.0 million to EUR 144.3 million. Because both the loss ratio and the combined ratio increased, the underwriting profit for the direct insurance business and the proportional reinsurance business assumed decreased by EUR 44.0 million to EUR 1.2 million.

In the following sections, key performance indicators, in particular the underwriting result, will be used to explain the results of the individual business segments.

The fire and other property insurance business continues to be the biggest business segment. However, net premiums earned decreased by EUR 25.0 million to EUR 68.4 million. Although the net loss expense of EUR 38.3 million was below the prior-year figure, costs – including expenses for profit-sharing – increased by EUR 8.5 million to EUR 55.7 million, despite a decrease in premium volumes. The result was an underwriting loss of EUR 25.6 million, compared to an underwriting profit of EUR 1.1 million for this division in the previous year.

In general liability insurance, net premiums earned stood at EUR 32.4 million, EUR 34.6 million lower than in the prior-year period. Net loss expenses also decreased by EUR 17.3 million to EUR 9.2 million. The underwriting result of EUR 13.2 million was EUR 1.5 million below the prior-year figure.

Net premiums earned in the marine, aviation and transport insurance segment dropped by EUR 30.0 million during the fiscal year to EUR 13.7 million. During the same period, loss expenses declined by EUR 11.2 million, leading to an underwriting loss of EUR 0.6 million, compared to an underwriting profit of EUR 11.7 million in the previous year.

In the various financial losses business segment, net premiums earned also decreased, by EUR 10.0 million, to EUR 10.9 million. The net underwriting result of EUR 16.6 million was maintained at the prior-year level due to positive claims adjustment results.

Non-Proportional Reinsurance Business

The non-proportional reinsurance business assumed was further expanded during the fiscal year. Although a reduction in fronting volumes resulted in a EUR 90.8 million decrease in gross premiums written, to EUR 773.2 million, net premiums earned increased by EUR 60.4 million to EUR 166.4 million. The net underwriting result also increased, by EUR 14.2 million, to EUR 64.8 million.

The non-proportional reinsurance business is influenced by the internal reinsurance business segment. As in previous years, ART AG primarily insured the first and second layers of AGCS SE's global reinsurance program. Net premiums earned in this business segment increased by EUR 5.3 million to EUR 74.2 million. Expenses for retro coverage were more or less stable at EUR 31.2 million in 2016. The 2016 underwriting year was characterized by a major loss in the property insurance segment of around EUR 55.0 million, which was partially offset by the reduction in prior-year events. In spite of the effects of the aforementioned major loss, the net underwriting result improved from EUR 20.2 million to EUR 24.5 million. Factors contributing to the positive result were internal reinsurance and commission income from the fronting business.

A breakdown of the underwriting result by region and business lines is not provided because in the past fiscal year direct insurance business was mostly written in Switzerland. Policies could only be issued in all EU and EEA countries under the freedom to provide services after the head office was redomiciled to Liechtenstein.

A.3 Investment Performance

In 2016, investment income totaled EUR 12.1 million and consisted mainly of EUR 25.2 million of current income and EUR 12.4 million of unrealized valuations. Investment income also included EUR 0.9 million of realized gains and losses from investment disposals and EUR 1.6 million of investment management expenses.

Current income is typically driven by the bond portfolio, but in the past year it benefited from EUR 9.5 million of extraordinary income from equity positions. Income from loans relate to an internal group loan. Interest income is derived from the underwriting business.

Persistently low interest rates led to lower portfolio turnover, which is reflected in lower figures for realized gains and losses. Write-downs of participating interests were driven by changes in exchange rates and not by other economic considerations at the subsidiaries.

Valuation reserves for investments in affiliated companies totaled EUR 27.1 million at year end and EUR 6.1 million in other investments.

Investment Result

Type of Investment	Current Income	Profit	Loss	Write-ups / Write-downs	Investment Result
€ thousand	2016	2016	2016	2016	2016
Investments in affiliated companies and participating interests	0	0	0	-13,218	-13,218
Equities	9,531	0	0	0	9,531
Bonds	10,562	1,405	-476	770	12,260
Loans	1,452	0	0	0	1,452
Money	527	0	0	0	527
Other investments	3,175	0	0	0	3,175
Expenses	0	0	0	0	-1,627
Total	25,247	1,405	-476	-12,449	12,100

A.4 Performance in Other Activities

There were no noteworthy transactions under other business activities in the year under review. ART AG did not enter into any significant lease agreements.

A.5 Other Disclosures

All relevant disclosures about ART AG's business activities and performance are included in previous discussions.

B Governance System

B.1 General Information about the Covernance System

B.1.1 Board of Directors and Executive Board

B.1.1.1 Board of Directors – Principle and Function

The Board of Directors of ART AG consists of at least three members. Members of the Board of Directors hold office for a period of three years, unless a shorter term of office is stipulated in the resolution appointing them. The term of office for the members of the Board of Directors ends on the day of the next regular general meeting of shareholders. The general meeting of shareholders is entitled to appoint members of the Board of Directors and may discharge members of the Board of Directors from liability. Without prejudice to the above, the Board of Directors may itself coopt additional members. Additional members coopted by the Board of Directors must be approved by the next General Meeting.

The Board of Directors currently has five members.

The Board of Directors is charged with the ultimate management of the corporation and the supervision of the conduct of business. The Board of Directors is responsible for establishing the company's organizational framework and an adequate governance system (including risk management, the actuarial function, compliance, internal control and internal audit). The Board of Directors is also responsible for organizing the accounting, financial control and financial planning systems, as well as all duties and responsibilities assigned to the Board of Directors under the applicable regulatory provisions. The Board of Directors represents the corporation externally and issued Organizational Regulations regulating the duties and powers of the Board of Directors and its Chairman, the Committees of the Board of Directors, the Executive Board and the Chief Executive Officer. In addition, the Board of Directors is responsible for appointing the members of the Executive Board and for producing ART AG's Annual Report.

The Board of Directors shall meet as often as business requires. Any member of the Board of Directors is entitled to request that a meeting be called without undue delay, specifying the purpose of such meeting. The Board of Directors shall have a quorum if at least half of its members are present. Resolutions by the Board of Directors shall be adopted by an absolute majority of those members of the Board of Directors present or represented at the meeting, with the Chairman casting the deciding vote in the event of a tie.

The members of the Board of Directors have the right to reimbursement of their expenditures made in the interest of the corporation, as well as to compensation commensurate with their activities, which the Board of Directors itself shall determine. Compensation is paid only to external members of the Board of Directors who have no other full-time position within the Allianz Group.

The structure of the Board of Directors is specified in the Articles of Association and the Organizational Regulations of ART AG. The Articles of Association were revised on September 26, 2016 with the redomiciliation of ART AG's headquarters from Zurich, Switzerland to Schaan, Liechtenstein; the Organizational Regulations were revised on September 21, 2016. There were no material changes to the governance system in connection with that or otherwise in 2016.

B.1.1.2 Executive Board – Principle and Function

The Executive Board must have at least two members. It consists of the Chief Executive Officer and other members as determined by the Board of Directors.

The Executive Board currently has five members.

The Executive Board is responsible for the direct management of ART AG’s business, under the leadership of the Chief Executive Officer and on behalf of and following the guidance and directives of the Board of Directors. The Executive Board issued Management Regulations regulating the function, division of tasks and powers of the ART AG's Management and Committees, which must be approved by the Board of Directors. The Executive Board regularly briefs the Board of Directors on the current course of business and the more important business transactions. Extraordinary occurrences

must be reported to the members of the Board of Directors without delay.

The Executive Board meets as and when any meeting is required or requested by a member of the Executive Board. The Executive Board meets at least once every quarter. The Executive Board shall have a quorum if a majority of the members of the Executive Board are present. Any resolution or other decision to be adopted by the Executive Board requires the absolute majority of the members present at the meeting, with the Chairman casting the deciding vote in the event of a tie.

Any member of the Executive Board and any member of ART AG's Management Team is entitled to submit any matter relating to his/her area of responsibilities for decision to the Executive Board or seek concurrence from the Chief Executive Officer. These persons also are entitled to submit any matter of fundamental importance for ART AG relating to the area of responsibilities of any other member of the ART AG Management Team for consideration by the Executive Board or the Chief Executive Officer.

B.1.1.3 Committees of the Board of Directors

The Board of Directors forms three Committees from among its members. Subject to certain reservations, within the defined responsibilities, the Committees have final decision-making authority.

The Business Approval Committee consist of two Sub-Committees: the Sub-Committee Transaction Matters and the Sub-Committee General Management Matters. The Sub-Committee Transaction Matters decide among other things, on conclusion of transactions that exceed the decision-making authority of the Executive Board based on the applicable authorization limits. The Sub-Committee on General Management Matters is – subject to the duties of the Board of Directors which are non-transferable according to the Articles of Association such as ultimate oversight of persons entrusted with the management of the company – responsible for supervision of ART AG's Executive Board and its management of the business, unless such responsibility is delegated to the Audit Committee.

The Remuneration Committee takes, among other things, decisions regarding the determination of compensation at the level of the Board of Directors and the Executive Board as well as modifications to the compensation system.

The Audit Committee assists the Board of Directors in its duties of ultimate oversight and financial control. The Audit Committee reviews the annual financial statements. It is responsible for assessing the effectiveness of the internal control system taking into consideration the risk management system. The Audit Committee receives regular reports concerning ART AG’s solvency and forms a view of the ART AG's compliance with applicable laws and regulations. Internal Audit reports to the Audit Committee on all significant findings at each meeting.

B.1.1.4 Committees of the Executive Board

The Executive Board established Committees relating to the business and other affairs. Upon recommendation of the Chief Executive Officer, the Executive Board may, at any time, modify the committee structure. The Chief Executive Officer appoints and dismisses the members and chairpersons of the Committees. The responsibilities and authorities of each Committee are specified in the relevant charter of the Committee.

In the Alternative Risk Transfer line of business (ART LOB), the Underwriting Committee is in charge of the underwriting process[1].

The Local Investment Management Committee provides support to the Executive Board on investments and monitoring of the investment portfolio. The Board of Directors has ultimate responsibility for the investment strategy.

1 In the industrial business or the core business of the Allianz Global Corporate & Specialty Group (AGCS Group), the AGCS Group's global decision-making processes (Referral Process) apply.

The Risk Management Committee is responsible for establishing and maintaining independent oversight of ART AG's risk management activities. It is the main decision-making body for risk management issues at ART AG.

The Loss Reserve Committee makes decisions regarding the quarterly assessment of underwriting obligations pursuant to IFRS and in the process reviews associated activities, developments and information.

The Financial Disclosure & Reporting Committee assists the Chairman of the Executive Board and the Chief Financial Officer of ART AG to fulfill their responsibility to file IFRS financial statements and related information in full, accurately and on time.

The Legal Committee sets company rules relating to legal, regulatory and compliance issues. In addition, it monitors the organizational and regulatory status of ART AG and recommends necessary adjustments.

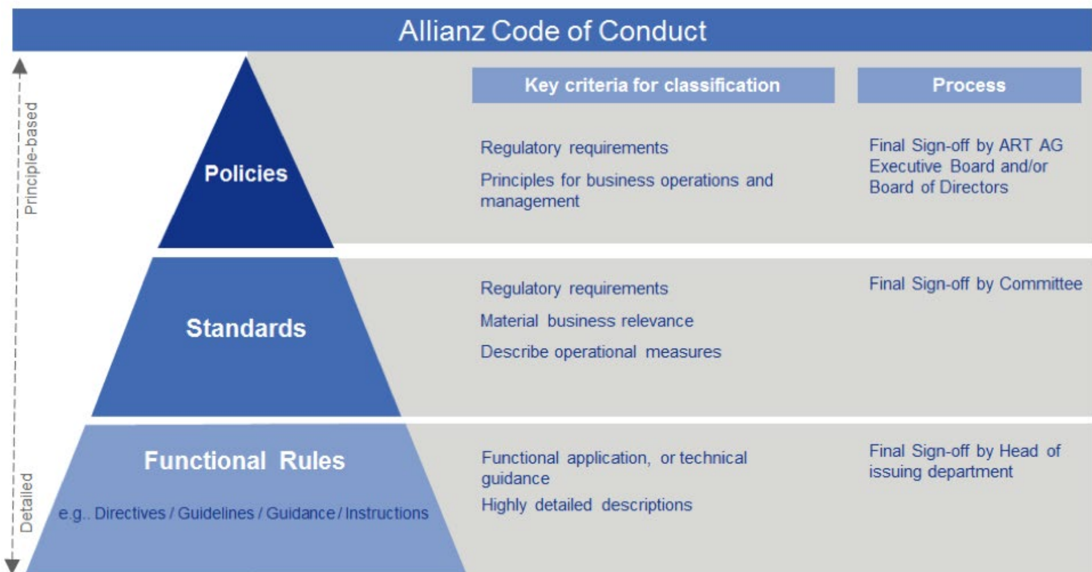
The Procurement & Outsourcing Committee manages and oversees ART AG's outsourcing and procurement activities.

B.1.2 Set of Rules

B.1.2.1 Company Rules

Company rules include all internal rules established by an authorized party with the intention of creating a company-wide binding standard or a binding guideline. Every company rule must be documented and approved by a relevant body. There is a defined set of rules within the AGCS Group that describes the relevant criteria for drawing up and updating company rules (including the underlying rule-definition process). ART AG basically follows the classification and approval concept found in the set of rules for the AGCS Group. Some adjustments to the nomenclature in the internal set of rules have not yet been completed. The set of rules encompasses four levels:

- Code of Conduct
- Policies
- Standards
- Functional Rules



B.1.2.2 Three Lines of Defense Modell

A basic component of ART AG's control framework is the Three Lines of Defense Model described below.

The separation between various lines of defense is principle-based and defined by the following activities.

The first line of defense is performed in the business through the management of day-to-day activities, risk management and controls. Key activities, in particular, include:

- Operational management of risks and returns by taking or directly influencing the origination, pricing and acceptance of risks.
- Designing and implementing methodologies, models, management reports or other control standards to support the optimization of risks and returns.
- Participating in business decisions.

The second line of defense provides independent oversight and challenges the day-to-day risk taking and controls by the first line. Its key activities, inter alia, include:

- Defining the overarching control frameworks within which the business is entitled to operate.
- Performing control activities, such as oversight on adherence to control frameworks and challenge of business decisions.
- Providing assurance on the design and operation of the control environment, including the evaluation of control models and methodologies.
- Advising on risk mitigation strategies and control activities, including providing professional opinions towards business and Management.

The second line of defense has the following main authorities:

- Independence in terms of reporting lines, objectives, target setting and compensation towards the first line of defense.
- Direct reporting and unfettered access to the Board of Directors.
- If necessary, escalation of relevant issues to the Chairman of the Board of Directors.
- All Key Function Holders (except for the Head of Internal Audit) have the right to veto business decisions that fall within the purview of the control function if they have sound reasons for doing so.

- The right to participate in key business decisions processes (but no direct management) and to request all relevant information necessary to conduct a professional judgment.

The third line of defense provides independent assurance across the first and second lines. Its activities include particularly:
- An independent assessment of the effectiveness and efficiency of the internal controls, including the activities of the first line of defense and the second line of defense.
- A report to the Audit Committee of the Board of Directors.

The same authorities for the functions of second line of defense also apply to the third line of defense (with the exception of the veto right).

In order to ensure an effective internal control system, all control functions are required to cooperate and to share relevant information.

B.1.3 Functions

The following sections discuss the actuarial function, the compliance function and the risk management function. These are part of the second line of defense.

Internal Audit, which acts as the third line of defense, is also discussed.

B.1.3.1 Actuarial Function

The actuarial function is embedded in the ART Corporate Actuarial department and is headed by the Appointed Actuary, who reports to the Chief Financial Officer of ART AG. In order to avoid any conflicts of interest, employees who carry out actuarial work for the underwriting department (so-called business actuaries) are not part of ART Corporate Actuarial. ART Corporate Actuarial includes the following areas of responsibility: Reserving/Analysis, Actuarial Diagnostics, Actuarial Risk Modeling and Actuarial Pricing Analytics.

Within ART Corporate Actuarial, the actuarial function carries out tasks based on regulatory and business requirements. The function heads up the Loss Reserve Committee, which makes decisions about the amount of technical provisions pursuant to IFRS, makes a recommendation to this body regarding the appropriate amount of such provisions and is itself represented and entitled to vote via the person holding the actuarial function. The actuarial function determines the provisions for the Market Value Balance Sheet (MVBS) and also expresses an opinion regarding the appropriateness of the reinsurance structure, the company's underwriting policy and the effective implementation of the risk management system.

The actuarial function interfaces and works closely with other functions, in particular the risk management function:
- In addition to the appropriate amount, the actuarial function also analyses the sensitivity and uncertainty of underwriting reserves.
- In addition, the actuarial function is responsible for assessing all underwriting risks in accordance with the standard formula.
- The actuarial function plays an active role in the entire risk management process to the extent that actuarial risks are involved. The Appointed Actuary reviews whether the company has sufficient funds equal at least to the Solvency Capital Requirement.

B.1.3.2 Compliance Function

The compliance function is headed up by the Group Compliance Officer, who reports to the General Counsel of ART AG.

The compliance function encompasses the following duties:

- Supporting and monitoring compliance with applicable legal and administrative requirements in order to protect ART AG from compliance risks; this includes identifying, assessing and minimizing such risks;
- Advising Management and supervisory bodies on the legal and administrative requirements adopted pursuant to the Solvency II Directive and evaluating the potential impact of these changes on the legal environment for ART AG's operating business.

The legal and compliance function is primarily responsible for monitoring and evaluating applicable legal or regulatory requirements, implementing processes and controls and introducing the internal quality-assurance measures required under the AGCS Compliance Policy, whereby specific requirements are monitored by other functions.

The legal and compliance function addresses risk areas in accordance with the following structure:

- Carrying out advisory work;
- Risk control;
- Early warning;
- Monitoring and reporting;
- Providing compliance training and communication;
- Advisory work and
- Establishing and complying with compliance principles and processes.

B.1.3.3 Risk Management Function

Risk management is headed up by the Head Risk Management, who reports to the Chief Financial Officer of ART AG and to the Chief Risk Officer of the AGCS Group. The Head Risk Management chairs ART AG's Risk Management Committee and is a (non-voting) member of other ART AG committees.

ART AG's risk management function, which is embedded in the AGCS Group's risk management, includes the following duties:

- Helping the Executive Board of ART AG and other functions to effectively deal with the risk management system;
- Monitoring the risk management system;
- Monitoring the overall risk profile of ART AG;
- Providing detailed reporting on ART AG's risk exposures and advising the Executive Board on risk management issues, including on strategic concerns relating to corporate strategy, mergers and acquisitions or larger projects and investments; and
- Identifying and assessing emerging risks.

B.1.3.4 Internal Audit

Audit forms the third line of defense. Internal Audit is headed up by AGCS's Global Head Internal Audit, who reports to the Audit Committee of the Board of Directors. Allianz Group Audit and the audit outsourced to AGCS SE for ART AG regularly carry out an independent review of the organizational structure and workflow of the risk management system. In addition, quality reviews of risk processes are conducted and adherence to business standards and compliance, including compliance with the internal control framework, are tested.

The internal audit function evaluates and provides recommendations on improving the effectiveness of the internal control system and the organizational structure and workflows by applying systematic audit approaches. The audit spectrum, which covers

all risks, including risks arising from outsourcings, is defined and reviewed on an annual basis using risk-based approaches. This audit spectrum is then used to control and prioritize internal audit activities. The entire audit spectrum must be adequately covered within a five-year period.

For every audit conducted, the internal audit function produces an audit report, including recommendations based on facts and professional judgement, a summary of the most important results and an overall assessment. Follow-up plans for remedying deficiencies identified in the audit report are drawn up by the audited unit and provided to the internal audit unit. The internal audit function holds follow-up meetings to ensure that the deficiencies identified are remedied.

B.1.4 Compensation System

Selected key figures from the financial plans form the basis for financial and operating targets, which reflect the strategy of the overall Group and of ART AG. As stipulated, this is intended to:
- Prevent excessive risk-taking;
- Help to avoid conflicts of interest;
- Ensure that risk-taking does not exceed the operating unit's risk-tolerance limits; and
- Adequately reflect the main risks, including with respect to their time horizon and their effect on the company's overall success.

ART AG has implemented the Allianz Group's performance management system. The Allianz Group's global compensation system has been adjusted to support Allianz's strategic Renewal Agenda. In addition to Group or company key financial performance indicators (KPIs), the compensation system considers an employee's individual performance (including the Executive Board), which is measured on the basis of quantitative and, primarily, qualitative criteria. This approach promotes a stronger focus on the behavioral aspects of performance (including compliance) and sets a common standard which is intended to advance cultural change throughout the Group.

For the annual bonus (short-term) of the Executive Board and employees of ART AG, ART AG's quantitative targets comprise 50 % of the performance evaluation. The IFRS operating profit accounts for 25 % and net income calculated in accordance with IFRS accounts for the other 25 %. Another 50 % of the performance evaluation is comprised of qualitative targets. An overall assessment of individual priorities (WHAT targets) is drawn up, along with the HOW target, consisting of four personal attributes which relate to the behavioral aspects:
- Excellence in the market and with customers;
- Team-oriented leadership behavior;
- Entrepreneurial conduct; and
- Trust.

For members of the Executive Board and other employees, 50% of the annual bonus is paid in cash; the other 50% is allocated in the form of participating interests in Allianz SE's equity incentive plan. Payout of the equity component is delayed for four years after the allocation date and the payout amount is equal to the respective market value of Allianz SE shares on the payout date.

A mid-term bonus may be granted to members of the Executive Board. This mid-term bonus includes sustainability indicators that match the Group's external targets and can be broken down into key performance indicators and health indicators.

The key performance indicators are:
- Sustainable improvement / stabilization of return on equity (excluding unrealized gains / losses from bonds); and
- Compliance with economic capitalization guidelines (degree of capitalization and volatility limit).

The health indicators, which are consistent with the Renewal Agenda, include:
- True customer centricity;
- Digital by default;
- Technical excellence;
- Growth engines; and
- Inclusive meritocracy (including the gender-equality initiative / women in leadership positions).

B.1.5 Information on Material Transactions

In 2016, AGCS SE, originally the sole shareholder, transferred 60 % of the shares of ART AG to AGCS International Holding B.V. Indirectly, ART AG continues to be a wholly-owned subsidiary of AGCS SE, because AGCS SE holds 100 % of the shares in AGCS International Holding B.V.

ART AG and AGCS SE are parties to a Service Level Agreement for the provision of advisory and support services in various fields, such as risk analysis and risk assessment. Compensation for the services provided is invoiced at cost, plus a profit margin.

ART AG grants non-proportional reinsurance to AGCS SE. In turn, AGCS SE protects ART AG's own funds from losses arising from the overall insurance business through an internal group whole account stop loss contract. Reinsurance contracts between ART AG and AGCS SE are entered into as arm's-length transactions.

During the 2016 reporting period, there were no material transactions with members of the Board of Directors or the Executive Board.

B.2 Fit and Proper Requirements

The key functions include both Key Function Holders and key function employees. Key Function Holders are the people who are responsible for carrying out the key functions. They are the heads of the respective departments and report directly to the responsible member of the Executive Board or (in the case of Internal Audit) to the Board of Directors of ART AG. There is one Key Function Holder for each key function.

The key function members are other people working within the key function, including people who report directly to the Key Function Holder and experts with independent decision-making powers.

The key functions and the respective Key Function Holders of ART AG are:
- Actuarial function: Appointed Actuary
- Legal function:
  General Counsel
- Compliance function:
  Group Compliance Officer
- Risk management function:
  Head Risk Management
- Internal Audit function:
  AGCS Global Head Internal Audit
- Accounting function:
  Chief Financial Officer

The evaluation of fit and proper requirements for all these people is relevant for Solvency II purposes and must be ensured. The requirements are listed in AGCS's Fit and Proper Policy. AGCS's Fit and Proper Policy has been implemented by ART AG and approved by the Executive Board and / or the Board of Directors. Any changes to AGCS's Fit and Proper Policy are in each case submitted to the competent ART AG approval body in charge for ratification.

The AGCS Fit and Proper Policy describes principles, criteria and processes designed to ensure that these people who actually control the company and work in key functions do indeed meet the professional qualifications and demonstrate the personal propriety required. AGCS's Fit and Proper Policy includes a definition of the required professional qualifications and personal propriety for the various positions involved. It also describes the processes necessary to ensure the professional qualifications and personal propriety.

The professional qualification requirements for internal and external candidates must be defined in the application procedure. Every candidate must submit a resume and various interviews must be conducted, including an interview with the Human Resources Department. A review must be carried

out of the candidate's personal background (which includes sending copies of relevant credentials, criminal record (or similar document) and proof that the candidate is not and has not been involved in insolvency proceedings as a debtor).

Human Resources must review references and carry out a search in public media. This is optional for key function members, but mandatory for Key Function Holders.

Performance reviews (for all people who are the focus of the AGCS Fit and Proper Policy) and career-development conferences (for executives and Key Function Holders) are mandatory and must be held on a regular basis.

Spontaneous reviews of fit and proper requirements shall be carried out in extraordinary situations if professional qualifications and / or personal propriety have been called into question.

Ongoing professional training programs ensure that the professional qualification requirements are always met. Training courses in ethical business conduct, anti-corruption and combating fraud are offered to provide employees with clear rules regarding appropriate behavior.

AGCS's Fit and Proper Policy sets benchmarks for evaluating professional qualifications and personal propriety regardless of which findings and information have been collected during the application process, the regular or spontaneous reviews and as a result of negative evaluations.

B.3 Risk Management System, including Own Risk and Solvency Assessment

B.3.1 Risk Management System

The organizational structure and workflows of ART AG's risk management system make it possible to control risks in an integrated manner and ensure that risks assumed are consistent with the company's risk-bearing capacity and, specifically, with the risk appetite defined in the risk strategy. The organizational structure and workflows of the risk management system follow a top-down approach:

1. Board of Directors of ART AG
The Board of Directors is responsible for the overall supervision of the company. The Board of Directors defines the organization and an appropriate governance system (including risk management) and exercises supervision and control over the management of ART AG. ART AG's risk strategy is approved by the Board of Directors.

2. Executive Board of ART AG
The Executive Board is responsible for direct management of the business. The Executive Board issues the Management Regulations concerning the function, allocation of responsibilities and powers of management. Among other things, the Executive Board is responsible for:

- Appropriately implementing the AGCS Risk Policy within the organizational structure and work processes of ART AG;
- Implementing ART AG's risk strategy, the risk appetite defined therein and the limits, as well as aligning the risk strategy with ART AG's business strategy and the Allianz Group's risk strategy.
- Setting up a risk management function which is responsible for independent monitoring of risks;
- Defining and implementing risk management processes, including processes for assessing the company's solvency.

An overarching risk management system is defined by implementing guidelines and standards for the organizational structure, the risk strategy, the system of limits and documentation and reporting requirements. These guidelines ensure that there is prompt and complete communication about risk-relevant developments within the company and decisions made, as well as a predefined process for making and implementing decisions.

Risk management is a core competency of ART AG – an international insurance company with industrial and corporate clients – and is an essential component of its business processes. Assessing, minimizing and assuming risks for policyholders is part of everyday business at ART AG.

The purpose of ART AG's risk management is to increase the company's value sustainably by considering the risk and earnings situation. The risk management system should help to protect ART AG's financial strength in the interest of the shareholders while safeguarding the claims of the policyholder. Risk management includes the necessary strategies, processes and reports for identifying, assessing, observing and controlling existing and potential risks. Another core element of risk management is translating risk drivers, dependencies and capital requirements for risks into decision templates for management. ART AG supports the company's risk culture with a comprehensive, systematically implemented risk governance structure.

B.3.1.1 Basic Principles of Risk Management

ART AG's risk management assesses the company's risk-bearing capacity. It is based on a uniform understanding of the risks taken and risk management processes as well as the associated control mechanisms. Risk management therefore follows the principles listed below:

Basic Principle 1: Responsibility of the Board of Directors for the Risk Strategy
ART AG's Board of Directors has ultimate responsibility for developing and refining a risk strategy derived from the business strategy. The risk strategy is reviewed by the Board of Directors on an annual basis, adjusted if necessary and readopted every year.

Basic Principle 2: Risk Capital as a Key Risk Indicator
Risk capital and the associated results of the stress scenario calculations are the main control parameters for risk appetite and for assessing the company's solvency. It is pivotal for corporate decision-making and the basis of risk management and controlling limits. The effects of material business decisions on risk capital are considered in advance.

Stress tests and additional scenarios are carried out as part of the company's Own Risk and Solvency Assessment (also referred to as ORSA) in order to ensure that the company has sufficient risk-bearing capacity, even in the case of unexpected, extreme financial losses.

Basic Principle 3: Separation of Risk-Taking and Independent Risk Oversight
The risk organization is characterized by the three lines of defense model. The risk management system is based on decentralized risk control and responsibility (first line of defense) with centralized monitoring functions (second and third lines of defense).

Managers of the individual business segments with direct influence over the company's profits and losses are directly responsible for assuming operating risks.

There is a strict separation between this active risk-taking by the business units and their decentralized risk management system, on the one hand, and risk monitoring by independent functions (centralized risk management function) on the other hand.

This independent monitoring function of the second line of defense – defined in the AGCS Governance Policy and the AGCS Enterprise-Wide Risk-Based Integrated Control (ERIC) Policy approved and implemented by the Executive Board and the Board of Directors of ART AG – is what makes an independent, objective risk management system possible. This independence, which is guaranteed by an unlimited right to information and direct reporting channels to the Executive Board and to the Board of Directors, is designed to avoid conflicts of interest when exercising the control function.

Internal Audit acts as the third line of defense, as the independent supervisory authority for the first and second line of defense.

In the process, it monitors compliance with framework conditions and the appropriateness of the control system and reports its results to the Audit Committee of the Board of Directors.

Basic Principle 4: Clear Definition of the Organizational Structure and Risk Management Processes
ART AG has an organizational structure that clearly defines the duties, scope of authority and responsibilities for risk management processes and covers all risk categories. The organization and the related processes must be fully documented in an understandable manner and communicated to all affected parties.

Basic Principle 5: Consistent Risk Assessment
Consistent quantitative and qualitative methods are used to assess relevant risks, including both individual and cumulative risks. In the risk capital calculation, quantitative risks are considered using the standard formula.

Individual risks that cannot be quantified with the standard formula, as well as complex risk structures that combine several individual risks or risk categories, are assessed using quantitative criteria, economic portfolio models or, in some cases, simplified quantitative methods (e.g., scenario analyses). If quantification is not possible, the assessment will be performed using qualitative criteria.

Basic Principle 6: (Further) Development and Integration of the Limit System
A consistent limit system has been established that ensures compliance with the risk appetite and governs how concentration risks are dealt with. It includes relevant risk parameters and drivers of risk for risk capital and is supplemented by more extensive operating limits. The limit system is reviewed regularly as part of the risk strategy.

Basic Principle 7: Mitigation of Risks beyond the Risk Appetite
If the limit for individual risks exceeds their limit or total risks exceed the risk appetite, the risks must be mitigated appropriately. Measures shall be defined as to how the risks can brought back within the limits and, therefore, the planned risk appetite. For example, this could include adjusting reinsurance solutions, strengthening the control environment, reducing and / or hedging the risk position or adjusting the risk appetite.

Any risk limitation shall take place only within the context of the framework conditions mandated by economics and the law.

Basic Principle 8: Consistent and Effective Monitoring
Clearly defined reporting requirements and escalation processes ensure that if limits are exceeded, risk appetite compliance will be restored and the required mitigation measures will be instituted immediately, where necessary. More extensive early-warning systems also will be reported and reviewed on a regular basis. These include risk management processes for major risks, estimates of emerging risks and processes for product launches.

Basic Principle 9: Consistent Risk Reporting and Risk Communication
ART AG's risk management sends regular and, if necessary, ad-hoc reports to the Risk Management Committee and to the Executive Board. The report is supplemented by risk assessments that are especially relevant to outside stakeholders (supervisory bodies, rating agencies, etc.). The results of the company's Own Risk and Solvency Assessment (ORSA) are documented in the annual ORSA Report. The underlying data and assumptions on which the information is based are embedded in a comprehensive control environment that ensures adequate data quality for complete, consistent and timely reporting to management.

Basic Principle 10: Integration of Risk Management into Business Processes
Where possible, risk management processes are directly integrated into business processes, including strategic and tactical business decisions and decisions affecting day-to-day business, to the extent that they might affect the risk profile. Above all, such integration is intended to ensure that the risk management system will help to shape future risks while playing only a secondary role in reactively assessing and controlling existing risks.

Basic Principle 11: Comprehensive and Timely Documentation
The methods, structures and processes relevant to risk management are documented in a comprehensive and timely manner in order to ensure transparency and clarity.

Basic Principle 12: Consistent Risk Governance within the Allianz Group
There is a consistent risk governance system for ensuring uniform risk management within ART AG, the AGCS Group and the Allianz Group which gives the Executive Board the appropriate tools it needs to control the business.

Filling the key functions is pivotal to ensuring ideal implementation of the processes. As a result, when appointing or dismissing the Head Risk Management, the Chief Financial Officer consults with AGCS's Chief Risk Officer to ensure that the professional and personal qualifications of the Head Risk Management fully satisfy the requirements specified in the AGCS Fit and Proper Policy.

B.3.1.2 Risk Strategy

ART AG's risk strategy is the core element of the set of rules governing risk management. It is designed to ensure compliance with all obligations to our customers and to create sustainable added value for our shareholders. The risk strategy defines the company's tolerance and appetite for risk, while taking all of the company's material qualitative and quantitative risks into account.

ART AG's Board of Directors defines the business strategy, which is then approved in consultation with AGCS SE. As part of the so-called strategic dialogue and planning dialogue, the business strategy and the risk strategy are harmonized with one another.

B.3.1.3 Risk Categories

ART AG categorizes all risks into one of eight risk categories. These risk categories are constantly monitored by risk management as part of risk reporting. Concentration risks may arise for some of these risk categories – in conjunction with other disproportionately large risks – due to an unbalanced risk profile. Concentration risks and emerging risks are not separate risk categories.

For all quantifiable and non-quantifiable risks, there is a comprehensive risk management process that includes risk identification, risk assessment and risk management, as well as risk monitoring and risk reporting. This process is implemented as part of a clearly defined risk strategy and risk appetite and its appropriateness/adequacy is regularly reviewed.

Risk Category	Definition
Market risk	Unexpected losses due to changes in market prices or a change in parameters that affect market prices, as well as the risk of options and guarantees embedded in contracts, or changes in the value of assets or liabilities of participating interests resulting from relevant changes in parameters. In particular, this includes changes in equity prices, interest rates, property prices, exchange rates, credit spreads and implied volatilities. As a result, it also includes changes in market prices caused by a deterioration in market liquidity.
Credit risk	Unexpected losses in the market value of the portfolio due to a deterioration in the creditworthiness of counterparties, including failure to meet payment obligations or nonperforming instruments (e.g., missed payment deadlines).
Underwriting risk	Losses due to unexpectedly high future losses, including losses due to natural or man-made disasters and run-off losses on existing claim provisions.
Business risk	Losses due to unexpectedly high cancellation rates in the portfolio and the resulting loss of profits, as well as from continuing fixed costs in the case of plummeting new business.
Operational risk	Unexpected losses due to inadequate or faulty internal operating processes or systems, due to human error or misconduct and due to external events.
Reputational risk	Unexpected loss in the Allianz share price, the value of existing or future business caused by damage to the reputation of the Allianz Group or any of the specific business units from the shareholder's perspective.
Liquidity risk	Unexpected financial losses due to nonfulfillment of current short-term or future payment obligations or if fulfillment is based on adverse changes in terms and conditions, as well as the risk of refinancing at higher interest rates or through the sale of assets at a discount during a liquidity crisis.
Strategic risk	Unexpected negative change in the value of a business unit due to wrong management decisions relating to the business strategy and its implementation.

B.3.1.4 Set of Rules Governing the Organization and Workflow of Risk Management

ART AG has established an effective governance system to promote implementation of the business strategy, to ensure adequate monitoring and control of business risks and to guarantee compliance with legal requirements. This system includes guidelines on the methods used to assess risks, on the risk management structures and on risk governance processes.

For capital market risks, credit risks, underwriting risks, business risks, liquidity risks, operational risks and reputational risks, additional guidelines are defined which define the risks entered into and stipulate the risk appetite for these risk categories. This risk appetite is the foundation for risk-based control of the business. In addition, the guidelines specify responsibilities and the scope of authority and define measures for minimizing risk and for escalation if limits are exceeded. These guidelines for each risk category should be regarded as supplements to the requirements and provisions in the overarching ART AG Risk Strategy, the ART AG ORSA Standard and the AGCS Guideline on Top Risk Scoping and Assessment.

B.3.1.5 Framework for the Top Risk Assessment

The Top Risk Assessment (TRA) is a tool used in the company's Own Risk and Solvency Assessment and a key tool used by the Executive Board to control risk. The Top Risk Assessment requirements are documented in the AGCS Guideline on Top Risk Scoping and Assessment.

The Guideline on Top Risk Scoping and Assessment describes a consistent, transparent approach for identifying and managing critical risks at ART AG. All material risks are identified and evaluated in the Top Risk Assessment.

Once ART AG's Executive Board and Management have identified the critical risks, these risks are assigned to members of ART AG's Executive Board. The risk owner is responsible for making the risk landscape transparent and for defining actions to mitigate the relevant risk if the risk-tolerance level defined by the Executive Board is exceeded. The results of this risk assessment are reviewed by Risk Management and reported to the Risk Management Committee and to the Board of Directors of ART AG.

Reporting on Risks and Implementation of Risk Management Processes

ART AG's risk management function generates internal risk reports – both at regular, predefined intervals and on an ad-hoc basis – that contain the relevant risk-related information in a clear, concise format.

The ad-hoc reporting includes events which – in addition to regular reporting – are unexpected in terms of size and impact and involve material changes to known risk issues or completely new or emerging risks that may have significant repercussions. For example, these include material quantitative effects on financial results and capitalization, as well as material qualitative effects on reputation, business continuity or noncompliance with laws and regulations. The comprehensive nature of risk management ensures that all material risks within ART AG are identified and systematically managed and that potential deviations from ART AG's risk appetite are identified at an early stage. Appropriate risk-mitigation techniques are used to deal with cases in which identified risks exceed the specified risk appetite (e.g., violations of limits). If such cases occur, clear measures are instituted to address the problem, for example adjusting the risk appetite or – following an economic review of the facts – concluding reinsurance contracts, strengthening the control environment or reducing / hedging risks associated with the underlying assets or liabilities.

B.3.1.6 Significant Risks

For disclosures of significant risks to which ART AG is exposed during the term of its insurance and reinsurance obligations, as well as their inclusion in overall solvency needs, please consult Chapter C, Risk Profile.

Disclosures on material risks that are not fully covered when calculating the Solvency Capital Requirement using the standard formula can also be found in Chapter C, Risk Profile.

B.3.2 Own Risk and Solvency Assessment

Among other things, ART AG's Own Risk and Solvency Assessment (ORSA) includes:

- Overall solvency needs, taking into account ART AG's risk profile, approved risk-tolerance limits and ART AG's business strategy;
- Continuous compliance with capital requirements and requirements for technical provisions; and
- The significance of the deviation of the risk profile of the company in question from the assumptions on which the Solvency Capital Requirement is based and which were calculated pursuant to the standard

B.3.2.1 ORSA Standard

The guidelines for the company's Own Risk and Solvency Assessment are specified in the ART AG ORSA Standard.

The guidelines specify the processes and responsibilities of the Own Risk and Solvency Assessment.

The appropriateness of the guidelines is reviewed, and if necessary adjusted and approved, at least once a year by the Risk Management Committee.

B.3.2.2 Responsibilities

The Board of Directors of ART AG bears ultimate responsibility for the Own Risk and Solvency Assessment.

The Executive Board plays an active role in the Own Risk and Solvency Assessment. It controls the assessment, reviews the results, institutes measures based on the results of the assessment and takes account of these when making strategic decisions. The Executive Board approves ART AG's ORSA Report, which is used both for internal reporting and for regulatory reporting.

The Risk Management Committee ensures that the Own Risk and Solvency Assessment is designed and carried out in an appropriate manner.
The committee approves the guidelines and reviews the ORSA Report.

Risk Management coordinates implementation of the Own Risk and Solvency Assessment and contributes to the assessment along with the actuarial function and other relevant functions. The ORSA Report is drawn up by Risk Management.

B.3.2.3 ORSA Processes

ART AG's Own Risk and Solvency Assessment consists of various processes that extend over the entire annual period and are closely linked. Some ORSA processes are performed on an annual basis, while others take place on a quarterly or ad-hoc basis.

- Top Risk Assessment: All risks that represent the biggest threat to the company are identified in an annual process, analyzed, assessed and, if necessary, mitigated.
- Business and risk strategy process: The business strategy is the basis for planning. During the annual planning cycle, a capital plan is developed that ensures ongoing compliance with the target capital ratios specified as part of the risk appetite, whereby expected solvency over the next three years is taken into account (i.e., based on projected figures). Stress scenarios are also included in the analysis. During the planning process, effects on capitalization are analyzed and, if necessary, adjustments to the limits for the next fiscal year are analyzed. In this way, the risk strategy is reviewed annually and a risk appetite is defined, taking the corporate targets into account.
- Appropriateness of the standard formula: The appropriateness of the standard formula in terms of ART AG's risk profile is reviewed annually.
- Volatility adjustment: Evaluation of the sensitivity of the volatility adjustment to technical provisions and eligible own funds in terms of the assumptions on which the calculation of the volatility adjustment is based and the potential effects of a forced sale of assets on the eligible own funds; valuation of the effect of a decrease in the volatility adjustment to zero.
- Loss-absorbing capacity of the unpaid share capital: Assessment of the loss-absorbing capacity of the unpaid capital of ART AG, including changes in the structure or the contractual terms and conditions of the agreement, changes in the status of the counterparties involved and changes in the recoverability of the ancillary own funds.
- Calculation of ART AG's solvency position: The Solvency Capital Requirement based on the standard formula and the eligible own funds are calculated on a quarterly basis.
- Sensitivities and stress scenarios: ART AG's solvency position is assessed on a quarterly basis under a set of stress scenarios. Every year, additional stress scenarios, sensitivity analyses and reverse stress tests are carried out.
- Capital management: Ensuring adequate capitalization at all times in terms of regulatory requirements and rating capital requirements, as well as specific market requirements, is essential to ART AG. The solvency position of ART AG is discussed at quarterly meetings of the Risk Management Committee and is reviewed for compliance with the capital requirements in ART AG's risk strategy. If necessary, steps are taken to ensure adequate capitalization.
- Compliance with limits: Compliance with quantitative risk limits for market, credit and underwriting risks is continuously reviewed throughout the year. If necessary, steps are taken to ensure utilization within the prescribed limit.
- Appropriateness of ART AG's claim provisions: The provisions are calculated on a quarterly basis and are reviewed and approved by the Appointed Actuary and the Loss Reserve Committee of ART AG.
- Risk reporting: Risk Management reports to the Risk Management Committee on a quarterly basis.
- Effectiveness of the internal control system: Ensuring the effectiveness of ART AG's internal control system through annual assessments of operational risks, analysis of operational losses, review of the control design and the operating effectiveness of controls, consideration of the internal and external audit reports.

The aforementioned regular ORSA processes are supplemented by irregular evaluations of the risk profile, as needed. Such a need exists if significant changes occur or are expected to occur in ART AG's risk profile.

B.3.2.4 ORSA Report

As mentioned previously, the company's Own Risk and Solvency Assessment is documented in an ORSA Report. ART AG's ORSA Report is used both for internal reporting and for regulatory reporting.

The regular ORSA Report is finalized and adopted by the Executive Board in the second quarter of the fiscal year.

Preparation of the ORSA Report is coordinated by the risk management function. The underwriting, actuarial, capital management, accounting, compliance and other relevant functions are involved in producing the report. The Risk Management Committee discusses and reviews the results of the ORSA Report before the report is submitted to the Executive Board for approval and to members of the Board of Directors for their attention. Finally, the results of the company's Own Risk and Solvency Assessment are made available to everyone who plays a key role in decision-making processes relating to the corporate strategy, the risk strategy and risk and capital management (e.g., ART AG's Key Function Holders).

B.4 Internal Control System

ART AG has implemented a formal internal control system, the so-called ERIC System (Enterprise-wide Risk-based Integrated Control System), to control significant operational risks for ART AG on an ongoing basis through monitoring and control activities and to ensure that the relevant key controls are effective. In compliance with legal and regulatory as well as Allianz Group requirements, and following internationally recognized control frameworks such as COSO[1], the ERIC System is designed to ensure that:

- The achievement of strategic business objectives is effectively supported and ART AG's ability to conduct business is safeguarded;
- Governance elements and business operations are effective;
- Both internal and external financial and regulatory reporting processes produce complete and accurate information to support effective internal management decisions and to meet expectations of external stakeholders.

The ERIC System formalizes key controls required to mitigate significant operational risks to ART AG. A holistic view on these risks and controls is facilitated, and reasonable assurance is provided to the ART AG Executive Board with regards to meeting the above objectives. Through the harmonized approach when engaging with the individual functions for operational risk and control assessments, the ERIC System also fosters the collaboration and information sharing across the Key Governance Functions under Solvency II (Compliance, Risk Management, Actuarial and Internal Audit).

Furthermore, the ERIC System creates risk and control awareness across the organization and provides transparency with respect to risk and control ownership. Supported by an effective Operational Risk Management Framework under the overall Risk Management System, potentially significant operational risks are identified at an early stage and measures are taken to avoid or mitigate these risks, in order to meet the operational risk tolerance[3] set by ART AG's Executive Board.

2 The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

3 ART AG's risk tolerance is defined and reviewed in the Top Risk Assessment and in the individual risk and control assessment programs.

The internal control system relates to operational risks. However, to facilitate readability, the term "operational" is omitted below. At the same time, the terms "key control" and "control" are used synonymously.

B.4.1 Key Principles

The following key principles apply to the ERIC system:

- Focuses on significant risks;
- Focuses on key controls;
- Risk and Control Awareness;
- Effectiveness at all times of key controls; Documentation of risks, controls and business processes;
- Use of service providers and integration into the internal control system and
- Control strategies such as separation of duties or dual-control principle.

B.4.2 Risk and Control Assessment Programs

Risk and control assessment programs form the fundamental procedures to determine those operational risks that are in scope of the internal control system; they focus on significant risks relating to the aforementioned targets. All programs provide individual views on the risk and control landscape at ART AG and complement each other. A balanced combination of these programs ensures a comprehensive coverage through the ERIC System while still being efficient and manageable

Significant risks and key controls are identified and assessed along three levels:

- Management level (e.g., entity-level controls, Global Operational Risk Assessment Program);
- IT level (e.g., IT general controls); and
- Process level (important business processes, financial and regulatory reporting).

Through these assessment programs, significant risks are first identified and evaluated, then existing associated key controls are explicitly identified and assessed in terms of their appropriateness. Furthermore, operating effectiveness of key controls is assessed through structured control testing under the ERIC System (operating effectiveness).

If the level of risk is not acceptable (e.g., due to missing or ineffective key controls or due to inappropriate design of key controls), remediation activities will be defined and taken to meet the operational risk tolerance.

B.4.3 Important Process Steps for the Eric System

The ERIC system's core process follows an annual cycle comprised of four steps:
- Risk Scoping;
- Integrated Risk and Control Assessments and Remediation;
- Control Testing and Deficiencies;
- Monitoring and reporting.

These steps are supported by the ERIC Advisory Group at ART AG. The following functions are therein represented:
- Risk management function;
- Compliance function;
- Actuarial function; and
- Accounting.

On a regular basis The ERIC Advisory Group forms an opinion on:
- The ERIC System with respect to comprehensiveness and consistency;
- The existence and execution of clear and consistent operational responsibilities and processes for the ERIC System;
- The appropriateness and comprehensiveness of the focus of the risk and control assessment activities (e.g., key business operations, risk scope, control testing scope);
- The effectiveness of the ERIC System (e.g., control testing results as documented in the ERIC report) particularly including the materiality of identified control deficiencies.

B.4.3.1 Risk Scoping

Proper scoping is crucial to focus risk and control assessment efforts on the significant risks and associated key controls. The scoping is an annual process following a top-down approach and coordinated by Risk Management. Various aspects are considered in this context to ensure comprehensiveness including benchmarking or comparing with best-practice and consideration of known weaknesses.

B.4.3.2 Integrated Risk and Control Assessments and Remediation

Based on expert judgment, the inventory of ERIC risks and controls is regularly reviewed and updated. In particular all in-scope risks and associated key controls are assessed with respect to their potential negative impact on the ERIC objectives. The assessment of the set of key controls associated with a given risk particularly considers known weaknesses and the design in order to conclude whether the controls are appropriately designed to effectively mitigate the underlying risk ("Test of Design"). Missing key controls or key controls that are not deemed to be designed appropriately lead to a deficiency and require remediation.

B.4.3.3 Testing Controls; Eliminating Weak Spots, Where Necessary

Control testing is crucial to demonstrate effectiveness of ART AG's internal control efforts to external stakeholders (including the Audit Committee of ART AG's Board of Directors) and to build and maintain trust of stakeholders in the reliability of these efforts. Clear and up-to-date documentation of key controls forms the basis for efficient control testing.

Risk Management proposes a structured and risk-based control testing scope, considering the outcome of previous risk and control assessments as well as further aspects such as identified deficiencies and significant changes in processes, controls or IT systems. The scope is reviewed by the ERIC Advisory Group with respect to its appropriateness and comprehensiveness.

Following this scope, individual key controls are tested to assure the effectiveness of risk mitigation activities. Based on documented evidence, testing of individual key controls aims at concluding (i) whether or not the control is designed appropriately to mitigate the underlying risks ("Test of Design") and (ii) whether or not it is operating effectively ("Test of Operating Effectiveness"). The testing is carried out in so-called independent testing by the risk management function.

The appropriateness and adequacy of the design may also be tested as part of the risk and control assessment considering a set of controls rather than an individual control. Missing key controls, or key controls that are not deemed to be designed appropriately or operating effectively, lead to a deficiency and require remediation. The materiality of the deficiency is assessed, and a realistic and detailed remediation plan is set up. When a control deficiency is considered to be remediated, the control needs to be re-tested.

B.4.3.4 Monitoring and Reporting

At least on an annual basis, the risk management function prepares an ERIC Report, which is submitted first to the ERIC Advisory Group for review, and then to ART AG's Risk Management Committee for signing off the overall effectiveness of the ERIC system. Finally, the report is distributed to the Audit Committee of ART AG and to the Executive Board of ART AG for acknowledgement.

The risk management function also coordinates and monitors all activities necessary for the ERIC system, in particular remedial actions to eliminate control weaknesses. Risk Management provides a regular update and overview to the ERIC Advisory Group and the ART AG's Risk Management Committee.

B.4.4 Duties of the Compliance Function

Under the Solvency II framework directive, the compliance function has the following duties:

- Carrying out advisory work, in particular advising the Executive Board on compliance-related issues;
- Risk monitoring;
- Early warning; and
- Monitoring and reporting.

To carry out these duties, the ART Group Compliance Officer has introduced a Compliance and Governance Management System at ART AG after consultation with and approval by the AGCS compliance function and within the ART Group. The main elements and processes are described in the Compliance Program.

The elements of the Compliance and Governance Management System are:
- Promoting a culture of integrity and compliance;
- Establishing and complying with compliance principles and processes;
- Providing and implementing training courses and communication;
- Advising the Executive Board and the operating units;
- Evaluating employee complaints and investigating compliance incidents;
- Interacting with regulatory authorities; and
- Monitoring compliance rules and reporting.

The main processes (not definitive) of the Compliance Management System are described below.

B.4.4.1 Performing Risk Assessments

The compliance function regularly identifies and assesses the compliance risks associated with business activities in the assigned areas of risk. The results are documented and form the basis for the Compliance Plan. The methods, timing and procedures for these assessments are coordinated with Risk Management.

B.4.4.2 Compiling, Coordinating and Updating the Compliance Plan

ART's Compliance Department develops and implements an annual risk-oriented Compliance Plan. This plan defines the planned compliance control activities for the relevant individual risk areas, including an underlying time frame, and considers the activities from the Compliance Plan of the AGCS Group and the Allianz Group. The annual Compliance Plan is submitted to the member of the Executive Board in charge of compliance and is reviewed for any necessary changes and adjusted at least every six months.

B.4.4.3 Resolving Compliance Incidents

The Compliance Department deals in an appropriate manner with incidents involving compliance violations – if necessary by escalating such issues to the AGCS Global Integrity Committee and / or to the Audit Committee of the Board of Directors. Where needed, the compliance function may request support and help from experts in other functions, or from outside specialists, in order to carry out an investigation.

B.4.4.4 Quality-Assurance Procedure

The compliance function carries out regular risk-based monitoring of the appropriateness and adequacy of implementation and of the effectiveness of the compliance programs, processes and controls. This may involve taking random samples, performing surveys or other analyses.

B.5 Internal Audit

For a description and discussion of how Internal Audit works, please consult Section B.1.3.4.

B.6 Actuarial Function

The actuarial functions are described in detail in Section B.1.3.1. It is therefore unnecessary to restate that information here.

B.7 Outsourcing

ART AG began applying the Global Procurement & Outsourcing Policy of the AGCS Group (AGCS P&O Policy) in 2015, reflecting the growing significance of outsourcing. All of the requirements specified in the Allianz Group Outsourcing Policy (GOP) are included in the AGCS P&O Policy. Any changes to the GOP are reflected in adjustments to the AGCS P&O Policy, which are submitted accordingly to ART AG's internal approval bodies for ratification.

The current Version 4.1 of the AGCS P&O Policy was adopted by the competent body of ART AG and / or the Executive Board on February 24, 2017.

The AGCS P&O Policy applies to:

- ART AG, including all branch offices; and
- All legally independent companies that are subject to ART AG's management control.

Legally independent companies must incorporate the AGCS P&O Policy into their internal system of governance through ratification.

In particular, the AGCS P&O Policy governs the following aspects:

- Definition of outsourcing;
- Criteria for selecting, commissioning and managing suppliers;
- Defining roles, responsibilities and approvals; and
- Rights of control while outsourcing (including termination).

A special role is played by the outsourcing function, which ensures that the necessary processes required for monitoring and supervising the outsourced outsourcing functions and services are defined and implemented.

The outsourcing function assumes responsibility for ensuring that the necessary processes required for monitoring and supervising the outsourced outsourcing functions and services are defined and implemented. This is done in consultation and agreement with the local key functions involved (e.g., Legal Department, Compliance, Risk Management, Business Continuity Management, Information Security Officer, Allianz Group functions) and the persons in charge of the outsourcing agreement.

The outsourcing function has special responsibility for the following main activities:

- Instructing the organization on how requirements are to be satisfied from an outsourcing standpoint.
- Supporting all business owners in their activities in order to ensure compliance with the AGCS P&O Policy.
- Centralized filing / archiving of all outsourcing agreements (inventory), along with related documents and evidence (e.g., risk assessment, business plan, due diligence).
- Reporting the AGCS outsourcing agreements to the Allianz Group, on request.

Terms and conditions for implementation and operating documents continue to be defined and reviewed annually in the governance toolkit with the contract owner, in consultation and agreement with global and regional key functions. The toolkit thereby takes into account the various outsourcing phases, from decision through implementation and operational phase to termination of the agreement. If the terms and conditions are not met, escalations in respect of incidents are defined.

Critical and Important Outsourcing Agreements of ART AG

Service Provider for ART	Country	Description
Allianz Investment Management SE	Germany	Investment Services *
Allianz Global Investors (Schweiz) AG	Switzerland	Investment Services *
PIMCO Deutschland GmbH	Germany	Investment Services *
Allianz Global Corporate & Specialty SE	Germany	Interne Audit **

* Functional responsibility – Thomas Schatzmann

** Functional responsibility – Bill Guffey

B.8 Other Disclosures

ART AG's governance system ensures that the company is in a position to identify, measure, control and report properly risks to which the company is, or may be, exposed. This is supported by the internal control system.

C Risk Profile

ART AG categorizes all risks into one of eight risk categories (see Section B.3.). These risk categories are constantly monitored through risk management and risk reporting. ART AG's risk profile is described below using these eight categories.

C.1 Underwriting Risk

Underwriting risks are risks arising from obligations of the direct insurance business (non-life insurance business) and the reinsurance business (all risks) relating to the risks covered and the processes used in pursuing the business. The uncertainty of the results with respect to insurance and reinsurance obligations under existing policies and the new business expected over the next twelve months is taken into account.

A distinction is made between premium risk, i.e., the risk that, due to unexpected future claims, there will not be sufficient premium income to finance them, and reserve risk, i.e., the risk that provisions will be inadequate to cover existing claims due to unexpected run-off losses.

Premium and reserve risks only take into account loss events that occur with regular frequency. Extreme events that occur very rarely are not included in the premium and reserve risks, but instead in the catastrophe risk. Under catastrophe risk, a distinction is made between natural disasters, man-made events and other catastrophic events.

Underwriting risks also include lapse risk. This refers to the possibility of unexpectedly high cancellations in the existing business and the resulting loss of future profits.

ART AG calculates all underwriting risks using the standard formula.

No material insurance risk is transferred to special purpose vehicles, and there is no material exposure from off-balance-sheet items.

ART AG actively controls premium and catastrophe risks; risk assessments and underwriting limits are integrated into the underwriting process and ART AG's risk appetite encourages purchase of reinsurance coverage. Assessing risks as part of the underwriting process is a key element of risk management at ART AG. As part of strategic planning, future business volumes and associated risks, as well as their impact on solvency, are forecasted.

With regard to reserve risk, ART AG regularly monitors the development of technical provisions at individual policy level. In addition, ART AG performs annual reserve uncertainty analyses in order to evaluate the sensitivity of reserves to the assumptions on which the calculations are based.

With regard to risk concentration, ART AG's catastrophe risk before reinsurance is driven primarily by man-made catastrophes. The remaining portion of the gross catastrophe risk is based on natural disasters. Other catastrophic events play a minor role. One of the main drivers of premium risk is non-proportional internal group active reinsurance.

There is currently no sign of concentration risks in the underwriting risk after reinsurance that could significantly influence the solvency ratio.

Excessive risks are mitigated through internal and external reinsurance contracts. In addition to traditional forms, ART AG also uses modern forms of reinsurance, such as industry loss warranties.

The risk arising from active internal non-proportional reinsurance is limited with aggregate excess of loss reinsurance. Own funds are protected from losses arising from the overall insurance business through an internal group whole account stop-loss contract with the parent company, AGCS SE.

No structural changes to the reinsurance program are planned. Reinsurance is therefore a continuously effective risk-mitigation technique.

The sensitivity of the underwriting risk is analyzed through sensitivity analyses and stress tests. Here, the sensitivity to higher business volumes is analyzed, along with the impact of a major loss and the sensitivity to claims reported at a later date and losses that develop at a later date. The company also looks at the risk that would arise in the absence of the whole account stop-loss contract. Among the scenarios analyzed, the latter scenario has the biggest impact on risk: as of year-end 2016, it leads to a solvency ratio of 109 %. The Solvency Capital Requirement is met in all the scenarios reviewed.

C.2 Market Risk

ART AG defines market risk as the risk of loss due to changes in market prices or parameters resulting in changes in market prices of financial assets and liabilities. This also includes the change in market prices due to a deterioration in market liquidity.

Market risk consists of the following subrisks:

- Interest rate risk is the possible change in value of the portfolio due to changes in interest rates;
- Equity risk is the possible change in value of the portfolio due to price changes in the equity markets;
- Property risk is the possible change in value of the portfolio due to changes in market values of properties;
- Spread risk is the possible change in value of the portfolio due to changes in the credit spread; and
- Currency risk is the possible change in value of the portfolio due to fluctuations in exchange rates.

In addition, market risk concentrations are assessed under the standard formula.

The main market risks facing ART AG are the currency risk and the market risk concentrations driven by the values of participating interests in the subsidiaries.

Interest Rate Risk

ART AG's interest rate risk is controlled as part of a comprehensive asset / liability management (ALM) system. In the non-life insurance business, payment obligations are typically shorter-term than the investments hedging them. ART AG's target duration is based on the assumption that it will continue to operate as a going-concern. This results in a longer duration on the asset side than on the liability side. This duration overhang implies interest rate risk. On the asset side, the duration is controlled by limits.

The sensitivity of the interest rate risk is analyzed using stress tests (among other things, a 100-basis-point increase / decrease in the interest rate).

Equity Risk

ART AG's equity risk is primarily due to participating interests in ART AG subsidiaries in Brazil, the USA, Bermuda and the Netherlands.

In addition, ART AG holds two smaller positions totaling EUR 1.6 million that come from an Alternative Asset Portfolio that has been in run-off since 2009.

As of December 31, 2016, ART AG holds no further equity positions.

The sensitivity of the share price risk is analyzed using stress tests (30% decrease in the values of participating interests and the rest of the Alternative Asset Portfolio).

Property Risk

ART AG has no real properties in its investment portfolio.

Spread Risk

ART AG's spread risk is driven by bonds and loans.

ART AG normally holds fixed-interest securities to maturity. As a result, short-term changes in market values have no negative financial effects on us. As a long-term investor, ART AG therefore has the option of investing in securities whose spreads are above the risk-free rate, and also to realize these spreads.

Exchange Rate Risk

Aside from the Euro, ART AG has assets and liabilities in various currencies, in particular in US dollars (USD), Brazilian Reais (BRL) and Swiss Francs (CHF). An appreciating Euro causes assets denominated in currencies other than the Euro to fall in value. At the same time, though, the corresponding capital requirements from a Euro standpoint decrease, which reduces the impact on capitalization.

The local own funds of ART AG's subsidiaries in Brazil and Bermuda are invested in the local functional currencies, BRL or USD. ART AG's BRL risk exposure comes exclusively from the participating interest in the Brazilian subsidiary.

The exchange rate risk is dominated by USD, followed by BRL and CHF.

Stress tests are used to analyze the sensitivity of the exchange rate risk (depreciation of foreign currencies against the Euro by 10%).

Market Risk Concentrations

Market risk concentrations within the meaning of the standard formula relate primarily to the participating interests in the subsidiaries in Brazil, the USA and Bermuda. Investments in German, French, Spanish and U.S. government bonds contribute only marginally to the Solvency Capital Requirement for market risk concentrations.

Prudent Person Principle

ART AG's assets are invested in accordance with the prudent person principle (Article 80 VersAG):

- ART AG invests only in assets and instruments whose risks it can adequately identify, measure, monitor, manage, control and report and which it can adequately consider in determining the total Solvency Capital Requirement.
- All assets, in particular those covering the Solvency Capital Requirement and the Minimum Capital Requirement, shall be invested in such a way as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Assets held to cover the technical provisions shall be invested in a manner appropriate to the nature and maturity of the insurance and reinsurance liabilities.

The Strategic Asset Allocation (SAA) defines the investment strategy for ART AG's investment portfolio.

The SAA is based on an analysis of assets and liabilities and a medium-term performance perspective. In structuring the SAA, great care is taken to ensure suitable target levels for quality and security, e.g., ratings, additional collateral and sustainable profits, as well as adequate liquidity and availability of the investment portfolio as a whole.

This ex-ante assessment is underpinned by constant compliance with the SAA (including leeway and limits) in the investment process and ex-post monitoring in order to facilitate corrective actions in the event of divergence from the targets.
ART AG's SAA stipulates investing 100% of assets in fixed-interest investments (the remainder of the Alternative Assets Portfolio of EUR 1.6 million is exempted from the SAA).

In order to ensure that individual investment decisions satisfy the prudent person principle, the Allianz Group and ART AG have:

- Drawn up a list of standard investments and
- Set up a process for investments which are not (yet) viewed as standard investments [New Financial Instrument (NFI) Process].

Only investments that are made regularly and over a sufficiently long period of time and in which ART AG and / or the Allianz Group's outsourced investment functions have relevant expertise are regarded as standard investments. Moreover, the internal processes and IT systems must be able to depict such investments adequately. Standard investments form the basis of ART AG's investment portfolio.

Before investments not included in the list of standard investments can be made, the NFI process must be completed successfully. This process checks the following aspects in particular: ART AG's ability to control all investment-specific risks, compatibility of the investments with the interests of the insured parties and effect of the investment on the quality, security, liquidity, availability and profitability of the investment portfolio as a whole.

ART AG's risk management system defines the framework conditions for managing market risk. In particular, these include the standards and the uniform methods and models for market risks, comprehensive limit systems for the investment portfolio and the system for reporting market risks. Further, the responsibilities for managing market risk are defined in detail in Allianz's Standards for Market Risk Management. These include:

- Analyzing the market risk capital, identifying concentration risks and monitoring measures to reduce risk;
- Identifying and controlling market risks;
- Monitoring compliance with limits;
- Internal reporting to management and external reporting (including reporting to the supervisory authority) regarding market risk; and
- Optimizing the portfolio in terms of profitability and market risk.

ART AG does not use derivatives to mitigate investment risks. The Corporate Finance & Treasury Department is responsible for monitoring and regularly reporting on ART AG's identified market risks. Reporting is handled through regular reports and, if necessary, ad-hoc reports. The purpose of risk reporting is to provide an up-to-date overview of risks to decision-makers (among others, the Board of Directors and the Executive Board) and to point out the utilization of limits. In addition, it is intended to improve risk transparency at all levels of the company and to help management make decisions.

C.3 Credit Risk

ART AG defines credit risk as the possible loss in value of the portfolio within a defined time horizon caused by changes in the credit quality (creditworthiness) of debtors in the portfolio, including default or nonfulfillment of financial obligations. Default on a loan receivable may be caused either by a deterioration in creditworthiness (migration risk) or by the inability or unwillingness of the debtor to fulfill contractual obligations.

The framework for controlling credit risk pursues two major goals:

- Auditing and monitoring outstanding debts from individual parties with the goal of reducing the risk of default by individual counterparties, but also to ensure adequate diversification across the portfolio as a whole (e.g., with respect to various industries, regions), or to avoid a strong concentration of individual counterparties; and
- Ensuring that ART AG at all times has sufficient capital to bear reliably the credit risk it has assumed.

Along with both of the goals mentioned above, the following aspects are taken into account:

- Reporting and managing the risks assumed;
- Defining and managing limits per counterparty and country; this also includes maintaining lists of counterparties subject to particular scrutiny (Watch List) or with which no business should be concluded (Black List);
- Business planning and capital management;
- Controlling the investment portfolio;
- Complying with investment accounting (including auditing required write-downs); and
- Including credit risks when estimating the price of insurance policies.

ART AG monitors and controls credit risk exposures and concentrations in order to ensure that it is in a position to satisfy its policyholder obligations. ART AG is supported in this by the Allianz Credit Risk Platform (CRisP), an Allianz application for monitoring and controlling credit risks. Among other things, the CRisP application makes it possible to:

- Set limits for individual debtors or groups of debtors;
- Monitor and control limits based on reporting, including notification of updates for data and limits on names of counterparties who either are subject to a special audit (Watch List) or with whom no business should be concluded (Black List).

The Allianz Group assigns credit limits to Allianz companies in a centralized process via CRisP. CRisP calculates the maximum limit for individual counterparties based on a large number of factors (such as the debtor's rating, total assets, the associated business segment and region) and follows the respective limit utilization.

ART AG has the option, based on its own determination, of adjusting downward the assigned limits for maximum risk to a debtor or group of debtors. The limit assigned by the Allianz Group or the internal limit set by ART AG – whichever is lower – shall determine the discretionary limit for investments, credit insurance and/or reinsurance.

The Allianz Public Rating Plus (PR+) is used as an early-warning system to test the quality of counterparties and to provide information for preparation of the Watch List on individual counterparties for which the limits in CRisP may have to be adjusted.

The two different components of ART AG's credit risk exposure are the investment portfolio and the reinsurance portfolio.

Premium income and the capital ("own funds") required to cover written risks are mainly invested in fixed-interest securities. Because of the type of business activity in the non-life insurance business, typical investments by ART AG are short- to medium-term fixed-interest securities, which leads to a lower credit risk. The limit systems for the investment portfolio described in the section on market risk also include, in particular, limits to mitigate the credit risk from investments.

The credit risk for external reinsurers arises from insurance risks which ART AG transfers to external reinsurance companies in order to reduce its own insurance risk. Potential losses may arise either from defaults on payment of already existing demands for payment from the reinsurance business or from default on reinsurance contracts. Reinsurance partners are checked by the Allianz Security Vetting Team (SVT). The SVT ensures that, to the greatest extent possible, companies with strong credit profiles are selected. In addition, it demands letters of credit, cash deposits or other financial collateral to further reduce the credit risk.

The sensitivity of the credit risk (investment and reinsurance portfolio) is analyzed using stress tests (e.g., downgraded two rating grades, whereby the rating grade refers to the rating subcategories, e.g., AA+, AA and AA- at Standard & Poor's).

ART AG's main risk exposures, which among other things are used to calculate counterparty default risk in the standard formula, include:
- Internal reinsurance with Allianz Group companies;
- Reinsurance with captives (as part of ART AG's fronting business); and
- Deposits with South African banks as part of a structured reinsurance transaction in South Africa.

ART AG mainly uses the following risk-mitigation techniques to reduce credit risk from the following instruments.

Instrument	Minimizing Risk
Reinsurance	All reinsurance partners are checked by SVT. Depending on this evaluation, collateral, e.g., through guarantees, cash or other suitable financial measures, is often requested in order to reduce the credit risk.
Fixed-interest securities	Requirement to invest primarily in high-grade securities and to limit concentrations in counterparties in the portfolio. Secured investments will be selected, where required. Good portfolio diversification is required.

C.4 Liquidity Risk

Liquidity risk is defined as the risk of unexpected financial losses due to a failure to meet, or to meet based on unfavorable altered conditions, short-term current or future payment obligations. Above all, liquidity risk may arise if, over time, there are mismatches between cash flows on the asset side and the liability side.

The main objective in planning and controlling ART AG's liquidity position is to ensure that the company is always in a position to satisfy its payment obligations. To accomplish this goal, ART AG monitors and forecasts its liquidity position on a daily basis.

Liquidity planning for each of the next three years is carried out as part of strategic planning. It takes into account conditional liquidity requirements and liquidity sources in order to ensure that ART AG can satisfy future payment obligations.

In addition to liquidity planning, ART AG's liquidity risk is controlled by monitoring liquidity requirements against sources of liquidity under various stress scenarios which are summarized in the Liquidity Risk Report (see below).

ART AG controls liquidity risk in order to ensure that available liquidity and liquidity needs are adequately balanced. The investment strategy guarantees adequate quality and liquidity of the investment portfolio, e.g. by investing in liquid funds such as high-grade government bonds. This means that even if unlikely events do occur, higher liquidity requirements can be met without substantial financial losses. ART AG applies actuarial methods to estimate the liabilities under insurance policies. During the course of liquidity planning, it ensures that all cash flows on the asset and liability sides match.

Coverage of short-term liquidity needs (less than two weeks) is supported by ART AG's access to the Allianz Group's cash pool.

Every quarter, ART AG compiles a Liquidity Risk Report. It contains a forecast of cash inflows and outflows over various time horizons (ranging from one week to a year), an assessment of available countermeasures, including the realization of liquid investments, the application of various stress scenarios and an aggregation with KPIs such as the liquidity coverage ratio. Thresholds for warning levels and limit violations ensure that management is able to assess the liquidity situation under current and hypothetically tougher market conditions.

The stress scenarios examined in the quarterly liquidity report comprise scenarios that are run by every Allianz Group company. These include claims stress scenarios that examine claims leading to losses that at most occur once in 200 years. The premium stress scenario examines an interruption in premium income (from existing and new business) within the next two months. In addition to Allianz Group-wide stress scenarios, there are also ART AG-specific stress scenarios, including one that analyzes a downgrade of ART AG's rating.

In all the stress scenarios examined, the liquidity coverage ratio for every time horizon considered is under 35%. The liquidity coverage ratio is the ratio of cash outflows to cash inflows, taking into account available countermeasures.

Risk-mitigation measures must be prepared and sent to Group Risk Management as soon as any limit is exceeded under at least one scenario examined in the liquidity report. Depending on the size of the liquidity gap, there are various escalation levels that require the involvement of the Risk Management Committee. An example of such a mitigation measure is the cancellation of a planned activity that would negatively affect the company's liquidity profile.

Concentration risks play a subordinate role in liquidity risk.

The expected profit included in future premiums totals EUR 36.4 million at year-end 2016.

The expected profit included in future premiums is equal to the difference between the technical provisions without the risk margin and a calculation of the technical provisions without the risk margin under the assumption that the premiums relating to existing insurance and reinsurance contracts that are expected to be received in the future are not received for any reason other than the insured event having occurred, regardless of the legal or contractual rights of the policyholder to discontinue the policy.

C.5 Operational Risk

ART AG defines operational risk as unexpected losses resulting from inadequate or faulty internal operating processes or systems, due to human error or misconduct or due to external events. This definition includes legal risks and compliance risks. It does not include strategic risks and reputational risks.

Operational risks are divided into the following categories:
- Willful misconduct;
- Improper actions by third parties;
- Employment practices and workplace safety;
- Business practices and product features;
- Damage to operating and office equipment;
- Business interruption and failure of technical systems; or
- Business process risks.

The risk management system for operational risks is based on the Allianz Group's three lines of defense model. ART AG's employees are aware of and control potential operational risks by examining the management of operational risks for all day-to-day business activities. As part of a positive risk and control culture, it is assumed that the decision-makers, in particular, will make all identified weak spots and risks transparent so that the necessary countermeasures can be carried out in a timely manner.

Operational risks are inherent in all kinds of products, activities, processes and systems and cannot be avoided entirely. Unlike most other kinds of risks, they occur suddenly and unexpectedly and can significantly affect the balance sheet, profits, corporate targets, business activities or reputation of ART AG. Operational risks are controlled by setting up a series of appropriate and effective countermeasures (i.e., controls for the respective risks).

Because of their importance, the quality of key controls is assessed in a structured manner, i.e., the company reviews (1) whether key controls are located at the right points in the business processes; (2) whether their design is adequate to reduce the anticipated risks; and (3) whether they are being implemented effectively. Operational risks are controlled, first and foremost, on a cost-benefit basis; the expected additional benefits from reducing losses should exceed the costs associated with improving the controls. However, there may be exceptions to this cost-benefit ratio: compliance with laws and requirements, protecting ART AG's reputation or other strategic objectives.

The operational risk capital is used as a cushion to protect the company from extreme operating losses caused by unexpected failures of key controls.

In a broader context, operational risks are controlled by ART AG's Top Risk Assessment (TRA) program and are supplemented by risk and control assessment programs.

ART AG's risk management system for operational risks was specially developed to learn from risk events that have occurred and to avoid surprises from operational risks.

First, an understanding must be developed of what could happen. This occurs in two ways:
- Operational risk events that have occurred are analyzed retrospectively on an ongoing basis and their causes are identified. External operational losses that are made available by the Allianz Group are also taken into account.
- Specific forward-looking scenarios with potentially negative effects are analyzed on an annual basis.

ART AG identifies, assesses and controls operational risks and control weak spots through this structured approach. Both perspectives help to set priorities and to deploy resources to effectively manage operational risks in a targeted manner in order to make processes, systems, governance structures and methods more robust and to respond proactively to expected internal or external changes with the aim of avoiding operational risk events or reducing their negative effects on ART AG.

ART AG's risk management system promotes a culture of risk transparency. ART AG endeavors to learn from negative experiences and to identify potential weak spots at an early stage in order to avoid the possibility of similar losses in the future. Such a mentality is a prerequisite for effectively managing operational risks.

ART AG's risk management system for operational risks is supplemented and supported by important activities. They are controlled by functions outside of Risk Management and include:

- Compliance initiatives on combating fraud, combating corruption, antitrust law, economic sanctions, (unauthorized) cross-border business, insider trading, money laundering, sales compliance and data protection;
- Framework for Business Continuity Management (BCM); and
- Framework for all AGCS procurement transactions, including outsourcing.

C.6 Other Material Risks

In addition to underwriting risk, market risk, credit risk, liquidity risk and operational risk, ART AG also monitors business risk, reputation risk and strategic risk (see Section B.3.).

Strategic risk is the risk of an unexpected negative change in company value due to the adverse effect of management decisions regarding the business strategy and implementation thereof.

This risk is estimated and analyzed every year as part of the Top Risk Assessment process and is within ART AG's risk appetite.

In order to ensure that the strategic targets in the current business plan are correctly implemented, strategic controls are used to monitor the relevant business targets. Market and competitive conditions, capital market requirements, regulatory conditions, etc. are constantly monitored to decide whether strategic adjustments need to be made. Strategic decisions are also discussed by various committees at the level of the Executive Board (e.g., by the Risk Management Committee). The Head Risk Management is represented on all strategically relevant committees. Assessing the relevant risks is a fundamental element of such discussions.

Reputational risk is the risk of unexpected decreases in the share price of Allianz SE, the value of the insurance policy portfolio or the value of future business volume that are attributable to damage to ART AG's image.

This risk is likewise estimated and analyzed every year as part of the Top Risk Assessment process and is within ART AG's risk appetite.

The perception of ART AG as a respected, responsible provider of financial services is affected by ART AG's conduct in a number of areas, such as product quality, corporate management, financial strength, customer service, personnel management, intellectual property and corporate responsibility. Individual management decisions on reputational risk are integrated into the risk management system. ART AG and the Allianz Group continue to apply a clearly defined reporting process on a case-by-case basis to deal with reputational risk.

Business risk – losses due to unexpectedly high rates of cancellation in the portfolio and the resulting loss of profits, as well as losses caused by ongoing fixed costs in the case of plummeting new business – is evaluated both using the standard formula and in the Top Risk Assessment process.

C.7 Other Disclosures

All relevant disclosures regarding ART AG's risk profile are contained in the preceding notes.

D Valuation for Solvency Purposes

Comparison of Balance Sheet Figures

ASSETS			
12/31/2016 in € thousand	Solvency II	PGR	Differenz
Intangible assets	0	0	0
Deferred tax assets	1,095	0	-1,095
Surplus in retirement benefits	0	0	0
Real estate, property, plant & equipment and inventories for own use	22	22	0
Investments (excluding assets for index-linked and fund-linked contracts)	1,098,723	1,023,575	-75,148
Real estate (other than for own use)	0	0	0
Shares in affiliated companies, including participating interests	169,911	142,796	-27,115
Equities	1,591	1,591	0
Equities - unlisted	0	0	0
Bonds	913,307	865,275	-48,032
Government bonds	345,346	343,020	-2,326
Corporate bonds	567,192	521,502	-45,690
Collateralized securities	770	752	-18
Collective investment undertakings	0	0	0
Derivatives	13,913	13,913	0
Loans and mortgages	103,255	145,160	41,905
Other loans and mortgages	103,255	145,160	41,905
Amounts recoverable from reinsurance contracts:	457,003	589,673	132,670
Non-life and health similar to non-life	457,003	589,673	132,670
Non-life excluding health	455,178	587,608	132,430
Health similar to non-life	1,824	2,065	241
Funds held by others (deposits to cedants)	11,922	11,922	0
Receivables from insurance companies and intermediaries	62,369	181,703	119,334
Receivables from reinsurers	4,188	4,182	-6
Receivables (trade, not insurance)	147,867	16,816	-131,051
Cash and cash equivalents	26,905	26,905	0
Other assets not shown elsewhere	1,220	1,220	0
Total assets	1,914,568	2,001,178	86,610

LIABILITIES			
12/31/2016 in € thousand	Solvency II	PGR	Differenz
Technical provisions - non-life	999,161	1,178,911	179,750
Technical provisions - non-life (excluding health)	985,656	1,165,675	180,019
Best estimate	923,417	1,165,675	242,258
Risk margin	62,238	0	-62,238
Technical provisions – health (similar to non-life)	13,505	13,236	-269
Best estimate	12,102	13,236	1,134
Risk margin	1,403	0	-1,403
Other technical provisions	0	0	0
Provisions other than technical provisions	18,077	16,384	-1,693
Pension benefit obligations	0	0	0
Deposits from reinsurers	71,687	71,687	0
Deferred tax liabilities	0	0	0
Financial liabilities other than liabilities to banks	62,236	62,236	0
Liabilities to insurance companies and intermediaries	1,322	1,322	0
Liabilities to reinsurers	12,701	117,426	104,725
Payables (trade, not insurance)	4,544	4,544	0
Other liabilities not shown elsewhere	199,634	1,178	-198,456
Total liabilities	1,369,362	1,453,688	84,326
Excess of assets over liabilities	545,206	547,489	2,283

D.1 Assets

The table below compares valuation methods under Solvency II and PGR. International Financial Reporting Standards (IFRS) provide the framework for recording and measuring assets and liabilities. Basically, IFRS rules serve as an adequate approximation for valuation under Solvency II; however, the specific Solvency II regulations in the Omnibus II Directive (Directive 2014/51/EU) and the Delegated Regulation (Directive 2015/35/EU) shall take precedence. For assets that are valued at amortized cost under IFRS and for which the difference between market value and amortized cost is immaterial, the amount stated under IFRS was used. There were no changes in the recognition and valuation methods or estimates used during the period under review.

MVBS Position	Solvency II	PGR
Intangible assets	Intangible assets are identifiable, non-monetary assets that are not physical in nature. If intangible assets can be sold separately and the insurance company can prove that there is a market value for these or comparable assets, they can be stated at market value in the Solvency II balance sheet. Otherwise, intangible assets must be valued at zero under Solvency II valuation principles, as stipulated in Article 10 (2) of Regulation (EU) 2015 / 35.	Intangible assets are stated at production or acquisition cost and are amortized over their useful lives (generally five years).
Deferred tax assets	Deferred taxes are calculated for temporary differences in the values of individual assets and liabilities under Solvency II and the balance sheet prepared for tax purposes (Article 15 of Delegated Regulation 2015 / 35). Deferred tax assets are assets that can be used to reduce income tax expense in future periods. Deferred taxes are not discounted.	No accruals are recorded for deferred tax assets.
Real estate, property, plant & equipment and inventories for own use	Amortized cost figures are deemed to be a reasonable estimate of the fair value pursuant to Article 9 (4) of the Delegated Regulation.	The item property, plant & equipment is stated at acquisition or production cost, less scheduled or unscheduled depreciation.
Shares in affiliated companies, including participating interests	Pursuant to Article 13 of Delegated Regulation 2015 / 35, participating interests are valued using the adjusted equity method or are valued at zero.	Participating interests are stated at cost. In the event of a probable permanent impairment, the corresponding value adjustments are made.

Equities	Listed shares are stated at the share price on the most recent day of trading.	They are stated at the lower of cost or market.
Bonds	Listed bonds are stated at the market price on the most recent day of trading. If there is no active market, the fair value of unlisted securities will be provided by brokers or market-makers or calculated using the discounted cash flow method. The relevant discount rates are based on observable market parameters and take into account the financial instruments' remaining term to maturity and probability of default.	They are carried at amortized cost.
Collateralized securities	Market values are provided by independent commercial banks. They are generally calculated using valuation models which in turn are based on available market data.	They are carried at amortized cost.
Derivatives	Derivatives are measured at fair value pursuant to IAS 39.	The carrying amount is stated at fair value.
Other loans	They are valued at fair value based on valuations by independent data providers or using the discounted cash flow method. The effective interest rate on similar debt securities was used.	They are stated at face value and adjusted for any impairments.
Amounts recoverable from reinsurance contracts	See Chapter D.2.	See Chapter D.2.
Reinsurance deposits	They are stated at face value, because for the deposits in question, the future interest payments essentially reflect the market interest rate.	They are stated at face value and adjusted for any impairments.

Receivables from insurance companies and interme-diaries	They are recorded at face value less repayments. For accounts receivable from the direct insurance business, general loss allowances are made to account for the general credit risk. Receivables for premiums that are not yet due are not shown here, but rather as negative technical provi-sions.	They are recorded at face value less repayments. For accounts receivable from the direct insurance business, general loss allowances are made to account for the general credit risk.
Receivables from reinsurers	They are recorded at face value less repayments. Receivables for pre-miums that are not yet due are not shown here, but rather as negative technical provisions.	They are recorded at face value less repayments, taking into account any necessary value adjustments.
Receivables (trade, not insurance)	They are measured at face value less repayments, adjusted for the probability that the counterparty will default.	They are recorded at face value less repayments, taking into account any necessary value adjustments.
Cash and cash equivalents	They are recorded at face value.	They are recorded at face value.
Other assets not shown elsewhere	They are stated at amortized cost, by analogy with Article 9 (4) of the Delegated Regulation.	They are valued at amortized cost. Assets of low value were immediate-ly written off.

D.2 Technical Provisions

Under Solvency II, technical provisions have three components: premium provision, provision for claims and risk margin.

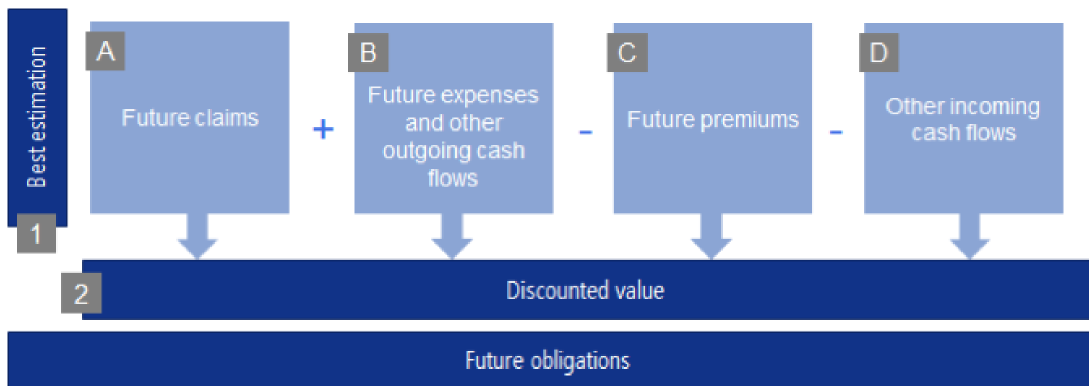
Premium provision is defined as the discounted best estimate of future cash flows (claim payments, expenses, premiums) relating to obligations under future events covered by policies in existence on the valuation date. Claim provision is defined as the discounted best estimate of future cash flows (claim payments, expenses, premiums) relating to loss events occurring before the valuation date. The risk margin is defined as the amount in excess of the best estimated value that a third party assuming the liabilities on the valuation date would require in order to close the transaction. The risk margin is calculated using a cost-of-capital approach.

ART AG's valuation of the premiums and claim provisions is initially undiscounted. In a second step, the future cash flows - separate, in each case, for premium provision and claim provision, as well as for the gross provision and reinsurance – are used to calculate an adjustment for the current monetary value of the cash flow (discounting). The risk margin is calculated using a blanket cost-of-capital approach, including discounting.

The following sections describe the calculation of the individual components, and in each case the undiscounted best estimate for premium provision and claim provision on a gross basis and after reinsurance, the associated discounting and the risk margin. Next, the resulting technical provisions pursuant to Solvency II will be presented as of December 31, 2016 and the approaches for calculating reserve uncertainty will be discussed. Finally, a comparison is made between the technical provisions pursuant to Solvency II and the corresponding provisions calculated in accordance with PGR. The main differences in the calculation are described and the figures for December 31, 2016 are presented.

Premium Provisions

The following chart depicts the calculation of the gross premium provisions:



Premium provisions include all expected premiums, commissions and claim payments under existing policies as of the balance sheet date that will not become due and payable until after the balance sheet date.

As the first step in calculating gross premium provisions, the degree of exposure – the not-yet earned premium components for all policies active as of the balance sheet date – is identified, regardless of whether the premiums were already due and payable before the balance sheet date or whether the premiums will become due and payable only after the balance sheet date. The accrued premium components are referred to below as Solvency II unearned premiums.

Based on the above, the best estimate for each of the individual components shown in the chart is calculated separately:

A Future claims: The expected loss ratio (excluding internal and external loss adjustment expenses) is applied to the Solvency II unearned premiums;

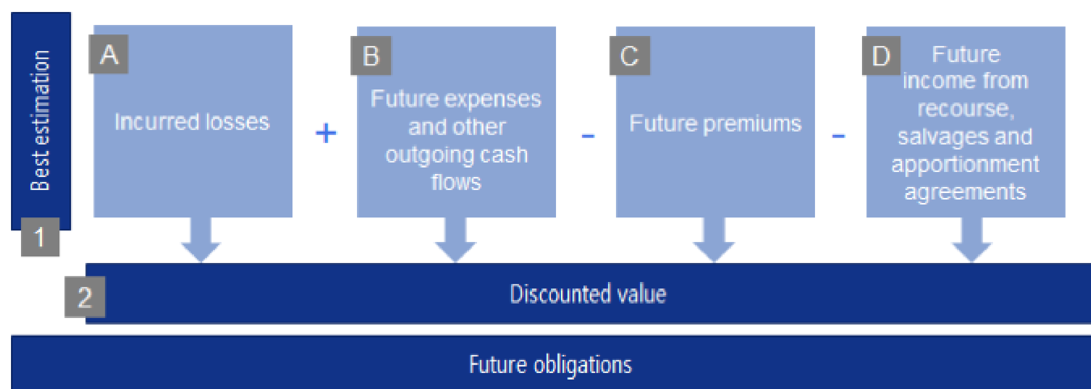
B B. The following components are used to calculate future expenses:
- Not-yet-due portions of agent, broker and lead insurer commissions for existing policies;
- Internal and external loss adjustment expenses: the expected loss adjustment expense ratio is applied to Solvency II unearned premiums;
- Administrative expenses: the expected administrative expense ratio is applied to Solvency II unearned premiums;
- Not-yet-due premium refunds and profit commissions.

C Future premiums: premiums under existing policies that will not become due and payable until after the balance sheet date are always included.

D Other incoming cash flows, if applicable

Claim Provisions

The following chart depicts the calculation of the gross claim provisions:



The undiscounted best estimates for the individual components shown in the chart above are calculated separately. IFRS approaches are used to calculate undiscounted specific case provisions and late claim provisions.

A Incurred losses: equal specific case provisions + late claim provisions (in both cases excluding loss adjustment expenses);
B Future expenses and other outgoing cash flows: equal specific case provisions and late claim provisions for external loss adjustment expenses + provisions for internal loss adjustment provisions;
C Future premiums: reinstatement premiums for reserved damages;
D Future income from recourse, salvages and apportionment agreements for damages already incurred as of the balance sheet date.

Below is a description of the calculation of late claim provisions under IFRS and PGR for the various business segments as of December 31, 2016.

AGCS Switzerland and Dubai Division

The provisions are analyzed in detail once a year, either in the second or third quarter, depending on division and region. The data used (e.g., run-off triangles) are based on the first and / or second quarter. In the fourth quarter, an update is calculated for all segments based on data for the third quarter. The results of the update – in particular for previous years – are rolled forward for the annual financial statements.

Business is divided into homogeneous reserving segments that are based primarily on the respective insurance division and allow a detailed analysis. The underlying currency is the Euro. All other currencies are converted into Euros using the exchange rate at the end of the quarter. Due to technical limitations, historical exchange rates are also used for some run-off triangles.

For reserving purposes, the external loss adjustment expenses and refunds from recourse, salvages and apportionment agreements are contained in the claims data (payments, specific case provisions, late claim provisions). For accounting purposes, the external loss adjustment expenses are extracted from the late claim provisions via percentage rates. The percentage rates are based on historical data.

The reserving approaches for claims during the fiscal year and for prior-year claims differ:

To forecast claims for the fiscal year, the claims data are divided into minor claims, medium-sized claims, major claims and catastrophic claims. Minor, medium-sized and major claims are based on the loss expense after facultative reinsurance across the various AGCS units. Minor and medium-sized claims are packaged into one run-off triangle per insurance division. For major claims, major claim run-off triangles are created. For catastrophic claims, all the relevant claims are combined, regardless of the claim amount. The threshold for medium-sized claims is EUR 1.0 million; for major claims, it is EUR 5.0 million. For all claims from the aviation and energy insurance divisions, as well as all claims in which our units in the USA or Canada were the lead underwriters of the underlying insurance policy, the U.S. dollar thresholds are used. In all other cases, claims classifications are Euro-based.

The approaches for calculating late claim provisions for the fiscal year distinguish between long-tail and short-tail insurance divisions. Long-tail insurance divisions include general liability, property damage liability insurance, aviation insurance subdivisions for manufacturer's risk, for airport liability and for reinsurance treaty business and insurance for medium-sized companies and major events. On the other hand, the short-tail divisions include fire and other property insurance, engineering insurance, aviation insurance subdivisions for airlines, general aviation, marine and transport insurance and energy risk insurance.

- For long-tail divisions, the late claim provisions are calculated on the basis of an expected loss ratio, with the minor claims and medium-sized claims categories offsetting one another. The expected loss ratios are generally consistent with the assumptions used in business planning. A separate analysis is carried out by the actuarial function to verify that these assumptions are consistent with actuarial models. The relevant parameters are part of the risk capital model and as such are approved by Allianz Group Actuarial. If there are substantial differences between the business planning figures and the actuarial analysis, the expected loss ratios are adjusted accordingly.
- For short-tail divisions, the approach is more nuanced: for minor and medium-sized claims, the Bornhuetter-Ferguson method is used both for a gross and a "gross-net" figure from which facultative reinsurance has been eliminated – based on the expected loss ratios (see explanations above) and specific run-off patterns for the loss expense according to the current annual reserve analysis. Except for quota share reinsurance, for which the corresponding quota share is deducted when calculating the net late claim provisions, no refunds are accepted under obligatory reinsurance contracts. It is assumed that, for the short-tail divisions, the claims exceeding the retention are already known. The net late claim provisions are therefore equal to those after facultative reinsurance.

The reserving approach for major claims is based on an analysis of the major claims run-off triangles. For engineering insurance, the aviation insurance subdivisions for airlines, general aviation, marine and transport insurance and energy risk insurance, a Bornhuetter-Ferguson approach is used to calculate late claim provisions for major claims. For fire insurance, the analysis of run-off triangles has demonstrated that no late claim provisions are needed for major claims.

For catastrophic claims, no late claim provisions had been set up for unknown claims at the end of 2016, because it can be assumed that all losses incurred are already known. However, specific late claim provisions were set up separately for already known events.

The methods described above are applied at the division level. A weighted completion factor is calculated for this purpose that is based on the factors for the individual underlying reserving segments (e.g., branch offices). The projected loss expenses serve as the weights. Reserving segments for which no completion factors were chosen during the annual analysis are not included when calculating the weighted completion factors for the division. In a second step, the late claim provisions calculated at division level for the three relevant claims categories are allocated to the underlying reserving segments. Various weights can be chosen for the allocation, e.g., premiums earned, the projected loss expense or the late claim provisions according to the Bornhuetter-Ferguson method. However, the allocation method is usually coordinated with the method selected to calculate the late claim provision Finally, it is still necessary to review whether the gross late claim provision for each reserving segment and each claims category is at least as high as the gross figure after facultative reinsurance and whether this, in turn, is at least as high as the net figure. If not, the late claim provisions for the gross amount and/or the gross figure after facultative reinsurance will be raised accordingly.

The annual reserve analysis is based on run-off triangles and the following projection methods:

- Chain ladder for claim payments;
- Chain ladder for loss expense;
- Loss ratio method;
- Bornhuetter-Ferguson method for claim payments; and
- Bornhuetter-Ferguson method for loss expense.

The final selection is based both on an individual assessment of the results from the specific methods and on qualitative information from the Underwriting and Claims departments. The method chosen depends, among other things, on the insurance division, the available claims history and the paid claims status for the respective claim year.

For the annual financial statements, the results of the reserve analysis (updated based on third-quarter data) are rolled forward. The basic approach is to hold paid claims stable in the fourth quarter compared to the results of the reserve analysis for the third quarter. However, based on the comparison of actual and expected claims development in the isolated fourth quarter, the run-off of prior-year claims will be adjusted, if necessary, especially for short-tail divisions. The expected claims development is based on the run-off patterns chosen as part of the reserve analysis.

For segments that were not the subject of the reserve analysis, suitable alternative approaches are applied.

Amounts that can be recovered from reinsurers are calculated as best estimates based on the underlying contracts.

The following incoming and outgoing cash flows from contractually agreed reinsurance contracts are shown under amounts recoverable from reinsurance contracts.

Incoming cash flows:

- Amounts recoverable from reinsurance contracts for claim payments and corresponding expenses; and
- Reinsurance commissions and profit-sharing pursuant to the individual reinsurance contracts.

Outgoing cash flows:

- Future reinsurance premiums under existing contracts, including reinstatement premiums.

Internal Group Reinsurance and ART LoB Business:

Specific (stochastic) actuarial models for reserving and risk-modeling are produced for the material transactions in this segment. The most suitable risk distributions and parameters are used for each transaction and the contractual arrangements, some of which are complex, are explicitly considered in the model. Smaller transactions are examined on a portfolio basis.

To calculate the late claim provisions, the models are updated every quarter, every six months or at least every year, depending on the transaction and availability of new data, and loss scenarios are simulated. The original assumptions from pricing and the actual claims experience are weighted using suitable credibility approaches in order to calculate the expected final loss burden as of the balance sheet date, which is then used to calculate and post the required late claim provisions.

Discounting

Premium provisions and claim provisions are discounted for each claim year, insurance division, region and currency and for the following cash flows:

- Gross:
  - Future claim payments;
  - Future expenses and other outgoing cash flows;
  - Future premiums;
  - Future incoming cash flows from recourse, salvages and apportionment agreements; and
  - Other incoming cash flows.

Amounts recoverable from reinsurance contracts. The following parameters are used in the calculation:

- Undiscounted premium provision and claim provision by claim year, division, region and currency;
- Expected payment pattern per type of provision, division and region; and
- Risk-free yield curve per currency, plus volatility adjustment per currency and maturity.

The following principles apply:

- The yield curve is specified by the Allianz Group;
- Premium provision and claim provision are calculated separately. In addition, they are separated by claim year, reserving segment and primary currency (EUR, CHF, USD, GBP, AUD, CAD and others);
- The cash flow forecast is based on payment patterns that were selected as part of the annual reserve analysis for each reserving segment;
- To simplify, it is assumed that payouts from claim provisions are made at mid-year, on average;
- It is assumed that payouts (mainly for future claims) that are reserved in the premium provisions as of the balance sheet date will be made from the premium provisions at the end of the respective year, on average;
- The same duration is used for technical provisions and the adjustment for potential bad-debt losses; and
- Gross and reinsurance cession (facultative and obligatory) are discounted separately. No adjustments were made to the risk-free yield curve used within the meaning of Article 77 (2) VersAG.

Risk Margin

There is no observable market value for technical provisions. Instead, an estimate is made of the amount that would have to be paid to sell the liabilities to an independent reference undertaking. The discounted best estimate plus a risk or market value margin (MVM) is used. The MVM represents the cost of the capital the acquiring company would have to provide during run-off.

The starting point for the cost of capital used is the Solvency Capital Requirement under Solvency II (SCR); however, this amount in each case only covers the capital requirement for a period of one year. Therefore, a time series of future SCRs must be estimated for the MVM. The cost of capital rate to be used is set at 6% (Delegated Regulation, Article 39), estimated as the cost of capital rate of the reference undertaking.

Initially, the MVM is calculated for ART AG as a whole. Subsequently, it is allocated to the insurance lines of business specified under Solvency II, whereby the respective sums of the discounted risk time series for the insurance risks are used as weights. Within the insurance lines of business, there is an allocation to claim provision and premium provision, with the respective undiscounted provisions used as weights. In the final step, both portions are further allocated to reporting segments and regions, whereby the relevant provisions under IFRS serve as weights.

Overview of Technical Provisions

Because the internal calculations are carried out at the level of the reserving segments, which are different from the Solvency II segments, the latter are based on a suitable allocation. The following table shows technical provisions – non-life under Solvency II as of December 31, 2016, in accordance with the segmenting pursuant to Solvency II:

Best Estimate

	Premium Provisions			Claim Provisions						
€ thousand	Gross	Amounts Recoverable from Reinsurance Contracts	Net	Gross	Amounts Recoverable from Reinsurance Contracts	Net	Total Net	Gesamt Netto	Risk Margin	Technical Provisions
Direct insurance business										
Health insurance	433	138	295	930	727	203	1,362	498	115	614
Income replacement insurance	4	6	-2	305	77	229	309	227	30	257
Marine, aviation and transport insurance	317	736	-419	59,477	32,722	26,754	59,794	26,335	2,569	28,904
Fire and other property insurance	3,576	6,487	-2,911	13,104	8,072	5,031	16,680	2,120	515	2,635
General liability insurance	5,273	1,322	3,951	119,021	73,800	45,220	124,294	49,171	6,193	55,364
Various financial losses	494	338	156	882	432	450	1,377	606	462	1,068
Subtotal	**10,097**	**9,028**	**1,070**	**193,718**	**115,831**	**77,888**	**203,816**	**78,957**	**9,884**	**88,842**
Proportional reinsurance assumed										
Health insurance	1,266	402	864	1,109	470	639	2,375	1,504	153	1,656
Income replacement insurance	6	3	3	75	2	72	81	75	9	85
Motor vehicle liability insurance	-768	0	-768	7,058	0	7,058	6,291	6,291	863	7,154
Other motor vehicle insurance	-561	0	-561	2,038	0	2,038	1,476	1,476	204	1,680
Marine, aviation and transport insurance	-1,050	49	-1,099	21,797	6,050	15,748	20,747	14,648	2,939	17,587
Fire and other property insurance	24,404	-47	24,451	77,189	9,606	67,583	101,593	92,035	4,124	96,159
General liability insurance	3,095	897	2,198	134,807	91,962	42,845	137,902	45,043	6,624	51,666
Various financial losses	9,878	-2,731	12,609	5,654	639	5,015	15,532	17,624	3,409	21,032
Subtotal	**36,270**	**-1,427**	**37,696**	**249,728**	**108,729**	**140,999**	**285,997**	**178,695**	**18,324**	**197,020**

€ thousand	Premium Provisions Gross	Premium Provisions Amounts Recoverable from Reinsurance Contracts	Premium Provisions Net	Claim Provisions Gross	Claim Provisions Amounts Recoverable from Reinsurance Contracts	Claim Provisions Net	Total Gross	Total Net	Risk Margin	Technical Provisions
Non-proportional health reinsurance	7,530	0	7,530	445	0	445	7,975	7,975	1,096	9,070
Non-proportional liability reinsurance	56,073	28,230	27,843	136,202	26,370	109,832	192,275	137,676	22,116	159,791
Non-proportional marine, aviation and transport reinsurance	3,097	427	2,670	12,851	1	12,850	15,948	15,519	2,055	17,575
Non-proportional property reinsurance	58,453	75,946	-17,493	171,056	93,868	77,188	229,509	59,695	10,166	69,861
Subtotal	125,153	104,603	20,549	320,554	120,239	200,315	445,707	220,864	35,433	256,297
Total non-life insurance obligations	171,520	112,204	59,315	764,000	344,798	419,202	935,520	478,517	63,641	542,158

Risk of Change in Technical Provisions

ART AG, working jointly with AGCS SE, carries out an annual review of the risk of change to which the technical claim provision is exposed. The following approaches were applied in the various segments in 2016:

AGCS Switzerland and Dubai Division

BIn order to ensure consistency with the reserve analysis, third-quarter data are used.

The run-off triangles used are equal to the total triangles that were also used in the reserve analysis. The run-off patterns selected also use the same basis - the gross figure or the gross figure after facultative reinsurance - as in the reserve analysis.

Two types of methods are always used to determine the reserve risk: the bootstrapping technique (based on incurred Mack, paid Mack and paid over-dispersed Poisson) and a stochastic Bornhuetter-Ferguson method. The bootstrap procedures are used for short-tail divisions and the Bornhuetter-Ferguson method is used for long-tail divisions. Both the suitability of the model and consistency with the reserve analysis play a role when selecting the method for the individual claims triangles analyzed. For every claims triangle analyzed, the standard error is first calculated under the bootstrapping method and / or under the Bornhuetter-Ferguson method. The residuals and the comparison of simulated ultimate claim amounts with the results of the reserve analysis are used to judge whether the model is suitable.

Internal Group Reinsurance and ART LoB Business

The underwriting risk, which consists of a premium risk and a reserve risk, is calculated using transaction-based or portfolio-based stochastic models. In the process, to determine the reserve risk, the models for all policies are resimulated from the beginning of the contract term in order to determine the reserve risk for past contract periods. At the same time, the degree of progress in settling claims is taken into account: Exposures from old claim years that have already been almost completely settled have only minor residual reserve risk, whereas relatively new, not yet settled exposures from recent claim years report elevated reserve risk.

Discussion of Material Differences between Solvency II and PGR in Terms of the Valuation of Technical Provisions and Amounts Recoverable from Reinsurance Contracts

Both Solvency II and PGR are based on the Best-Estimate Principle. Nevertheless, there are some differences, which are described below.

Premium Provisions (undiscounted)

Under Solvency II, premium provisions are set up for expected future claims and expenses under existing insurance policies. The provisions are calculated by multiplying the expected loss ratio, the expected loss adjustment expense ratio and the expected administrative expense ratio from the internal actuarial model by the PGR unearned premiums. In addition, not-yet-due premium income under contracts in existence as of the balance sheet date is deducted from the premium provision and the related, not-yet-due closing expenses are added to the premium provision. There are no plans to capitalize commissions that are due and payable on or before the balance sheet date. Under Solvency II, the entire profit margin from existing insurance policies is reported in own funds.

Claim Provisions (undiscounted)

There are basically no differences between specific case provisions and late claim provisions under Solvency II and PGR. For relevant segments, late claim provisions are calculated using reporting year data in order to separate a claim year's newly reported claims from the development of already known claims.

Discounting

While no discounting is stipulated for the non-life insurance business under PGR, the Present-Value Principle applies under Solvency II. That means that future cash flows are discounted using a discount curve specified by the Allianz Group.

Counterparty Default Risk (Credit Risk)

Under Solvency II, the adjustment for counterparty default risk is calculated using the simplified approach in Article 61 of Delegated Regulation (EU) 2015/35. This adjustment is not made under PGR.

Risk Margin

Under Solvency II, the risk margin reflects the cost of capital derived as part of the fair value in a theoretical transfer of obligations to a third party due to the uncertainty in the run-off of the technical provisions. Solvency II assumes a cost of capital rate of 6% in this case. Under PGR, there is no provision for a risk margin.

Technical Provisions

€ thousand	Technical Provisions under PGR	Revaluation of Premium Provisions (undis-counted)	Revaluation of Claim Provisions (undis-counted)	Discounting of Future Cash Flows	Adjustment for Coun-terparty Default Risk (Credit Risk)	Risk Margin under Solvency II	Technical Provisions under Solvency II	Lower Provisions under Solvency II vs. PGR
Direct insurance business								
Health insurance	576	-63	0	-16	0	115	614	-37
Income replacement insurance	255	-27	0	-2	0	30	257	-2
Marine, aviation and transport insurance	28,234	-799	0	-1,125	25	2,569	28,904	-670
Fire and other property insurance	3,967	-1,928	0	61	19	515	2,635	1,332
General liability insurance	52,715	-1,510	0	-2,117	83	6,193	55,364	-2,649
Various financial losses	626	-13	0	-7	0	462	1,068	-442
Subtotal	86,375	-4,340	0	-3,206	128	9,884	88,842	-2,467
Proportional reinsurance assumed								
Health insurance	1,745	-189	0	-52	0	153	1,656	89
Income replacement insurance	82	-6	0	-1	0	9	85	-3
Motor vehicle liability insurance	13,139	-6,476	0	-372	0	863	7,154	5,984
Other motor vehicle insurance	2,739	-1,164	0	-99	0	204	1,680	1,059
Marine, aviation and transport insurance	17,138	-2,058	0	-432	0	2,939	17,587	-449
Fire and other property insurance	38,042	54,757	0	-769	5	4,124	96,159	-58,117
General liability insurance	48,115	-481	0	-2,716	124	6,624	51,666	-3,551
Various financial losses	24,919	-6,648	0	-648	0	3,409	21,032	3,887
Subtotal	145,919	37,736	0	-5,089	129	18,324	197,020	-51,101
Non-proportional reinsurance assumed								
Non-proportional health reinsurance	8,512	-56	0	-482	0	1,096	9,070	-558
Non-proportional liability reinsurance	187,822	-46,581	0	-3,644	79	22,116	159,791	28,031
Non-proportional marine, aviation and transport reinsurance	17,833	-1,968	0	-346	0	2,055	17,575	259
Non-proportional property reinsurance	142,777	-82,768	0	-650	336	10,166	69,861	72,916
Subtotal	356,945	-131,373	0	-5,122	414	35,433	256,297	100,648
Total non-life insurance obligations	589,238	-97,976	0	-13,416	671	63,641	542,158	47,080

D.3 Liabilities

Below are separate descriptions of the bases, methods and main assumptions used to value each major group of other liabilities for solvency purposes, as well as comparisons with PGR principles.

MVBS Position	Solvency II	PGR
Provisions other than technical provisions	Under IAS 37, they are measured at the amount that an entity would rationally pay to settle the obligation at the balance sheet date (best estimate). For provisions with a maturity of greater than one year, a present-value approach is advisable if discounting will significantly affect the amount stated. Under Solvency II, these provisions are discounted using a market interest rate, pursuant to IAS 37.	Non-technical provisions are always stated at the expected settlement amount. The expected settlement amount is derived from the best estimate.
Deposits by reinsurers	They are recorded at face value less repayments, unless the market value is different.	They are recorded at the repayment amount less repayments.
Deferred tax liabilities	Deferred taxes are calculated for temporary differences in the values of individual assets and liabilities on the Solvency II balance sheet and the balance sheet prepared for tax purposes. Deferred tax liabilities are liabilities that will lead to income tax expenses in future periods.	No deferred tax liabilities are included.
Financial liabilities other than liabilities to banks	They are measured at fair value pursuant to IAS 39 and Article 14 of Delegated Regulation 2015 / 35, without taking into account changes in own default risk. Receivables and liabilities are netted, where permitted by contract.	They are recorded at the repayment amount.

Liabilities to insurance companies and intermediaries	They are measured at fair value pursuant to IAS 39 and Article 14 of Delegated Regulation 2015 / 35, without taking into account changes in own default risk. Receivables and liabilities are netted, where permitted by contract.	They are recorded at the repayment amount.
Liabilities to reinsurers	They are measured at fair value pursuant to IAS 39 and Article 14 of Delegated Regulation 2015 / 35, without taking into account changes in own default risk. Receivables and liabilities are netted, where permitted by contract. Not-yet-due liabilities (e.g., for reinstatement premiums) are shown under technical provisions.	They are recorded at the repayment amount. Receivables and liabilities are netted, where permitted by contract. This item also includes provisions for reinstatement premiums for outstanding reinsurance reserves.
Payables (trade, not insurance)	They are measured at fair value pursuant to IAS 39 and Article 14 of Delegated Regulation 2015 / 35, without taking into account changes in own default risk. Receivables and liabilities are netted, where permitted by contract.	They are recorded at the repayment amount.
Other liabilities not shown elsewhere	They are measured at fair value pursuant to IAS 39 and Article 14 of Delegated Regulation 2015 / 35, without taking into account changes in own default risk. Receivables and liabilities are netted, where permitted by contract.	They are recorded at the repayment amount.

D.4 Alternative Valuation Methods

As there are no listed market prices for ART AG’s participating interests, they are valued using the adjusted equity method.

D.5 Other Disclosures

All relevant disclosures regarding ART AG's valuation for solvency purposes are contained in the preceding notes.

E Capital Management

E.1 Own Funds

Targets, Guidelines and Processes

ART AG's capital base is a central resource for sustainable business activity and corporate management. Capital management encompasses almost all ART AG activities aimed at ensuring that the company and its branches have an adequate capital base in terms of legal requirements, the capital requirements set by rating agencies, market specifications and pursuant to the risk-tolerance level specified in the risk strategy.

Capital management principles and processes are defined in AGCS's Global Capital Management Policy, which is implemented by ART AG. In addition to specifications for controlling and planning the capital base and dividends, the policy also includes definitions of relevant duties and processes. It is closely linked with the company's risk strategy, which defines risk-bearing capacity and risk tolerance in the form of a target capitalization and a minimum capitalization.

ART AG's capital base is reviewed at least once a quarter for compliance with all relevant requirements. The review includes current consistency with the target and/or minimum capitalization and consideration of developments and measures that might affect future capitalization, as well as an assessment of their impact. All results, valuations and capital control measures are reported to the Executive Board on a regular basis in order to ensure prompt countermeasures can be taken in the event of noncompliance with the target capital requirement.

The effects of projected business performance on compliance with the target capital requirement are also examined as part of the three-year business plan. At the same time, the target and minimum capital requirements themselves are reviewed. The results of capital and dividend planning are approved by ART AG's Chief Financial Officer.

Reconciliation of the Excess of Assets over Liabilities in the PGR and Market Value Balance Sheets

The excess of assets over liabilities in the Market Value Balance Sheet totals EUR 545.2 million, while the excess of assets over liabilities in the PGR balance sheet (shareholders' equity) amounts to EUR 547.5 million. The differences between the excess of assets over liabilities under Solvency II (basic own funds) compared to PGR shareholders' equity are due to the differing recognition and valuation requirements under the two approaches. Detailed explanations of the main differences in valuations of individual balance sheet items can be found in Chapter D of this report. The following overview shows the main items for which the valuation requirements differ under PGR accounting and Solvency II. The table reconciles PGR shareholders' equity with basic own funds under Solvency II.

Reconciliation of the Excess of Assets over Liabilities in the PGR and Market Value Balance Sheets

€ thousand	12/31/2016
PGR shareholders, equity	**547,489**
Investments	48,032
Participating interests	27,115
Adjustments to technical provisions (net)	110,722
Risk margin	-63,641
Revaluation of other asset and liability items	-125,606
Change in deferred taxes (net)	1,095
Total Solvency II revaluations	**-2,283**
Solvency II basic own funds	**545,206**

Basic Own Funds and Available Own Funds

Own funds amount to EUR 615.3 million and are composed of EUR 483.8 million of basic own funds and EUR 131.5 million of ancillary own funds. The basic own funds are equal to the excess of assets over liabilities from the Market Value Balance Sheet after deducting the expected dividend payment of EUR 61.4 million. Ancillary own funds consist of the portion of equity capital that has not been paid in.

Basic own funds consist of EUR 482.7 million of Tier 1 own funds and EUR 1.1 million of Tier 3 own funds. Own funds satisfying the Tier 1 requirements consist of EUR 131.5 million of paid-in capital, the statutory reserve of EUR 131.5 million and a reconciling entry of EUR 219.6 million. These funds are untied and can be used without restrictions to cover losses. Tier 2 own funds total EUR 131.5 million and consist of the portion of share capital that has not been called in and/or paid in. Equity capital that has not been called in may be called in to absorb losses and through regulatory approval is eligible to be used as ancillary own funds. Own funds that satisfy Tier 3 requirements are equal in amount to the deferred tax assets. The following table shows the basic own-fund items and their allocation to the various tiers ("quality classes") in detail.

Composition of Basic Own Funds

€ thousand 12/31/2016	Total	Tier 1 unrestricted	Tier 3
Paid-in share capital	131,529	131,529	0
Statutory reserve	131,529	131,529	0
Reconciling entry	219,601	219,601	0
Amount equal to the value of deferred tax assets	1,095	0	1,095
	Total	Tier 1 unrestricted	Tier 3
Basic own funds	**483,754**	**482,659**	**1,095**

Eligible Own Funds

The items are classified into tiers in accordance with the criteria described in Articles 93 to 96 of Solvency II Directive 2009 / 138 / EC and Articles 69 to 78 of Delegated Regulation (EU) 2015 / 35. The share capital, the statutory reserve and the reconciling balance are classified as Tier 1, not restricted own funds. The amount equal to the value of deferred tax assets is classified as Tier 3 own funds.

Ancillary own funds are classified as Tier 2.

Eligible own funds are calculated by applying the maximum quantitative tier limits to available own funds. As of December 31, 2016, application of the maximum tier limits had no effect on the amount or structure of eligible own funds.

Therefore, the total amount of own funds of EUR 615.3 million is available to meet the Solvency Capital Requirement (SCR). The own funds available to meet the Minimum Capital Requirement (MCR) consist of Tier 1 basic own funds and amount to EUR 482.7 million.

Composition of Eligible Own Funds

€ thousand	Total	Tier 1 unrestricted	Tier 2	Tier 3
Available own funds to meet the SCR	615,283	482,659	131,529	1,095
Available own funds to meet the MCR	482,659	482,659	0	0

Changes in Own Funds

Eligible own funds increased from EUR 506.2 million in Day One reporting to EUR 615.2 million as of December 31, 2016. This was primarily attributable to the change in the reconciling balance following recognition of the non-EEA participating interests. Eligible own funds therefore continue to be composed largely of Tier 1 own funds.

€ thousand		2016
Tier 1	Paid-in share capital	131,529
	Statutory reserve	131,259
	Reconciling entry	219,600
Tier 3	Amount equal to the value of deferred tax assets	1,094
Total	**Own Funds**	**483,754**

The biggest item in changes in the reconciling entry is an increase in the value of participating interests after recognition of the Brazilian subsidiary, Allianz Global Corporate & Specialty Do Brasil Participações Ltda. (EUR 72.0 million) and the participating interest in the U.S., Allianz Risk Transfer, Inc. (EUR 62.8 million) (see Chapter A.1. of this report). This valuation meets the local solvency requirements.

E.2 Solvency Capital Requirement and Minimum Capital Requirement

ART AG uses the standard formula to calculate the Solvency Capital Requirement. To determine exposure to counterparty default risk, the amounts recoverable from reinsurance contracts were calculated using the simplified calculation stipulated in Article 107 of Delegated Regulation 2015 / 35. The company-specific parameters referred to in Article 59 VersAG were not used.

The table summarizes the Solvency Capital Requirements at year-end 2016.

As of year-end 2016, the diversified Solvency Capital Requirement after taxes amounted to EUR 430 million. The biggest contributors to risk were market risk, credit risk and non-life underwriting risks.

Requirement was EUR 107 million.

In addition to the Solvency Capital Requirement, the calculation of the Minimum Capital Requirement is based on technical provisions excluding the risk margin, after deducting the amounts recoverable from reinsurance contracts and premiums written for insurance and reinsurance obligations in the last twelve months after deducting premiums for reinsurance contracts.

At year-end 2016, the Solvency Capital Requirement was calculated using the standard formula, due to the redomiciliation of ART AG's headquarters from Zurich, Switzerland to Schaan, Liechtenstein in 2016. At year-end 2015, the Solvency Capital Requirement was calculated as part of the Swiss Solvency Test using an internal model; as a result, the capital comparison is not very meaningful.

€ million	12/31/2016
Market risk	156
Counterparty default risk (credit risk)	110
Non-life underwriting risk	253
Health underwriting risk	1
Undiversified Basic Solvency Capital Requirement	512
Diversification	124
Diversified Basic Solvency Capital Requirement	396
Operational risk	34
Diversified capital requirement before taxes	430
Tax effect	0
Diversified capital requirement incl. taxes	**430**

At year-end 2016, the Minimum Capital Requirement was EUR 107 million.

E.3 Use of the Duration-Based Equity Risk Submodule to Calculate the Solvency Capital Requirement

No duration-based equity risk submodule pursuant to Article 18 VersAV is used to calculate the Solvency Capital Requirement.

E.4 Difference between the Standard Formula and any Internal Models Used

ART AG does not use an internal model.

E.5 Noncompliance with the Minimum Capital Requirement and Noncompliance with the Solvency Capital Requirement

ART AG was in compliance with the Minimum Capital Requirement and the Solvency Capital Requirement at all times in 2016.

E.6 Other Disclosures

All relevant disclosures regarding ART AG's capital management are contained in the preceding notes.

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Allianz Risk Transfer AG
Im alten Riet 102
9494 Schaan
Principality of Liechtenstein

Telephone: +423 235 85 00
www.art.allianz.com

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